POINTS TO REMEMBER

Fighting the Post-Bankruptcy Survival of Federal Tax Liens on Property That Is Excluded from the Bankruptcy Estate (Part 1)

By Michael DeBlis*

The federal tax collection system is founded on the concept of voluntary compliance. The government expects taxpayers to compute and timely pay all taxes owed, and most taxpayers fulfill this obligation. The minority who refuse to comply are subject to forced collection and various penalties. This article provides an overview of the mechanics of the federal tax system's forced collection scheme, with a special emphasis on post-bankruptcy survival of federal tax liens.

The Code empowers the Service to assess a federal tax, to impose a lien for the amount assessed upon all property belonging to the taxpayer, and, if the taxpayer still refuses to pay the liability, to sell the taxpayer's property and use the proceeds to satisfy the obligation. The Service has the authority to summon documents and other information, including testimony, from taxpayers and third parties. I.R.C. § 7602. It may exercise these powers without prior judicial approval. Taxpayers also have certain rights and remedies. These rights and remedies, along with the powers of the Service, vary according to the nature of the case.

The Service has several tools in its collection arsenal. Chief among them are liens and levies. The Service makes frequent use of these tools, and it does so aggressively. In fact, until 2011, it was automatically filing liens when just over $5,000 in tax was due. Since at least 2008, each year, the Taxpayer Advocate's Report to Congress has questioned whether automatic lien filing does more damage than good as it seriously impairs a taxpayer's credit and the ability to get new financing. As of the 2013 report, TAS is still investigating the consequences.

Changes to automatic lien filing began in February 24, 2011, when the Service started a new program called "fresh start." As a result, the automatic lien filing floor increased to $10,000. The Service also offered a number of other initiatives to remove liens, and to make other taxpayer friendly changes, but most of these changes applied only to relatively small dollar cases.

After the Service raised the automatic lien filing threshold, it ramped up its collection efforts using nominee liens and levies, including their counterparts—the alter ego, transferee, and fraudulent conveyance liens and levies. Unfortunately, these liens and levies lack Collection Due Process (CDP) rights upon which taxpayers have come to rely.

Federal Tax Liens

The federal tax lien is a powerful collection tool. It constitutes legal notice of a claim or interest in property, preserves the status quo among certain creditors, and establishes priority between competing claims to the property. I.R.C. § 6323.

Before a federal tax lien comes into existence, the Service makes an assessment by recording the liability in the office of the Secretary. I.R.C. § 6203. Notice of the assessment, along with a demand for payment, is sent to the taxpayer within 60 days of the assessment. I.R.C. § 6303(a). If the taxpayer neglects or refuses to pay the tax, the amount due—including interest, penalties, and associated costs—becomes a lien in favor of the United States. I.R.C. § 6321.

Once it attaches, a valid federal tax lien encumbers the taxpayer's property until the underlying liability is paid or becomes unenforceable due to lapse of time. I.R.C. § 6322. Generally, this is ten years from the date of assessment. I.R.C. § 6502(a)(1). If the Service brings an action to reduce a lien to judgment, it can enforce the lien *after* the ten-year period has expired.

A federal tax lien attaches to all property and property rights belonging to the taxpayer as of the date the lien *arises*, as well as all property and property rights acquired by the taxpayer *after* that time. *See Glass City Bank v. United States*, 326 U.S. 265 (1945). The lien arises on the date of the assessment. A federal tax lien also attaches to property held by a taxpayer and his wife as tenants by the entireties. *See In Re Basher*, 291 B.R. 357 (Bankr. E.D. Pa. 2003); *United States v. Craft*, 535 U.S. 274 (2002).

Property that is transferred *prior* to the creation of a federal tax lien is not subject to a federal tax lien. Deficient taxpayers may transfer their property to purchasers and creditors free of the tax lien. I.R.C. § 6323(a). However, the Service has theories it can assert to reach property that the taxpayer has transferred to a third party or that is no longer in the taxpayer's possession or name. These theories include nominee, alter-ago, and transferee liability.

* DeBlis & DeBlis Law Firm, Bloomfield, NJ.

The scope of property and rights to property are governed by state law. Very simply, if there is a property interest recognized under state law, the lien attaches to it. Federal law determines the manner and extent to which the federal tax lien encumbers a taxpayer's property interest. *Aquilino v. United States*, 363 U.S. 509 (1960); *Gardner v. United States*, 34 F.3d 985 (10th Cir. 1994). State laws that protect property from creditors do not apply to the federal tax lien. The state homestead exemption, for example, does not prevent the attachment of a federal tax lien. There are some exemptions under federal law, but these exemptions apply to levies, not to liens. I.R.C. § 6334. As previously discussed, a general tax lien attaches to *all* of the taxpayer's property as of the date of assessment or acquired thereafter as long as the lien is in effect.

No statutory exemptions exist to soften the blow of this expansive rule that a federal tax lien attaches to *all* property. Not even the taxpayer's principal residence is immune from a federal tax lien. *In Re Carlson*, 224 F.3d 716 (7th Cir. 2000). The taxpayer's principal residence, along with certain other types of property, is, however, protected from levy. For example, a principal residence may *not* be seized and sold under the levy provisions unless a judge or magistrate of a federal district court approves the levy. I.R.C. § 6334(e)(1)(A).

Property transferred *after* a federal tax lien has attached is still subject to the lien, but certain third parties are protected unless the Service has previously filed a Notice of Federal Tax Lien (NFTL). I.R.C. § 6323. In some cases, third parties are protected even after the Service has filed the NFTL. I.R.C. § 6323(b).

The taxpayer has certain rights and remedies with respect to federal tax liens, but they are very limited. First, the Service must serve the taxpayer with a notice of assessment and a demand for payment *before* a federal tax lien can arise. Second, the taxpayer is entitled to a certificate of release of the lien in the following circumstances: (1) the liability has been satisfied; (2) the taxpayer has posted a bond for the amount due; or (3) the lien has become legally unenforceable. I.R.C. § 6325(a). The certificate serves as conclusive proof that the lien has been extinguished (I.R.C. § 6325(f)(1)) and must be issued within thirty days of the occurrence of one of these events. I.R.C. § 6325(a)(1).

Finally, the taxpayer may seek relief in a quiet title action by attempting to remove the lien from the title to the property. 28 U.S.C. § 2410. However, challenging the validity of the underlying tax liability during such an action is prohibited. *Falik v. United States*, 343 F.2d 38 (2d Cir. 1965). A quiet title action is limited to situations involving some defect in the collection procedure or full payment of the liability.

In addition to the creation of federal tax liens, the Service may also levy upon property, including rights to property. However, before it can do so, the taxpayer must have refused to pay within ten days of notice and demand. I.R.C. § 6331(a). In addition, it must provide written notice of intent to levy at least 30 days *before* the actual levy. I.R.C. § 6331(d)(1), (2). This waiting period does not apply if the Secretary makes a finding that the collection of the tax is in jeopardy (jeopardy levy) or relates to employment taxes when the taxpayer is a "repeat offender." I.R.C. §§ 6331(d)(3) & 6330(h). This later notice is called "Notice of Intent to Levy, and Your Right to a Hearing." If the taxpayer requests a hearing before the IRS Office of Appeals—*i.e.*, a Collection Due Process Hearing (CDP)—then the Service is barred from levying until the conclusion of the hearing. I.R.C. § 6330(e).

Post-Bankruptcy Survival of Federal Tax Liens

An issue that frequently arises pertains to federal tax liens and property that has been excluded from a taxpayer's bankruptcy estate. As used in this context, the term "exclusion" means property that never becomes part of the taxpayer's bankruptcy estate. The issue can be framed as follows: "Does a federal tax lien on property that has been excluded from a taxpayer's bankruptcy estate survive discharge of the underlying tax liability?" Does the answer to this question depend upon whether the government has filed a valid NFTL before the bankruptcy case commenced?

Consider the following example. John owns a home worth $200,000. It is his primary residence and is encumbered by a first mortgage in the amount of $98,000. John filed his 2007 federal tax return in a timely manner on April 15, 2008. On August 1, 2008, the Service mailed him a notice of deficiency for $50,000. John did not file a protest with Appeals or a petition to challenge the deficiency in Tax Court. As a result, the Service made an assessment for that amount on December 15, 2008.

John filed for bankruptcy protection on June 15, 2011. Included in his scheduled debts was a liability for $50,000 in unpaid income taxes for 2007. The Service filed an NFTL on June 16, 2011.

John's bankruptcy estate was valued at $50,000; his home was excluded from the bankruptcy estate because it was his primary residence. He subsequently received a discharge of his 2007 tax liability.

A federal tax lien attached to John's home. Because a tax lien attaches to virtually all of a taxpayer's property as of the date of the assessment, a lien arose in favor of the government on December 15, 2008. One issue is critical and can be framed as follows: Does the lien securing John's discharged tax liability continue to encumber his home even though it never became property of the estate? In other words, does the home remain subject to the lien even though it was excluded from the bankruptcy estate and the underlying tax liability was subsequently discharged in bankruptcy? The answer, surprisingly, is "yes." The tax lien continues to encumber John's home even though it never became part of the estate. *Johnson v. Home State Bank*, 501 U.S. 78 (1991). *See also Deutchman v. Internal Revenue Service*, 192 F.3d 457 (4th Cir. 1999); Cen-Pen Corp. v. Hanson, 58 F.3d 89 (4th Cir. 1995); *Isom v. United States*, 901 F.2d 744 (9th Cir. 1990). However, the Service is precluded from taking any action to collect the debt as a personal liability of John.

At this point, you might be wondering how property that was excluded from a bankruptcy estate could remain subject to a lien that was not filed until *after* the taxpayer filed for bankruptcy. Recall that the IRS did not file an NFTL until June 16, 2011, one day *after* John filed his bankruptcy petition. The answer to this perplexing question is that a lien on property that was excluded from a bankruptcy estate survives discharge regardless of whether or not a NFTL was filed. *See* Practical Tax Professional, § 47.225.20, Post-Bankruptcy Survival of Federal Tax Lien: Notice of Federal Tax Lien Filed.

It is on this last point that the Tax Court distinguishes between the effect of a pre-existing lien on property that is *exempt* from the bankruptcy estate under 11 U.S.C. section 522, on the one hand, and property that is *exclude*d from the bankruptcy estate under 11 U.S.C. section 541(c)(2), on the other hand. *See Wadleigh v. Commissioner*, 134 T.C. No. 280 (2010).

A lien on property that is *exempt* from the bankruptcy estate remains subject to the lien despite the discharge of the taxpayer's underlying tax liability only if the NFTL is filed *befor*e the bankruptcy case was commenced. On the other hand, a lien on property that is *excluded* from the bankruptcy estate—*i.e.*, never became part of the estate—survives discharge regardless of whether or not a NFTL was filed. Therefore, even if the Service had never filed an NFTL, its lien on John's home would nevertheless have survived discharge of the tax liability.

Let's assume that the Service files suit in federal court to reduce this assessment to judgment and to foreclose its federal tax lien on John's home. Will John lose his home? For federal tax liens that survive discharge of the taxpayer's underlying tax liability, the debtor is generally faced with losing his property in either a lien foreclosure action or a levy. *See* Practical Tax Professional, *supra*.

As a preliminary matter, the Service resorts to enforcement collection proceedings sparingly. As it has said time and time again, it "works with taxpayers that have post-bankruptcy dischargeable taxes to advise them of [its] lien interest and attempt to reach a mutually acceptable agreement. Enforcement collection actions are infrequent and are only used as a last resort and under very specific circumstances." *See* Comments to *Taxpayer Advocate Service, 2009 Annual Report to Congress, vol. I*, 2009 WL 5251017.

However, when the Service does resort to using the courts to enforce a tax lien, it can be relentless. While John is but a heartbeat away from losing his home, some last minute arguments can be made to avoid what is otherwise a draconian result. Any such argument would be grounded in equity. Courts have discretion to refuse foreclosure when equity dictates. *United States v. Rodgers*, 461 U.S. 677 (1983). Indeed, courts are more likely to proceed cautiously when the matter involves the sale of a person's home. For example, a district court held that it would be inequitable and offensive for the IRS to foreclose on land when the foreclosure would displace an innocent, unemployed, disabled woman of modest and limited means who lived there for several years while battling cancer. *United States v. Johns*, 2006 WL 3086869 (N.D. Fla. 2006). On the other hand, a district court allowed the Service to foreclose on a delinquent taxpayer's home that he held with his non-liable wife as tenants by the entirety, notwithstanding the undue hardship that the wife would face due to a forced sale. *United States v. Guthery*, 2009 WL 1010431 (M.D. Fla. 2009).

Assuming that the court rejects John's equity arguments, are there any last-ditch efforts he can make, such as negotiating an installment agreement? Unfortunately, that option is likely to suffer the same fate as the equity arguments. The Service considers installment agreements inappropriate. *See* Practical Tax Professional, *supra*. The rationale is that the debtor no longer has any personal liability for the discharged tax. An exception applies for compelling circumstances when payment can be made swiftly. However, that exception does not apply under these facts.

What if the value of John's home increases *after* June 15, 2011, the day that he files the bankruptcy petition? If the value of John's home increases from $200,000 on June 14, 2011, the day before he files the bankruptcy petition, to $250,000 on December 30, 2011, the government does not receive the benefit of that $50,000 post-petition appreciation in value. The government's claim is secured only up to the value of property to which the lien attached *before* the bankruptcy petition was filed. Stated otherwise, a lien securing discharged liability does *not* attach to post-petition increases to the value of estate, or non-estate, property. Nor does such a lien attach to property acquired by the debtor post-petition. *United States v. Gold*, 178 F.3d 718 (4th Cir. 1999); *In re Braund*, 423 F.2d 718 (9th Cir. 1970).

Theoretically, this means that the government's claim is secured up to $200,000, and not $250,000. However, we must not forget that John's home is encumbered by a $98,000 first mortgage. Therefore, while the federal tax lien encumbers John's residence, in reality, it does so only up to $102,000. Federal tax liens are subordinate to first mortgages. ■