Taxpayers Defense Institute

AN ASSOCIATION OF TAX PROFESSIONALS IN DEFENSE OF TAXPAYERS' RIGHTS

Dan Pilla's E-Bulletin

LIEN RELEASES IN SHORT SALES SITUATIONS

A short sale situation arises when a lender agrees to allow a property to sell for less than the mortgage balance. This situation is common in the current market due to the steep decline in real estate values that's occurred over the past several years.

In any property sale situation, when a federal tax lien is filed against a property, the IRS generally demands that the value of its lien be satisfied before it agrees to release its lien and allow the new buyer a clear title to the property. In the typical situation, the IRS is second in line behind the bank. After the bank is paid, the IRS takes the balance of the sale proceeds (after costs), up to the amount of the tax assessment, before the seller gets any money.

However, in a situation where the value of the property has declined to the point where it's worth less than the mortgage, the IRS's lien interest is essentially worthless. The first secured creditor is the bank and because of the depressed value of the property, not even the bank will recover the full value of its claim. In this case, the IRS should release its lien without any payment because it has no secured interest in the property.

In the 2010 Taxpayers' Defense Conference, I discussed the lien release and subordination procedures that are available to accomplish the removal of a lien in these cases. The IRS released another memorandum offering more clarity in these cases. The memo points out that the IRS should promptly release its lien in short sale situations. The memo is SBSE-05-1010-054. The full text is provided below.

Please review this carefully and be aware of it for purposes of facilitating lien releases in short sale situations.

Daniel J. Pilla
Executive Director

IRS SBSE Memorandum (SBSE-05-1010-054) on Processing, Approving Requests for Certificates of Discharge in Short Sale Situations
October 4, 2010
Control Number: SBSE-05-1010-054
Expiration Date: October 5, 2011
Impacted : IRM 5.12.3
MEMORANDUM FOR DIRECTORS, COLLECTION AREA OPERATIONS
DIRECTOR, ADVISORY, INSOLVENCY, AND QUALITY
FROM: Frederick W. Schindler /s/ Frederick W. Schindler
Director, Collection Policy
SUBJECT: Certificates of Discharge in Short Sale Situations

The purpose of this memorandum is to issue interim guidance for processing and approving requests for certificates of discharge in short sale situations. The impacted section of IRM 5.12.3, Certificates Relating to Liens, will be revised to include the information in this memorandum. Please ensure that this information is distributed to all affected employees in your organization.

The authority of the Internal Revenue Service (IRS) to issue a certificate of discharge of property subject to the federal tax lien is found in Internal Revenue Code (IRC) section 6325(b). Among other conditions, the IRS may issue a certificate of discharge when the interest of the United States in the such property is determined to have no value (section 6325(b)(2)(B)).

A short sale occurs when the senior lien holder agrees to accept less than the total amount owed as satisfaction for its lien claim. For example, a bank has a priority mortgage claim for $600,000, but, due to the significant decline in the real property market, the bank agrees to a sale of the mortgaged property for $300,000. Because the senior lien attaches to all the equity in the property, generally the lien interest of the United States in short sale properties is valueless. Therefore, applications for discharge for properties subject to short sales should be considered under IRC 6325(b)(2)(B).

To facilitate the sale of the property in these situations, the senior lien holder might negotiate the payment of expenses to be taken from its settlement amount. In certain situations, these expenses might be greater than normal closing costs allowed by the IRS and might include creditors that would otherwise be junior to the IRS. This action by the senior lien holder to carve proceeds out of its priority claim to pay these expenses does not create an equity interest on the part of the taxpayer which may be reached by the IRS lien. Provided there is no fraudulent aspect to the payment distribution and the lien interests of the IRS in other properties of the taxpayer is not being harmed, the IRS has no authority to require payment of the sum that otherwise would have gone to the senior lien holder. Following the previous example, the bank determines that out of the $300,000 sales price, it will allow $15,000 of expenses to be paid. Most of the $15,000 is for normal closing costs, but $5,000 of it is for a homeowner's association fee, which is junior in priority to the IRS, and $2,000 is for state transfer taxes. Because the payments made for the homeowner's association fee and the state transfer taxes are made from proceeds attributable to the bank's priority lien interest and the interest of the IRS in the property to be discharged is valueless, the IRS cannot condition discharge upon payment of any part of the amount going to these expenses.

Therefore, upon receiving an application for discharge of a property subject to a short sale, follow standard procedures outlined in IRM 5.12.3 to investigate the statements made in the application regarding the transfer, encumbrances on the property, property values, and proposed distribution of the proceeds. Additional documentation to complete the investigation may be requested if the information has not otherwise been provided. Presuming no issues are identified, the discharge application can be approved following existing IRM procedures.

In normal (non-short) sale situations, where the lien claim of the bank is fully paid and the federal tax lien attaches to surplus proceeds, the IRS's lien interest must be satisfied in accordance with IRC 6325(b) before the property can be discharged from the lien. Creditors junior to the IRS interest are not entitled to payment from the proceeds before the IRS lien interest is fully paid.