ID: CCA_20190521145632 57

UILC: 6325.28-01, 6325.00-00, 6325.03-00

Number: **201926012**
Release Date: 6/28/2019

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**From:** [redacted]
**Sent:** Tuesday, May 21, 2019 2:56:32 PM
**To:** [redacted]
**Cc:** [redacted]
**Bcc:**
**Subject:** RE: Priority & Discharge Question

If/when the Service's FTL interest in subject (real) property is zero, it may issue a certificate of discharge pursuant to section 6325(b)((2)(B). You should review IRM Part 5.12.10.3.3.1 which has guidance on short-sale situations. The big takeaway there is that even if there is money that goes to pay off other creditors who's interests are primed by the FTL, the Service may still discharge the property (in a short-sale situations). This is counter-intuitive, and perhaps difficult to support as a matter of statutory interpretation, but it is the position of the Service and it proves the point that a discharge may be issued in the situation you describe in which the FTL interest may be valueless (*e.g.*, even in the simpler situation in which there are no lower priority creditors walking away with any payment(s)).

The trouble I am having with your situation is that I don't know if it is a sale. You explained that the taxpayer is attempting to sell the property. But you also discuss a modification that seems to be happening in advance of any sale. Is the modification a refinance? I am not familiar with the mechanism that you describe, so it is not clear to me what the transaction entails. But you do explain that it is being done pursuant to the Home Affordable Modification Program ("HAMP"). If the loan is being refinanced (or otherwise modified), then I would suggest that the issue might involve subrogation. Section 6325(i)(2) allows for federal subrogation if there otherwise would be local law (state law) subrogation (usually equitable subrogation). If this is the case, then you would need to see if subrogation applies. Such analysis involves going through the elements of local law subrogation. You could take a look at the GL1 lesson on equitable subrogation. If all that is happening is a loan modification, then the Service should either allow subrogation or not (with respect to the modified loan). And such subrogation would never be allowed for an amount that exceeds the current loan balance that primes the FTL. And it might not be allowed at all if the new loan incorporated other balances that did not prime the FTL. So this really entails an entirely separate analysis. If the modified loan is not subrogated to the original, then, at some

later time if there is indeed a sale of the property, it might be difficult to conclude that the FTL interest has no value (because the FTL interest would prime the new and non-subrogated loan interest). And this discharge issue should be addressed separately after the dust settles on the subrogation issue.

Finally, the Home Affordable Foreclosure Alternatives Program (HAFA), which is part of the HAMP, was enacted by Treasury Department Supplemental Directive 09-01. There are restrictions for HAFA-governed sales that may affect discharge determinations. You should take a look at IRM Part 5.12.10.3.3.2 (09-30-2015) (immediately following the short-sale section). This section hopefully addresses your specific concern.

Immediately below the text of this e-mail is the relevant IRM provision on short sales. Below that I will paste the relevant discussion of subrogation from the GL1 lesson. And after that I will paste the IRM section on Home Affordable Programs. Once you have taken a look at these provisions feel free to give me a call to discuss.

Regards,

5.12.10.3.3 (09-30-2015)
**No Value, IRC § 6325(b)(2)(B)**
(1) Issue Form 669-C when it is determined that the interest of the United States in the property subject to the federal tax lien is valueless.
***Reminder:*** Consider all facts and circumstances of the case when determining the value of the government's interest in the property, including all other liens and encumbrances with priority over the federal tax lien.
(2) Foreclosing mortgagees may use this administrative provision rather than joining the United States as a party in a judicial foreclosure action. The discharge of property from the lien eliminates the government's right of redemption if the United States were joined as a party defendant. See 28 U.S.C. 2410(c).
(3) In determining the value of the government's interest in property to be discharged from a federal tax lien under IRC § 6325(b)(2), consideration may be given to the "forced sale value," as distinguished from the "fair market value" of the property.
a. Use of forced sale value as a valuation method is encouraged if market conditions, including depressed comparable sales, have resulted in lower values on properties and if taxpayers will be assisted by the discharge of the property from the lien. However, while applicants may suggest use of "forced sale value," it is Advisory's decision if it will be used.
b. Document any disagreement with using "forced sale value" in the case history, along with documentation of comparable sales data, prevailing market conditions, or other information that does not support its use as a method for determining the value of the property for the discharge.
5.12.10.3.3.1 (09-30-2015)
**No Value - Short Sales**
(1) Applications relative to "short sales" should be considered under IRC § 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.
***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.
(2) 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 Service and might include creditors that would otherwise be junior to the federal tax lien. 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 federal tax lien.

(3) Provided there is no fraudulent aspect to the payment distribution and the lien interests of the government in other properties of the taxpayer is not being harmed, the Service has no authority to require payment of the sum that otherwise would have gone to the senior lien holder.

***Example:*** A bank has a priority mortgage claim for $400,000, but the bank agrees to a sale of the mortgaged property for $300,000. 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 and $2,000 is for state transfer taxes, both which are junior in priority to the federal tax lien. The

Service, as a condition of discharge, cannot demand payment of the amount going to the homeowner's association fee or the state transfer taxes because these are being paid from the proceeds attributable to the bank's priority lien interest and do not impact the interest of the government in the property, which is still valueless.

(4) Occasionally, the senior lien holder may allow part of its proceeds to be paid to the taxpayer as a form of incentive. If these payments are taken from the senior lien holder's equitable interest, the payment would not have a bearing on calculating the government's interest in the property. This payment to the taxpayer, however, is an asset that may be levied. The decision to levy should be made judiciously based on the facts of the case.

***Note:*** The issue of the levy should have no detrimental effect on the issuance of the discharge. If there is no interest in the real estate, a no equity discharge should be granted upon sufficient proof of closing and transfer. If the proceeds going to the taxpayer are levied, the receipt or non-receipt of those funds would be something to address under levy procedures.

(5) 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 government'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 government's interest are not entitled to payment from the proceeds that belong, by priority, to the government.

# I. EQUITABLE SUBROGATION

## *A. In General*

Section 6323(i)(2) provides that if local law allows a subsequent lien holder to be subrogated to the rights of a lien holder with priority over a FTL with respect to its newly created lien or interest, the subsequent lien holder shall be subrogated to such rights under federal law. Therefore, when a FTL is not valid with respect to a particular interest as against the holder of that interest, then the tax lien also is not valid with respect to that interest as against any person who, under local law, is a successor in interest to the holder of that interest. Treas. Reg. § 301.6323(i)-1(b). Under state law, equitable subrogation allows a junior creditor or claimant to step into the shoes of a senior creditor.

Equitable subrogation is defined under state law. Accordingly, there is also no single rule for determining equitable subrogation in all cases. As one example, under California law, courts (e.g., United States v. Han, 944 F.2d 526 (9th Cir. 1991)) apply a five-factor guideline for determining equitable subrogation: (1) payment was made by the subrogee to protect his own interest; (2) the subrogee had not acted as a volunteer; (3) the debt paid was one for which the subrogee was not primarily liable; (4)

the entire debt has been paid; and (5) subrogation would not work any injustice to the rights of others.

Most equitable subrogation cases arise if a FTL has not been paid in situations involving the transfer of real property in nonjudicial foreclosures, voluntary sales, and refinancing. In a nonjudicial foreclosure under section 7425(b), if the Service is not provided notice, the purchaser takes real property encumbered with the FTL. In a voluntary sale, the Service files a NFTL; the taxpayer sells his real property; but due to some mishap, the FTL is not paid at closing. In refinancing, Bank 1 has the first lien, the NFTL is second, and Bank 2 satisfies the first lien on the property.

## *A. Factors Considered by Courts*

The following factors guide courts in applying equitable subrogation, but these factors are not applied consistently.

### 1. Windfall to Service

In California, if the Service enforces a FTL against a purchaser, the fact that the Service may recover more from the purchaser than it would have recovered from the taxpayer does not mean that the IRS would be unjustly enriched. United States v. Han, 944 F.2d 526 (9th Cir. 1991). "[N]o California court has said that equitable subrogation should apply solely because an existing lienholder is put in a better position." Id. at 529. In contrast, in Dietrich Industries v. United States, 988 F.2d 568 (5th Cir. 1993), in interpreting Texas law, the court held that a factor weighing for equitable subrogation was that the Service would receive a windfall. "Denying subrogation in this case would give the government an unearned windfall in that it would elevate the government's liens for no good reason." Id. at 573.

### 2. Satisfying Entire Debt

Under California law, equitable subrogation requires that the entire senior debt be paid. In contrast, in Dietrich Industries v. United States, 988 F.2d 568 (5th Cir. 1993), which interpreted Texas law, the court granted equitable subrogation even though the entire senior debt was not paid.

### 3. Real Party in Interest

If a title insurance company fails to find a NFTL, the title insurance company may be sponsoring the litigation against the Service to reduce the title insurance company's liability. In First Federal Savings Bank v. United States, 118 F.3d 532 (7th Cir. 1997), the court held that the bank that had refinanced the taxpayer's real property was not equitably subrogated to the senior lien satisfied because the title insurance company was the real party in interest, not the bank.

### 4. Nonjudicial foreclosures

In California, purchasers at forced sales might not qualify for equitable subrogation because the payments do not actually satisfy the debts. "What is important … is that [the purchasers] knew that the forced sale of the property would extinguish any liens regardless of how much they paid as a purchase price. Therefore, [the purchasers did not pay] money in order to satisfy the debt of another." Fidelity Nat'l Title Insur. v. United States, 907 F.2d 868, 870 (9th Cir. 1990).

### 5. Volunteer

While equitable subrogation is not provided to volunteers, the definition of a volunteer is not entirely clear. Interpreting California law, Fidelity Nat'l Title Insur., supra, denied equitable subrogation to a purchaser of property because he was a volunteer. Compare Han, supra (plaintiff was not a volunteer, even though he was a purchaser of property).

### 6. Actual and Constructive Knowledge

Many states will not allow the equitable subrogation of a refinancing lender's interest in property if the lender had actual knowledge of the intervening FTL. See, e.g., ContiMortgage v. United States, 109 F.Supp.2d 1038 (D. Minn. 2000). See also Dietrich, 988 F.2d at 572 ("In some jurisdictions constructive knowledge bars a subrogation claim [citation omitted], but, in Texas, a purchaser with constructive knowledge of the junior lien is not precluded from asserting equitable subrogation."

### 7. Assignment

In those states in which equitable subrogation is not available or is difficult to achieve, the new lender may obtain an assignment of the prior mortgage to obtain priority over an existing FTL.

In addition, equitable subrogation may not apply if the bank seeking the benefit of equitable subrogation is the same bank that held the original obligation. Wells Fargo Bank v. Svenby, 2016 WL 4719883 (M.D. Ala. 2016).

5.12.10.3.3.2 (09-30-2015)
**Home Affordable Programs**
(1) The Home Affordable Foreclosure Alternatives Program (HAFA), part of the Home Affordable Modification Program (HAMP), was enacted by Treasury Department Supplemental Directive 09-01 to assist individuals behind on their mortgage payments. Property sales conducted under HAFA have certain restrictions that may affect discharge determinations.
***Note:*** Dollar amounts referenced in this subsection are based on Treasury Department directives in effect as of this IRM publishing date. The dollar amounts are subject to change based on the issuance of future Treasury Department Supplemental Directives. See the *Treasury Department website* for more information.
(2) Payments to junior creditors under HAFA are subject to an aggregate cap established by the servicing mortgage. Also, the payments should be paid in the order of priority and must be reflected on the HUD-1 Settlement Statement.

(3) An investor (purchaser) can be reimbursed two (2) dollars for every three (3) spent, up to $8,000, for facilitating the release of subordinate lien holders. In other words, for each three dollars an investor pays to secure release of a subordinate lien, the investor will be entitled two dollars of reimbursement up to a maximum $8,000. For junior lien holders to qualify for payment and investors to qualify for reimbursement, the junior lien holders must agree to release their liens with respect to the property.
(4) The seller under HAFA is entitled to an incentive payment of $10,000 to assist with relocation expenses. To qualify, the property must be the seller's principal residence and the amount must be shown on the HUD-1 Settlement Statement.
• This relocation payment has no bearing on the taxpayer's equity in the property and, therefore, the Service cannot require payment of the sum as a condition of discharge; however, it is a payment that could be levied.
***Note:*** As a matter of policy, the Service will not levy this payment unless flagrant conduct circumstances exist. (See IRM 5.11.6, *Notice of Levy in Special Cases*.) A levy on this relocation allowance must be approved by the Territory Manager.
• Taxpayers who receive a relocation payment through this provision are not eligible to request the relocation expense allowance described in IRM 5.12.10.7.5, *Request for Relocation Expense Allowance*.
(5) Payments to the seller/taxpayer outside of this provision of HAFA may be income that can be attached by levy. If additional payments are to be made to the taxpayer, investigate the nature of the payment to determine if it can be reached by levy. Consult with management and Area Counsel as needed. If it is an asset that can be levied, you must exercise discretion in determining whether to proceed with levy action.
(6) The limitations of HAFA as described above have no effect upon the discharge authority in regular short sale situations. In other words, if the sale is not being conducted under the provisions of HAFA, the Service has no authority to require payment of amounts paid to junior creditors from the senior lien holder's proceeds as a condition of discharge of the subject property. If the sale is subject to the provisions of HAFA, the Service can ensure that the terms are being properly followed, but still cannot require payment of any sum to which we are not entitled.
(7) When a discharge application involving a short sale is received and information indicates that proceeds are being provided to a junior creditor, the purchaser, or the taxpayer, contact the mortgage company to determine if it is a loan service provider operating under the provisions of HAFA.
a. If the sale is under HAFA, evaluate the distribution according to the HAFA terms described above and notify the mortgage company of any discrepancies found.
b. If the sale is not under the provisions of HAFA, process the request following standard procedures outlined in IRM 5.12.10.7, *Applications for Discharge & Subordination Certificates*. Presuming no issues are identified, the discharge application can be approved following existing IRM procedures.