MLI #7 Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

SUMMARY

Internal Revenue Code (IRC) § 7403 authorizes the United States to file a civil action in U.S. District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or subject any of the delinquent taxpayer's property to the payment of tax. We identified 52 opinions issued between June 1, 2013, and May 31, 2014, that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 47 of these cases. The total number of cases represents a 58 percent increase from the previous year.[1]

PRESENT LAW

IRC § 7403 authorizes the United States to enforce a federal tax lien with respect to a taxpayer's delinquent tax liability, or to subject any property, right, title or interest in property of the delinquent taxpayer to the payment of a liability, by initiating a civil action against the taxpayer in the appropriate United States District Court.[2] All parties having liens on or otherwise claiming interest in the relevant property shall be made parties to the action.[3] The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.[4] However, if it is determined that the taxpayer has an interest in the property, federal law controls whether the property is exempt from attachment of the lien.[5]

The court may order that the property be sold by an officer of the court and the proceeds applied to the delinquent tax liability.[6] However, based on the Supreme Court case *United States v. Rodgers*, the court is not required to authorize a forced sale and may exercise limited equitable discretion.[7] When a forced sale involves the interests of a non-delinquent third party, the court should consider four factors from *Rodgers* when determining whether the property should be sold:

1. The extent to which the government's financial interests would be prejudiced if they were relegated to a forced sale of the partial interest of the delinquent taxpayer;
2. Whether the innocent third party with a separate interest in the property, in the normal course of events, has a legally recognized expectation that the property would not be subject to a forced sale by the delinquent taxpayer or taxpayer's creditors;
3. The likely prejudice to the third party in personal dislocation costs and inadequate compensation; and
4. The relative character and value of the non-liable and liable interests held in the property.[8]

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1 National Taxpayer Advocate 2013 Annual Report to Congress 403.
2 IRC § 7403(a); Treas. Reg. § 301.7403-1(a).
3 IRC § 7403(b).
4 *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985).
5 *United States v. Rodgers*, 461 U.S. 677 (1983).
6 IRC § 7403(c).
7 466 U.S. 677 (1983).
8 *Rodgers*, 461 U.S. at 709-11.

At the sale of the property in which it holds a first lien, the United States may bid an amount equal to or less than the amount of the lien, plus selling expenses.[9] Additionally, the United States may intervene in foreclosure actions initiated by other creditors to assert any lien on the property that is the subject of such action.[10]

The United States may also remove the case to a U.S. District Court if the case was initiated in a state court.[11] However, junior federal tax liens may be effectively extinguished in a foreclosure and sale under state law, even if the United States is not a party to the proceeding.[12] Additionally, the Code specifically authorizes the court to appoint a receiver to enforce the lien and, upon the government's certification that it is in the public interest, to appoint a receiver with all powers of a receiver in equity to preserve and operate the property prior to the sale.[13]

In 2013, the IRS clarified its procedures for referring cases to the Department of Justice (DOJ) when seeking to recommend a suit to foreclose on a taxpayer's principal residence.[14] When a tax lien attaches to the principal residence of a taxpayer or a residence owned by the taxpayer but occupied by the taxpayer's spouse, former spouse, or minor child, the IRS can use two methods to enforce the tax lien. The IRS can request that the DOJ:

- File suit to foreclose the federal tax lien against the principal residence under IRC § 7403; or
- Commence a proceeding to obtain a court order allowing administrative seizure of a principal residence under IRC § 6334(e)(1).[15]

Prior to the issuance of this guidance, the Internal Revenue Manual (IRM) provisions related to referring a case to the DOJ for administrative seizure of a principal residence under IRC § 6334(e)(1) required the IRS to consider who is living in the residence in determining whether referral was appropriate. The IRM provisions regarding referring cases to DOJ, to request the commencement of a foreclosure action of a principal residence, were not as clear about the considerations the IRS should make prior to referring a case.

9 IRC § 7403(c).

10 However, if the application of the United States to intervene is denied, the adjudication will have no effect upon the federal tax lien on the property. IRC § 7424. Under 28 U.S.C. § 2410, the United States may be named a party in any civil action or suit in any district court, or in any state court having jurisdiction of the subject matter. IRC § 7424.

11 28 U.S.C. § 1444.

12 *United States v. Brosnan*, 363 U.S. 237 (1960).

13 IRC §§ 7403(d) and 7402(a).

14 IRS Interim Guidance Memorandum (IGM) SBSE-05-0414-0032 (Apr. 18, 2014) (reissuing IRS Interim Guidance Memorandum SBSE-05-0413-035 (Apr. 30, 2013) (Principal Residence Suit Foreclosure Recommendations)), *available at* http://www.irs.gov/pub/foia/ig/spder/SBSE-05-0414-0032[1].pdf. This guidance is the result of action by TAS leadership. In 2012, TAS Systemic Advocacy developed and issued to the IRS an Advocacy Proposal recommending that the IRS consider the negative impact on the taxpayer of a suit to foreclose on a principal residence prior to forwarding the case to the DOJ. TAS, *Memorandum for Director, Collection Policy* (Aug. 20, 2012). The National Taxpayer Advocate followed this advocacy proposal with a legislative recommendation that Congress amend IRC § 7403 to require that the IRS, before recommending that the Attorney General file a suit to foreclose, first determine that the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*). Following this recommendation, Systemic Advocacy consulted extensively with the IRS to develop the IGM, which adopted the recommendations set forth by the National Taxpayer Advocate.

15 IRC § 6334(e)(1) requires that the IRS obtain court approval prior to administratively seizing a principal residence.

The interim guidance clarifies that the procedures for developing suit referral recommendations under IRC § 6334(e) apply to referrals under IRC § 7403 as well.[16] The guidance also emphasizes that the IRS should pursue a suit to foreclose a lien on a residence only when it has considered hardship issues and there are no reasonable administrative remedies.

ANALYSIS OF LITIGATED CASES

We reviewed 52 opinions issued between June 1, 2013, and May 31, 2014 that involved civil actions to enforce federal tax liens. Table 7 in Appendix III contains a detailed list of those cases. Fifty percent of the taxpayers appeared *pro se* and 50 percent were represented. Taxpayers with representation received full relief in one case and partial relief in two cases. *Pro se* taxpayers received full relief in one case and partial relief in another.

Foreclosure of Tax Liens Against Property that Has Been Transferred to a Third Party

In *Smith v. United States*,[17] a husband and wife bought a residence in 1993. In August 2001, while their divorce proceeding was pending, a *lis pendens*[18] was recorded by the wife on the residence. In March 2003, the IRS assessed income taxes against only the husband for the 2000 and 2001 tax years. In July 2003, the husband and wife were divorced, and the divorce decree stated that the husband's interest in the residence was to be transferred to the wife.

On August 14, 2003, a court order conveying title in the residence to the wife was recorded in the local land records. On September 15, 2003, the IRS filed a Notice of Federal Tax Lien (NFTL) against the husband for his 2000 and 2001 income tax liabilities. In June 2011, another NFTL was recorded against the wife as nominee of her now ex-husband. The nominee NFTL did list the wife's correct address and did not contain language stating that the lien attaches specifically to the residence. In response to the nominee lien filing, the wife filed a quiet title action seeking to remove the liens filed by the United States from the residence. In response, the United States filed a counterclaim seeking to foreclose the liens on the residence.

The wife argued that enforcement of the lien was inappropriate because her due process rights were violated, because she was not given notice of the existence of the lien prior to the entry of the divorce decree. The United States argued that it notified her ex-husband and was not required to give her notice. The Court agreed with the United States finding that the statute only requires the IRS to provide notice to the liable taxpayer.[19] The Court went on to say that the wife cannot also argue that she was denied due process because she was not given sufficient notice of the lien since she received notice of the lien in July 2011, well before any foreclosure proceeding started. The court noted that actual notice of the commencement of a foreclosure proceeding is all that due process requires.

The wife also argued that the NFTL filed in 2003 was not valid because her ex-husband had no interest in the residence at the time the assessments were made, because the residence was conveyed to her before

16 The IGM follows the legislative recommendation made by the National Taxpayer Advocate in 2012. National Taxpayer Advocate 2012 Annual Report to Congress, 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

17 113 A.F.T.R.2d (RIA) 1231 (D. Conn. 2014).

18 A "*lis pendens*" is a "notice, recorded in the chain of title to real property, required or permitted in some jurisdictions to warn all persons that certain property is the subject matter of litigation, and that any interests acquired during the pendency of the suit are subject to its outcome." *Black's Law Dictionary* 9th ed. (2009).

19 IRC § 6303(a).

the tax liens were recorded, and the *lis pendens* filed in 2001 was effective from the date filed. The United States argued that the *lis pendens* was not effective until the judgment was entered in the divorce proceeding, so the ex-husband's interest in the real property was not extinguished until that time.

The court found the ex-husband did have an interest in the property as a lien on the property arose in March 2003 when the taxes were assessed, which was before the divorce judgment was entered. The prior *lis pendens* does not affect the validity of the lien. With respect to the nominee lien filed in 2011, the United States conceded that it did not mean to suggest the wife is a nominee of the husband as the term is defined in law and that the lien was filed purely to provide record notice of the United States' claim to the property. Thus, the court found the 2011 lien invalid.

Because the wife was a non-liable third party, the court then applied the *Rodgers* factors to determine whether foreclosure of the liens on the residence was appropriate.[20] The court found the wife had little expectation of foreclosure—she had sole ownership interest in the property after divorcing her husband in 2003, and a title search conducted in 2005 showed that her interest was unencumbered. The court also found that foreclosure would cause significant prejudice to the wife, as she had lived on the property for over 20 years, and the forced sale of her home could foreseeably cause her to incur significant relocation costs. The court determined that only one of the *Rogers* factors may have weighed slightly in favor of the government—financial prejudice to the government. Thus, the court concluded that it was appropriate to use its limited discretion under *Rodgers* and deny the sale of the property.

In determining the appropriateness of foreclosure, the courts frequently consider whether a transfer of the property to another party extinguished the federal tax lien.[21] For the lien to remain valid after property has been transferred to a subsequent purchaser, an NFTL must have been filed before the transfer. However, if the third party is not a true purchaser under IRC § 6323(h)(6), the lien will be enforceable, even if an NFTL has not been filed.[22]

For example, in *United States v. Chambers*, the taxpayer refused to file an income tax return for tax years 1996 through 2001 and 2003.[23] Based on information returns filed by third parties, the IRS computed the taxpayer's tax liability and sent him a statutory notice of deficiency (SNOD) proposing an assessment. The taxpayer did not file a Tax Court petition or otherwise respond to the SNOD; thus, the liabilities proposed in the SNOD were assessed.

After the assessment, but before a notice of federal tax lien (NFTL) was filed for tax years 1997 through 2001 and 2003, the taxpayer transferred real property to his children, who paid ten dollars in consideration. Based on these facts, the court determined the government had demonstrated that it properly assessed the liabilities, that the liabilities remained unpaid after notice and demand for payment, and that a federal tax lien arose upon assessment that attached to all the taxpayer's property, including the property transferred to his children. The court found that because the taxpayer's children did not qualify

20 113 A.F.T.R.2d (RIA) 1231 (D. Conn. 2014). For an explanation of the *Rodgers* factors, see discussion in Present Law section, *supra*.

21 A federal tax lien arises "If any person liable to pay any tax neglects or refuses to pay the same after demand." IRC § 6321. This lien is called a "secret lien" because it arises upon assessment; nothing is filed publicly. Conversely, an NFTL is filed in the public record (*e.g.*, local courthouse) and provides public notice to creditors.

22 Under IRC § 6323(a), the lien is not valid against a purchaser until notice has been filed that meets the requirements of IRC § 6323(f).

23 113 A.F.T.R.2d (RIA) 2195 (M.D. Fla. 2014).

as a "purchaser" under IRC § 6323(h)(6), the tax lien remained on the property and thus it was subject to foreclosure.[24]

In *United States v. Denneny*,[25] the court considered whether it was appropriate to foreclose on property transferred to a third party after the federal tax lien arose and the IRS filed an NFTL. Since an NFTL was filed at the time the third party purchased the property, the property was purchased subject to the NFTL. It was appropriate for the United States to enforce the liens against the property via a foreclosure action.[26] Applying similar reasoning, the court in *United States v. Woodruff* found that, because the taxpayer transferred properties to his wife after federal tax liens arose and NFTLs were filed, the liens remained on the properties.[27]

Foreclosure of Tax Liens Against Property that Is Held by a Taxpayer's Nominee or Alter Ego

Several opinions involved foreclosure of federal tax liens against property titled in the name of a taxpayer's nominee or alter ego. A nominee is "one who holds bare legal title to property for the benefit of another."[28] Courts typically look at a number of factors to determine whether an entity is a nominee of a taxpayer, such as whether:

- The nominee paid no or inadequate consideration;
- The property was placed in the name of the nominee in anticipation of the tax debt or litigation;
- There is a close relationship between the transferor and the nominee;
- The parties to the transfer never recorded the conveyance;
- The transferor retained control; and
- The transferor continues to enjoy the benefits of property.[29]

In *United States v. Gilbert*,[30] the court held the trust set up by the taxpayer was the nominee of the taxpayer. The court based this conclusion on the fact that the taxpayer was convicted of tax evasion, in part, for using the trust to evade the payment of his federal income tax liabilities. In particular, the taxpayer was both a transferor of property to the trust and the managing trustee, and the taxpayer turned funds from the trust's bank account to his own personal use.

In *Fourth Investment LP v. United States*,[31] the taxpayers transferred title of their home and a commercial building to two limited partnerships, which the government argued were not functionally partnerships but were simply the taxpayers' nominees. The Ninth Circuit Court of Appeals agreed with the government, noting the transfers were made through a complex series of transactions involving shell entities

24 If a taxpayer transfers property subject to a federal tax lien to a purchaser before the government files an NFTL, the lien no longer attaches and the purchaser acquires the property free of the lien. IRC § 6323(a). A purchaser is defined in the Code as a person who for adequate consideration acquires an interest (other than a lien or security interest) in property that is valid under local law against subsequent purchasers without actual notice. IRC § 6323(h)(6).

25 112 A.F.T.R.2d (RIA) 7445 (E.D. Pa. 2013).

26 *Id.*

27 113 A.F.T.R.2d (RIA) 1062 (D.N.H. 2014).

28 *United States v. Sabby*, 113 A.F.T.R.2d (RIA) 1335 (D. Minn. 2014) (quoting *Scoville v. United States*, 250 F.3d 1198, 1202 (8th Cir. 2001)).

29 *Id.*

30 113 A.F.T.R.2d (RIA) 620 (W.D. Ky. 2014).

31 720 F.3d 1058 (9th Cir. 2013), *aff'g Leeds LP v. United States*, 807 F. Supp. 2d 946 (S.D. Cal. 2011).

created and controlled by the taxpayers.[32] Specifically, when considering the above-mentioned factors, the court found the entities were nominees because consideration received by the taxpayer for the transfer of real property was inadequate, and the taxpayer retained benefits and possession of the real property.

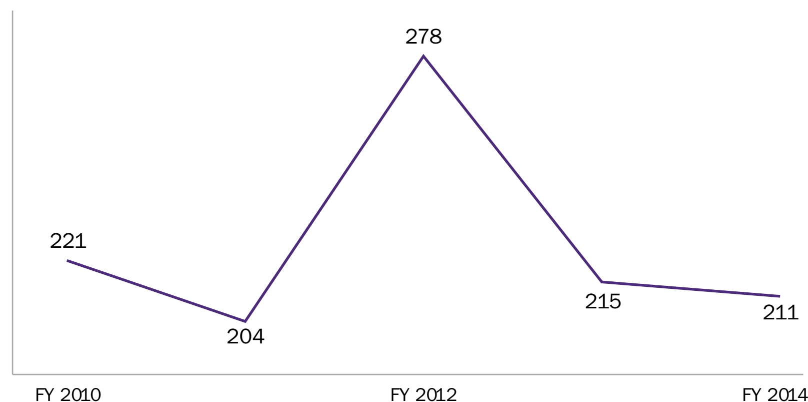
The court in *United States v. Powell*[33] reached a similar decision. The taxpayers formed a corporation with the taxpayer's wife as sole shareholder to hold a residence purchased with the taxpayers' money, and the residence was subject to a federal tax lien. After noting that the taxpayers lived at the residence and paid all the related expenses and taxes, the court held that the corporation was the nominee of the taxpayers and the taxpayer was the true beneficiary and equitable owner of the property. Thus, the court ordered the foreclosure of the tax liens on the properties held by the nominee entities.[34]

CONCLUSION

In the 2012 Annual Report to Congress, we predicted that one might see more court opinions involving lien enforcement in the coming years due to an increase in the number of cases referred to the DOJ by the IRS.[35] While there was a marked increase in lien opinions issued this year, it does not appear this increase was due to a greater number of cases being referred to DOJ. Compared with the FY 2012, the IRS referred fewer lien suits in both FY 2013 and FY 2014. However, because the number of cases referred to DOJ in FYs 2013 and 2014 is similar to years before FY 2012, it may be that FY 2012 was an outlier and the number of lien referrals has remained steady.

Figure 3.7.1, shows the number of cases referred to the DOJ by fiscal year.[36]

FIGURE 3.7.1



32 720 F.3d 1058 (9th Cir. 2013), *aff'g Leeds LP v. United States*, 807 F. Supp. 2d 946 (S.D. Cal. 2011).

33 113 A.F.T.R.2d (RIA) 1382 (2014).

34 *Id*.

35 National Taxpayer Advocate 2012 Annual Report to Congress 639.

36 DOJ Tax Division, *Suits to Foreclose Tax Lien - Summary by Fiscal Year of Case Receipt* (Oct. 3, 2012) and DOJ Tax Division, *Suits to Foreclose Tax Lien - Summary by Fiscal Year of Case Receipt* (Oct. 18, 2013).

The overall number of referrals to DOJ has not significantly diminished during this reporting period, notwithstanding the publication of the interim guidance memorandum in 2013. Because the guidance was primarily aimed at ensuring the IRS considers collection alternatives and equitable factors such as hardship prior to requesting the DOJ foreclose the lien on a personal residence, we believe that the number of cases like *Smith v. United States*, involving a personal residence where the *Rogers* factors weighed heavily in favor of the property owner, should diminish. However, the guidance may not impact the overall number of foreclosure referrals as some of the cases being worked by the IRS will not involve situations covered by the guidance.

Taxpayers have the *right to privacy*, which means that any enforcement action should be no more intrusive than necessary.[37] The interim guidance recognizes this right by requiring the IRS to take into account how foreclosure of a taxpayer's home will affect the taxpayer. The National Taxpayer Advocate anticipates the interim guidance will continue to have a positive effect on taxpayer rights in future years, as the IRS refers fewer suits to foreclose tax liens on taxpayers undergoing a hardship or in situations where there are reasonable alternatives. The National Taxpayer Advocate will work with the IRS to formally incorporate the interim guidance into the Internal Revenue Manual. In addition, it would be best for Congress to adopt the National Taxpayer Advocate's previous legislative recommendation to codify the approach used in the interim guidance.[38]

37 *See* IRS, Taxpayer Bill of Rights, http://www.irs.gov/Taxpayer-Bill-of-Rights (last visited Aug. 20, 2014); IRS, Publication 1, *Your Rights as a Taxpayer* (June 2014).

38 The National Taxpayer Advocate recommended Congress amend IRC § 7403 to require that the IRS, before recommending that the Attorney General file a suit to foreclose, first determine that the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due, and that the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer. National Taxpayer Advocate 2012 Annual Report to Congress 537-43 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).