MLI #6 Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

SUMMARY

The United States may file a civil action in U.S. District Court under Internal Revenue Code (IRC) § 7403 to enforce its federal tax lien by subjecting any of the delinquent taxpayer's property, right, title, or interest in property to the payment of the taxpayer's liability. Unlike cases in other Most Litigated Issues, lien enforcement cases are always initiated by the government through the Department of Justice (DOJ) rather than the taxpayer. If the United States succeeds in proving the lien is valid and may be enforced, the court will typically issue an order of sale that (1) authorizes the United States to foreclose on the taxpayer's subject property and (2) describes how the proceeds of sale should be distributed.

During our reporting period from June 1, 2018, to May 31, 2019, we identified 52 opinions that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 48 of these cases, taxpayers prevailed in two cases, and two cases resulted in split decisions in which the IRS and taxpayers or a third party prevailed in part. The 52 cases identified for this reporting period represent a 33 percent increase from the 39 cases reported last year.

TAXPAYER RIGHTS IMPACTED[1]

- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

A federal tax lien (FTL) arises when the IRS assesses a tax liability, sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days of the notice and demand.[2] An FTL is effective as of the date of assessment and attaches to all of the taxpayer's property and rights to property, whether real or personal, including those acquired by the taxpayer after that date.[3] This lien continues against the taxpayer's property until the liability either has been fully paid or is legally unenforceable.[4] Section 7403 authorizes the United States to enforce a federal tax lien over the taxpayer's liability or to subject any of the delinquent taxpayer's property, right, title, or interest in property to the payment of that liability by initiating a civil action in the appropriate U.S. District Court.[5]

1 *See* Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code. *See* IRC § 7803(a)(3).

2 IRC §§ 6321 and 6322. IRC § 6201 authorizes the IRS to assess all taxes owed. IRC § 6303 provides that within 60 days of the assessment the IRS must provide notice and demand for payment to any taxpayer liable for an unpaid tax.

3 *See* IRC § 6321; Internal Revenue Manual (IRM) 5.12.1.1.1, Federal Tax Liens, Background (July 11, 2018).

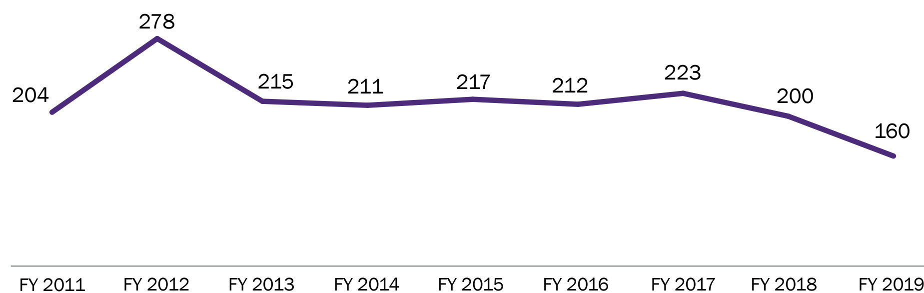
4 IRC § 6322.

5 IRC § 7403(a); Treas. Reg. § 301.7403-1(a).

To bring an enforcement suit, the IRS must refer a case to the DOJ and request it to file the foreclosure suit.[6] In fiscal year (FY) 2019, the IRS referred 160 cases to the DOJ. Figure 1 shows the trend in the number of lien enforcement cases referred to the DOJ since FY 2011, which has been mostly steady with a small downward trend in the last two fiscal years.

FIGURE 2.6.1

Liens Cases Referred to U.S. Department of Justice



The Internal Revenue Manual (IRM) provides the factors the IRS should consider when determining whether to initiate an enforcement suit, including the feasibility of administrative collection devices, the statute of limitations, and the economic value of lien foreclosure.[7] With respect to a recommendation to foreclose on a taxpayer's principal residence, the IRM instructs the IRS to refer a case to DOJ to file suit to foreclose only when there are no other reasonable administrative remedies and the foreclosure would not create or exacerbate hardship issues for the taxpayer or result in the inability of the taxpayer to secure future housing.[8]

Once the DOJ receives the referral, it can initiate suit to enforce the lien under IRC § 7403 by filing a complaint in the appropriate district court.[9] The DOJ is required to name all parties having liens on or otherwise claiming interest in the relevant property as parties to the action.[10] The law of the state where the property is located determines the nature of a taxpayer's legal interest in the property.[11] However, once it is determined that the taxpayer has an interest under state law in the property, federal law

6 IRC § 7401. The IRS prepares a suit recommendation package, and then the IRS Office of Chief Counsel reviews it, and if it agrees, sends a letter to the DOJ asking the DOJ to commence the litigation. Chief Counsel Directives Manual 34.6.1.1.1, Steps Prior to Litigation (Oct. 7, 2015).

7 IRM 5.17.4.8, Foreclosure of Federal Tax Lien (May 23, 2019).

8 IRM 5.17.4.8.2.5, Lien Foreclosure on a Principal Residence (May 23, 2019). The requirement to include an analysis of ability to secure future housing is an update from previous versions of the IRM. This provision is a step towards meeting the National Taxpayer Advocate's recommendation that the IRS instruct employees to more thoroughly consider the negative impact of foreclosing a principal residence. *See* National Taxpayer Advocate 2012 Annual Report to Congress 537 (Legislative Recommendation: *Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences*).

9 The United States may also intervene in foreclosure actions initiated by other creditors to assert any lien on the property that is the subject of such action. If the lien enforcement claim arises as a counterclaim or interpleader action in a case that originated in a state court, the United States may remove the case to a U.S. District Court. 28 U.S.C. § 1444. However, if the foreclosure action is adjudicated under state court proceedings, federal tax liens that are junior to other creditors may be effectively removed, even if the United States is not a party to the proceeding. *See United States v. Brosnan*, 363 U.S. 237 (1960).

10 IRC § 7403(b).

11 *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

determines the respective priorities of the federal tax lien and competing liens or, alternatively, whether the property is exempt from attachment of the lien.[12]

Section 7403(c) directs the court to "finally determine the merits of all claims to and liens upon the property." If the United States proves a claim or interest, the court may order an officer of the court to sell the property and distribute the proceeds in accordance with the court's findings with respect to the interests of the parties, including the United States' claim for the delinquent tax liability.

ANALYSIS OF LITIGATED CASES

We reviewed 52 opinions during our reporting period that involved civil actions to enforce federal tax liens. Table 6 in Appendix 5 contains a detailed list of those cases. Of the 52 cases, ten resulted in default judgment against the taxpayer. Taxpayers appeared *pro se* (without counsel) in 23 cases, while 19 of the cases involved taxpayers with representation. The IRS prevailed in all cases brought against *pro se* taxpayers. This section will highlight key issues in the cases we identified, including the enforcement of tax liens where a non-liable taxpayer has an interest in the subject property; the enforcement of a lien against property held by third parties; and the government's ability to enforce its lien during the existence of an installment agreement.

Foreclosure of Tax Liens Where a Non-Liable Taxpayer Had Interest in Property

Ordering the sale of a taxpayer's property is a powerful collection tool and directly affects any parties who have an interest in the property subject to sale. Based on the Supreme Court case *United States v. Rodgers*,[13] when a forced sale involves the interests of a third party who does not have a federal tax debt, the court should consider the following four factors 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.[14]

The *Rodgers* analysis balances the right of the United States to receive the highest return possible by selling the property in its entirety while also ensuring third parties receive just compensation through judicial valuation and distribution. Following the forced sale, any proceeds are distributed in accordance with the relative interests of the parties, with the United States receiving the proceeds of sale proportional to only the interest of the delinquent taxpayer.

The courts addressed the *Rodgers* factors in four cases during this reporting period. For example, in the case of *United States v. Jackson*, the defendant taxpayer and his wife contested the government's proposed sale of a property, arguing that the proposed sale and distribution would unduly diminish the taxpayer's wife's interest in the subject properties because her portion would be reduced after payments were made

12 *United States v. Rodgers*, 461 U.S. 677, 683 (1983).

13 *United States v. Rodgers*, 461 U.S. 677 (1983).

14 *Id.* at 709-711.

to Property Appraisal and Liquidation Specialists (PALS).[15] The court evaluated the appropriateness of sale using the *Rodgers* factors. First, the court found that the United States would be prejudiced if it were relegated to selling only the taxpayer's interest rather than the properties in their entirety, as this would diminish the value the government could expect to receive in a sale. Second, the wife lacked any expectation the properties would not be sold because she had participated in the fraudulent transfer of the properties, acting to frustrate the government's collection efforts and tilting the balance against her for this factor.[16] Third, the wife would not receive inadequate consideration for her share of the property, and she cited no legal authority to show that the administrative costs of sale should be borne by the government. The court relied on "the Government's paramount interest in prompt and certain collection of delinquent taxes" to conclude that the net proceeds from the sale of the properties should be distributed to PALS first.[17] Finally, the court held that the government would recover "more than 'a fraction of the value of the propert[ies]'" in a forced sale.[18] Thus, all factors weighed in favor of sale of the properties and distribution of the sale proceeds.

Foreclosure of Tax Liens Against Property Held by Third Parties

During this reporting period, we identified 18 cases in which the United States sought to enforce its federal tax lien against property that it claimed was nominally held by a third party. The IRM identifies the following legal theories under which a third party can be held liable for the tax liability of another: fiduciary liability, successor liability, transferee liability, and nominee or alter ego.[19] Although the "nominee" and "alter ego" doctrines frequently overlap, the nominee analysis typically focuses on the taxpayer's use and control of the property, while the alter ego analysis focuses on the nature of taxpayer's relationship to the entity with legal title to the property.[20] Nominee and alter ego situations also share common elements with fraudulent transfers but do not require transfer of legal title or that the taxpayer be insolvent for the lien to attach.[21] A tax lien attaches to property held by a third party such as the taxpayer's nominee or alter ego.[22]

In *Shaw v. United States*, the district court evaluated a delinquent taxpayer's transfer of property to a business trust under the nominee, alter ego, and fraudulent transfer theories, and found that each showed the transfer should be set aside and the tax lien enforced against the property.[23] First, in its nominee analysis, the court found that the taxpayer was the source of the funds used to purchase the property initially, and he transferred the property to the trust for no consideration. After the transfer, he continued to use the property without paying rent, and he paid for its maintenance out of an account containing solely his funds. In addition, the court emphasized that the taxpayer transferred the property to the trust in anticipation of evading his liabilities, as he explicitly stated the role of the trustee was to "protect

15 123 A.F.T.R.2d (RIA) 594 (W.D. Mo. 2019). The taxpayer and wife also objected to distribution to the county, another lien holder with priority. However, the court found that the wife was liable for outstanding property tax payments owed to the county, justifying the county's priority position in proceed distribution.

16 The taxpayer and his wife had attempted to transfer the subject properties to various trusts after the taxpayer's debts had arisen, but they conceded that those transfers were invalid during the course of litigation. 123 A.F.T.R.2d (RIA) 594 at *3.

17 123 A.F.T.R.2d (RIA) 594 at *3.

18 123 A.F.T.R.2d (RIA) 594 at *3, *citing United States v. Bierbrauer*, 936 F.2d 373, 375 (8th Cir. 1991).

19 IRM 5.17.14.1, Third Party Liability Overview (Jan. 24, 2012).

20 Alter egos typically relate to sham business entities controlled by or indistinct from the taxpayer, while a nominee is generally a third-party individual who holds legal title to property of a taxpayer while the taxpayer enjoys full use and benefit of that property. *See* IRM 5.17.2.5.7.1, Alter Ego (Mar. 19, 2018); IRM 5.17.2.5.7.2, Nominee (Mar. 19, 2018).

21 IRM 5.17.14.6, Nominee and Alter Ego Doctrines (Jan. 24, 2012). *See Holman v. United States*, 505 F.3d 1060, 1064-65 (10th Cir. 2007) (nominee lien against property purchased by nominee with money from the taxpayer is permissible).

22 *See, e.g., Fourth Inv., L.P. v. United States*, 720 F.3d 1058, 1066 (9th Cir. 2013).

23 122 A.F.T.R.2d (RIA) 6151 (D. Nev. 2018).

the trust from any third party or government agencies."[24] These factors indicated that the taxpayer still maintained use and control of the property, and thus the tax lien could be enforced against it.

Second, in its alter ego analysis, the court found that the taxpayer "showed no respect for the 'separate identity' of the corporation," as the trust did not keep records, issue quarterly reports, or even maintain a bank account separate from the taxpayer.[25] The court found the United States would suffer injustice if it treated the trust as a separate entity, as the taxpayer impoverished himself by transferring all his property to it. There was also fraudulent intent, as the transfer occurred just as the taxpayer was accruing significant tax liabilities, and the transfer was made for the purpose of protecting his assets. These factors showed the trust was a sham entity and supported the court's finding of alter ego liability.[26]

Third, the court found that taxpayer's transfer of the property was both constructively and actually fraudulent under Nevada law.[27] The court highlighted that the transfer occurred after the taxpayer reasonably should have believed he would incur debts beyond his ability to pay. Thus, the nominee, alter ego, and fraudulent transfer analyses all showed that the tax lien attached to the property, and the United States could enforce it by sale.[28]

In another case, *United States v. Orr*, the district court assessed the nominee doctrine in the context of married taxpayers.[29] The United States attempted to enforce a tax lien against a property held by a delinquent taxpayer's wife, asserting that she was his nominee. However, each had provided part of the cost for purchase of the property, weighing against nominee status. Importantly, the court noted the purchase occurred two years before the IRS assessed the tax against the taxpayer, indicating it was not in anticipation of litigation.[30] The court placed less weight on several factors that typically indicate a nominee situation because of the taxpayer's marital relationship. Although the taxpayer had a close relationship with his wife, and he possessed and enjoyed the benefits of the property, the court would "not hold it against a married couple to live together."[31] Thus, the court found that the wife was not the taxpayer's nominee. However, because the wife purchased the property with commingled funds, some of which were traceable to the taxpayer, the court found the taxpayer did have a partial interest in the property. The United States was allowed to foreclose on the property but was required to compensate the wife for her interest.

Lien Enforcement During Existence of an Installment Agreement

The existence of an installment agreement prohibits the IRS from continuing certain types of collection actions against taxpayers. For example, IRC § 6331(k) prevents the IRS from undertaking a levy against a taxpayer while installment agreement is pending or in effect. In *State Auto Prop. Cas. Ins. Co. v. Burnett*, the district court considered whether the existence of an installment agreement barred

24 *Id* at *8.

25 122 A.F.T.R.2d (RIA) 6151 (D. Nev. 2018) at *9-10.

26 The court addressed the question of whether federal or state standards should be used in the nominee analysis, and determined that the alter ego inquiry "goes not to the ownership of property (a question of state law), but rather to the question of who is liable for a tax," which should be evaluated under federal law. 122 A.F.T.R.2d (RIA) 6151 (D. Nev. 2018) at *9. However, even if state law applied, the court found the trust was the taxpayer's nominee as well.

27 Property rights are determined under state law. *See United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985).

28 Any one of these three findings would be sufficient for the lien to attached to the property and be enforced.

29 336 F. Supp. 3d 732 (W.D. Tex. 2018).

30 The court would not speculate that the couple had schemed for the taxpayer to fail to pay his income taxes that far in advance.

31 336 F. Supp. 3d 732, 760 (W.D. Tex. 2018).

the United States from enforcing its tax lien against interpleaded insurance funds.[32] The court found, "There is nothing in the IRS Code suggesting that the limitations found in the statue governing levies (§ 6331) are applicable to the statute governing liens (§ 6321)."[33] Thus, in light of the statute's plain language, as well as similar interpretations by other courts, the court held that despite the existence of an installment agreement, the United States was entitled to enforce its lien against the interpleaded insurance funds.[34]

CONCLUSION

Lien enforcement cases continue to be a frequent source of litigation and often implicate the rights of taxpayers and third parties. In particular, the National Taxpayer Advocate is concerned with the following aspects of the lien enforcement process.

First, seizure of a taxpayer's principal residence may have potentially devastating impact on the taxpayer and his or her family, especially if the taxpayer is at risk of economic hardship. As discussed in the 2018 Annual Report to Congress, the IRS is inadequately using internally available data to identify taxpayers at risk of economic hardship, which could be used to shield taxpayers from referral to the DOJ.[35] Foreclosing on a taxpayer's home when he or she is experiencing economic hardship jeopardizes the taxpayer's *right to a fair and just tax system*. While the May 2019 revisions to the IRM instruct the IRS to provide additional details in the referral including whether the action proposed would result in an inability to secure future housing or otherwise lead to an economic hardship, these provisions are simply instructions that can be modified or rescinded at any time. Furthermore, taxpayers may generally not use IRM violations as the basis for challenging IRS actions in court, leaving them little opportunity for relief at the stage of lien enforcement.[36]

Second, Collection Due Process (CDP) notice and hearing procedures described in IRC §§ 6320 and 6330 are not extended to third parties that may have an interest in property subject to lien enforcement. This deprives affected third parties, such as alleged nominees or alter egos, of the *right to challenge the IRS's position and be heard* prior to a lien enforcement suit. Allowing affected third parties the opportunity to raise defenses and propose collection alternatives in a CDP hearing could help reduce litigation by resolving these issues earlier in the process.[37]

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32 122 A.F.T.R.2d (RIA) 5407 (N.D. Miss. 2018). IRC § 6331(k)(3) prevents the IRS from referring a case to the Department of Justice "for the commencement of a proceeding in court against a person named in an installment agreement … if levy to collect the liability is prohibited under paragraph (a)(1)," but it does not prevent the United States from filing a counterclaim or defend the United States in an action under § 2410 in which the taxpayer's liability for a tax that is the subject of an installment agreement may be established.

33 122 A.F.T.R.2d (RIA) 5407 (N.D. Miss. 2018) at *3.

34 *See, e.g.*, *Am. Tr. v. Am. Cmty. Mut. Ins. Co.*, 142 F.3d 920, 923-24 (6th Cir. 1998) ("The United States Courts of Appeals that have considered the relationship between administrative levies and tax liens have recognized that a tax lien under § 6321 can attach to property that would be exempt from a § 6331 administrative levy."); *United States v. Cazzell*, 2016 U.S. Dist. LEXIS 168875, at *3 (W.D. Mo. Aug. 10, 2016) ("[W]hile the Government is precluded from using an administrative levy while an installment agreement is pending, the Government is not precluded from seeking judicial enforcement of their tax lien.").

35 *See* National Taxpayer Advocate 2018 Annual Report to Congress 228 (Most Serious Problem: *Economic Hardship: The IRS Does Not Proactively Use Internal Data to Identify Taxpayers at Risk of Economic Hardship Throughout the Collection Process*).

36 National Taxpayer Advocate 2020 Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 46-47 *(Provide Taxpayer Protections Before the IRS Recommends the Filing of a Lien Foreclosure Suit on a Principal Residence*).

37 National Taxpayer Advocate 2020 Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 48 *(Provide Collection Due Process Rights to Third Parties Holding Legal Title to Property Subject to IRS Collection Actions*).

Third, allowing the United States to seize funds through a lien enforcement proceeding while the taxpayer has a pending or existing installment agreement infringes on the taxpayer's *rights to finality* and *a fair and just tax system*. When a taxpayer enters into an installment agreement, the agreement constitutes a defined plan by which a taxpayer will address his or her liability and allows the taxpayer to create a budget for other expenses. If taxpayers continue to face the possibility that the IRS can intervene to enforce a lien against their property interests even after they enter a payment plan, they could be discouraged from entering into installment agreements. Allowing lien enforcement actions to continue is also incongruous with IRC § 6331, which prevents levies while offers in compromise or installment agreements are pending or in effect.

RECOMMENDATIONS TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that Congress:

1. Amend IRC § 7403 to codify current IRM administrative protections, including that an IRS employee must receive executive-level written approval to proceed with a lien foreclosure suit referral.[38]
2. Amend IRC § 7403 to preclude IRS employees from requesting that the DOJ file a civil action in U.S. District Court seeking to enforce a tax lien and foreclose on a taxpayer's principal residence except where the employee has determined that (1) the taxpayer's other property or rights to property, if sold, would be insufficient to pay the amount due, including the expenses of the proceedings, and (2) the foreclosure and sale of the residence would not create an economic hardship due to the financial condition of the taxpayer.[39]
3. Amend IRC §§ 6320 and 6330 to extend CDP rights to "affected third parties" who hold legal title to property subject to IRS collection actions.[40]

38 National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 46-47 *(Provide Taxpayer Protections Before the IRS Recommends the Filing of a Lien Foreclosure Suit on a Principal Residence)*.

39 *Id.*

40 National Taxpayer Advocate 2020 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 48 *(Provide Collection Due Process Rights to Third Parties Holding Legal Title to Property Subject to IRS Collection Actions)*.