

Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Associate Area Counsel (San Jose, Group 1)
(Small Business/Self-Employed)

from: Mitchel S. Hyman
Senior Technician Reviewer, Collection, Bankruptcy & Summonses, Branch 1

subject: Redemption of Subordinated Property

This Chief Counsel Advice confirms email advice dated February 17, 2005, that we provided to your office in response to your request for assistance dated February 1, 2005. This advice may not be used or cited as precedent.

ISSUE

Whether the Service must redeem _____ that were subject to a non-judicial trustee's sale when the Service's lien was senior to a possessory lienor on one of the lots but junior to the trustee who subordinated its lien to the possessory lienor.

CONCLUSION

Unless more information can be recovered concerning the proximate amount of _____,

interest and the first trust lien on _____, we recommend that you redeem both lots. The Service should redeem _____ because the Service's liens were junior to the first trust lien. The first trust lien on _____ retained its priority because it could not be subordinated to _____ who had no interest in _____. The Service's liens on _____ are likely junior to the first trust lien. Therefore, the Service should redeem both lots by paying _____, the purchaser at the sale. After redemption the Service will be subrogated to all of the rights of the first trust holder under California Civil Code section 2904. The Service is required to pay the purchaser _____ plus the applicable interest, expenses, and any payments made by the purchaser to a senior lienor.

FACTS

On February 1, 2005, SBSE counsel contacted our office by email requesting advice. Counsel asked whether the Service should pay _____ to redeem the property, and whether the Service was subject to _____' purchase option agreement.

First Deed of Trust

On _____, _____ (the taxpayers) purchased two properties known as _____

_____. These lots were purchased from _____ . On _____, the purchase of these lots and a first deed of trust secured by the lots and naming _____ as beneficiaries was recorded in the land records of _____. The amount of the indebtedness secured by the first deed of trust secured by both lots was _____.

Sometime between _____ and _____, _____, acquired the first deed of trust from the _____. On _____ filed a Notice of Default and Notice of Trustee's Sale to sell _____ by auction on _____. However, the sale was postponed due to _____' bankruptcy petitions. On _____ subordinated its first deed of trust on _____ to the exercised _____ in favor of vendee, _____. _____ signed the subordination agreement as a partner on behalf _____.

The Service's Interest

The taxpayers' _____ federal income tax return was filed and the tax was assessed on _____. The taxpayers' _____ federal income tax return was filed and the tax was assessed on _____. The taxpayers failed to pay the balances due and on _____, the Service filed NFTLs against the taxpayers for the _____ and _____ income tax years.

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, the Service filed an NFTL against the taxpayers for the income tax year. (taxpayer-) died in . There is no record of any individual income tax liabilities for taxpayer- after the tax year. Field counsel estimates that the liens will be worth on

(taxpayer-) also incurred individual liabilities for trust fund recovery penalties (TFRPs) for the quarters ending and

and from through . The TFRP was assessed on , Taxpayer- failed to pay the balance due and on , the Service filed an NFTL against the taxpayer for the quarter ending . Field counsel estimates that lien for will be worth on .

Interest

On entered into the agreement for , whereby

agreed to a lease with an option to purchase for . The agreement states that it was between the and but only signed. was required to pay down and interest on the principal of for the first year. This agreement was intended to be a lease lasting for one year, from to , with an option to purchase at the end of the lease-term for an additional plus interest on the principal at , or for interest on the principal at the rate of . The agreement specified that the

The was not filed. exercised this option and she asserts a vendee's lien of over , comprised of she paid towards the purchase price, the

and legal fees. insists that the Service will be estopped from arguing that her interest is less than claimed because she provided correspondence to the Service and made a bankruptcy claim supporting the amount. She claims that she can pay in order to complete the payments terms of the purchase agreement. subordinated their interest in to the vendee's lien. However, claims that they subordinated to her for both lots.

The Trustee's Sale

On or about , the Service received notice that would be sold at a non-judicial foreclosure sale. On , the sale was held, and made the winning bid. Out of the proceeds, was paid to and was paid to the Service.

LAW AND ANALYSIS

A non-judicial foreclosure sale has the same effect with respect to the discharge of the Service's liens as it does on similar liens under the local law of the situs of the property, provided that the notice of the sale was given to the Service, in writing by registered or certified mail, or personal service, not less than 25 days prior to the sale under I.R.C. section 7425(b). A sale under a trust deed holding first priority terminates and cuts-off all rights in the property which are created after the recording of the trust deed under California law. See Bank of America v. Hirsch Mercantile Co., 148 P.2d 110, 115 (Cal. Ct. App. 1944). Where a sale of real property occurs to satisfy a lien prior to the Service's lien, the Service may redeem such property within the longer of 120 days or the period provided under local law under section 7425(d). The price paid for a redemption is the actual amount paid for the property, interest at 6% per annum from the date of sale to the date of redemption, necessary expenses over the income realized on the property for the same period, and any payment made to the holder of a senior lien by the purchaser for the same period. I.R.C. § 7425(d)(2); 28 U.S.C. § 2410(d); Treas. Reg. § 301.7425-4(b)(1).

The Service's redemption rights are controlled by whether the Service's liens were senior or junior to the foreclosing lienor. State law determines whether a person has property or rights to property, but federal law determines the priority of the federal tax lien. Aquilino v. United States, 363 U.S. 509 (1960); United States v. Nat'l Bank of Commerce, 472 U.S. 713 (1985).

In the present case, the holder of the first trust deed, _____, subordinated its interest in _____ to _____ and then foreclosed its trust deed on _____. Before the subordination, _____ held a senior position to all of the federal tax liens on _____, and _____ had an interest in an unfiled option to purchase _____.

Pursuant to California Civil Code section 3050, _____ had a vendee's lien on _____ for _____, the amounts she paid under the purchase agreement. Under Civil Code section 1214, a conveyance, such as the one between _____ and _____, that is not recorded is void against mortgagees, subsequent purchasers, and lis pendens liens filed before the conveyance is recorded. However, the recording of the subordination agreement provides constructive notice to all persons of the contents of the agreement under California Civil Code § 2934. _____ lien on _____ was junior to the Service's liens at the time the subordination was recorded. After the subordination agreement _____ still had priority over the Service's liens on _____, but that agreement may have placed _____ in a junior position as to the Service's liens on _____. To determine whether _____'s position as to the federal tax liens, the question of circular priority must be answered i.e. who has priority when the Service's lien is senior to _____ but junior to _____ and _____' lien is senior to _____ by the terms of the subordination agreement?

In that vein, circular priorities are resolved by defining the amount of the Service's liens and then determining the amount of liens prior to and junior to the Service's position under federal law, and once the liens are ranked as to the Service's liens, state law

resolves the remaining priorities. See H. B. Agsten & Sons, Inc. v. Huntington Trust and Sav. Bank, 388 F.2d 156, 158 (4th Cir. 1967); United States v. City of New Britain, 347 U.S. 81, 87-88 (1954). In this case, the Government holds approximately _____ of liens that are junior to the first deed of trust on _____. The deed of trust secured a lien on _____ equal to _____ less any costs of the sale. However, after subordination _____ lien took the place of the first deed of trust up to _____ on _____. Assuming that the amount of the first deed of trust secured by _____ was 1/2 of the indebtedness, or _____, _____ would have the first place, the first trust holder would have second place up to _____, the Service's liens would be in third place, and the first trust holder would be in the fourth position for _____. In this case, the Service's liens would be terminated by the trustee's foreclosure.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.