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Lien on Me

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The Federal Tax Lien and Exemptions: Handling IRS Enforcement of Valid Tax Liens



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Generally, the Internal Revenue Service (IRS) is enjoined from taking collection action if taxes are discharged.¹ After an individual receives a discharge, the IRS is also precluded from issuing post-discharge collection notices, attaching and withholding the individual's wages, filing a notice of federal tax lien, or seizing property such as a tax refund. Faced with post-discharge collection actions, a taxpayer may petition the bankruptcy court for damages after exhausting administrative remedies with the IRS.²

Although taxes may be discharged, the IRS can still pursue collection post-discharge if the IRS has a valid federal tax lien and the debtor has exempt, abandoned or excluded property. With the increased homestead exemption in California and other states and large-dollar retirement accounts, expect the IRS to look to these assets to satisfy the government's lien interest. For example, suppose a taxpayer takes advantage of the new increased California homestead exemption and schedules a homestead exemption to save a house.³ Post-discharge, the IRS can force the debtor into a short-term payment plan, otherwise the debtor might face lien foreclosure. This article provides advice for guiding clients that seek to discharge taxes in bankruptcy and practical guidance to help avoid common pitfalls when dealing with IRS enforcement post-discharge.

Hypothetical Case

Suppose that a taxpayer has a balance due to the IRS of \$250,000, and the IRS issues a notice of federal tax lien with the intent to levy (seize) property. The client could offer a collection alternative, such as an offer in compromise or an installment agreement. Instead, the client files for chapter 7 and schedules \$250,000 as a priority unsecured claim owed to the IRS. The client also schedules the equity in a retirement account and personal residence as exempt property on Schedule C and receives a discharge.

After receiving a discharge, an IRS bankruptcy specialist at Field Insolvency sends a "soft letter" (Letter 4068)⁴ stating that the tax lien remains attached to the client's exempt property that he owned when his bankruptcy case began. The letter lists the tax years that the client thought were discharged and states that the IRS intends to enforce the tax lien if the IRS does not hear from the client. Now what do you do?

Collection from Exempt, Abandoned or Excluded Property

The discharge of tax debt in bankruptcy relieves the debtor of any personal liability for the debt under § 524. However, the IRS still may collect the debt from property encumbered by a prebankruptcy tax lien that remains enforceable after the case.⁵ If prepetition property survives the bankruptcy and the taxes are unpaid, the IRS can enforce the lien even though the taxpayer technically has a discharge.⁶

¹ 11 U.S.C. § 524.

² *In re Starling*, 617 B.R. 208, 211 (Bankr. S.D.N.Y. 2020) ("A taxpayer must exhaust administrative remedies under I.R.C. § 7433 and § 7430 prior to petitioning the bankruptcy court for damages.")

³ Effective Jan. 1, 2021, California increased the amount of its homestead exemption to the greater of \$300,000 or the "countywide median sale price for a single-family home in the calendar year prior to the calendar year in which the judgment debtor claims the exemption, not to exceed" ... \$600,000." Cal Code Civ. Proc. § 704.730.

⁴ The IRS uses a Letter 4068 when it intends to pursue exempt or abandoned property in a chapter 7 case. See I.R.M. 5.9.17.5.3(8) (10-10-2019).

⁵ I.R.M. 5.9.17.2(1) (10-10-2019).

⁶ *In re Isom*, 901 F.2d 744,754 (9th Cir. 1990) ("We hold that 26 U.S.C. § 6325(a)(1) does not require the IRS to release valid tax liens when the underlying tax debt is discharged in bankruptcy.")

The IRM, a must-read for lawyers handling post-discharge enforcement action by the IRS, provides the IRS's position concerning bankruptcy cases. The IRM explains that IRS Field Insolvency is tasked with closing a bankruptcy case. One issue requiring a case to remain open is exempt, abandoned or excluded property that the IRS can use to satisfy the taxpayer's liability after a discharge. The IRS's position regarding collection from exempt, abandoned or excluded property is summarized as follows: (1) upon discharge, nondischargeable liabilities can be collected from all of the debtor's property; (2) upon discharge, dischargeable liabilities can be collected from exempt property for which a notice of federal tax lien (NFTL) was filed prior to the petition date if the lien remains valid against the specific property; and (3) dischargeable liabilities can also be collected from abandoned or excluded property due to the IRS's statutory lien. An NFTL is not required to collect from excluded or abandoned property, so long as a statutory lien is in place.⁷

In the example, the tax lien survives regarding the client's excluded property, which means the equity in the client's home and the retirement account. The lien attaches to the value of any assets to which the lien attached on the petition date up to the amount of the unpaid liability secured by the lien.⁸ In addition, the lien attaches to any post-petition appreciation of the assets.⁹ Consequently, the IRS can seize the home's exempted equity and any appreciation in the home since filing for bankruptcy. While it is challenging to stop an IRS collection action post-discharge, there are a few steps that lawyers can take to help a client who is facing enforcement outside of bankruptcy.

Verify the Validity of the NFTL

The IRS's ability to collect against nonexcluded and non-abandoned property hinges on a valid NFTL. The IRS must verify that an NFTL is valid before pursuing collection on dischargeable periods with a recorded NFTL from exempt real property.¹⁰ Lawyers need to do the same by obtaining a copy of the NFTL and confirming that the IRS properly recorded the lien and that it has not expired.

Suppose that the IRS files an NFTL against the debtor's property in County A, but the debtor's residence is located in County B.¹¹ The IRS made a mistake when recording the notice, and the lien is not properly perfected. If the IRS files the NFTL in the wrong office, then it has not perfected a secured claim. If the IRS fails to file an NFTL in the appropriate place, the lien may be avoided by a bankruptcy trustee.¹²

Counsel should check the NFTL's duration, as it does not last forever, even if properly filed. The lien continues until the liability for the amount assessed is satisfied or becomes unenforceable because of the lapse of time (*i.e.*, the passing of the collection statute's expiration date).¹³ Generally, after assessment, the IRS has 10 years to collect the tax liability.¹⁴

Some circumstances, such as a taxpayer filing for bankruptcy, extend the life of the tax lien,¹⁵ but if the lien has expired, the IRS cannot take collection action. Taxpayers can check the lien's validity by obtaining the IRS account transcripts and, by using an Excel worksheet, manually computing the collections statute of limitations expiration date, often referred to as the collection statute's expiration date. A quick way to do this is to call the IRS and ask for the collection statute's expiration date for each tax year.

File an Administrative Appeal with the IRS

After discharge, IRS Field Insolvency will issue a "soft" letter explaining its intent to retain the lien and provide the taxpayer with an opportunity to pay the lien interest.¹⁶ If the taxpayer offers an acceptable amount, the IRS will adjust the taxpayer's account to zero after payment is received.¹⁷ One advantage is that the taxpayer does not pay the full balance as shown on the "soft letter" but only the equity in the excluded assets.

A debtor must respond to the "soft" letter within 30 days, or the IRS will proceed with collection by issuing a notice of intent to levy. The letter must include the collection due process (CDP) rights if a taxpayer has never been given them in the past.¹⁸ The CDP rights are only given once for each tax period,¹⁹ and they allow a taxpayer to file an administrative appeal and have the case heard by the IRS Office of Appeals. A taxpayer may stand a better chance if they appeal, as the appellate officer's mission is to resolve disputes without litigation, and fairly and impartially to the government and the taxpayer.

Given the importance of filing an appeal, counsel should investigate whether a taxpayer has CDP rights and not rely on the IRS to make this determination. For example, ask the client for past IRS correspondence, then obtain and review the IRS account transcripts for the years at issue. When the IRS has given a taxpayer CDP rights on a module, a TC 971 AC 069 will be present on the module.²⁰ If this transaction code exists on the module, it is best practice to follow up with the taxpayer and ask for copies of the correspondence to verify the transaction code.

Make a Settlement Offer with IRS Field Insolvency Unit

The client could find himself having to negotiate a payment plan with the IRS Field Insolvency Unit and the U.S. Attorney's Office to save a house. The good news is that the IRS can only collect up to the unpaid liability secured by the lien. For example, if the client owes the IRS \$500,000, but his house has equity of \$300,000, the IRS collection is limited to \$300,000, plus any post-petition appreciation of the home.

The taxpayer should provide the IRS with a written statement signed under penalty of perjury to justify the settlement offer with documentary evidence. The written statement should take into

7 I.R.M. 5.9.17.5.2(1) (12-09-2016).

8 I.R.M. 5.9.17.5.3(2) (10-10-2019).

9 *Id.*

10 I.R.M. 5.9.17.5.3(1) (10-10-2019).

11 Section 6323(f) of the Internal Revenue Code and state law determine the correct place to file an NFTL. For real property, the NFTL is filed in the one office designated by the state where the property is physically located. With respect to personal property, the situs of both tangible and intangible property is the residence of the taxpayer at the time the notice of lien is filed. *See* I.R.M. 5.17.2.3.2 (03-19-2018). Generally, the proper place to file these liens is the county in which the individual resides. *Id.*

12 11 U.S.C. § 544(a)(1), (3).

13 I.R.C. § 6322; I.R.M. 5.17.2.2.2 (03-27-2012) (duration of the federal tax lien).

14 I.R.C. § 6502.

15 I.R.C. § 6503(h) (providing that "[t]he running of the period of limitations provided in section 6501 or 6502 on the making of assessments or collection shall, in a case under title 11 of the United States Code, be suspended for the period during which the Secretary is prohibited by reason of such case from making the assessment or from collecting and — (1) for assessment, 60 days thereafter, and (2) for collection, six months thereafter").

16 I.R.M. 5.9.17.5.3(8) (10-10-2019).

17 *Id.*

18 *Id.*

19 *Id.* ("CDP rights are only required once for the taxable period and any unpaid tax [that] is subject to the intent to levy on the period.")

20 *Id.*

consideration the following factors: (1) the events precipitating the bankruptcy; (2) the debtor's financial circumstances after bankruptcy; (3) the total unpaid balance(s) of assessments of dischargeable lien periods; (4) the percentage of the unpaid balance(s) of assessments to be paid by settlement; (5) the current equity in the exempt, abandoned or excluded property; (6) the local outlook for property appreciation; and (7) the NFTL self-release date.²¹ Making a good-faith settlement offer is essential to allowing a taxpayer to keep a personal residence or retirement account, as well as to avoid IRS collection actions post-bankruptcy.

IRS Procedures for Retirement Plans

If the case involves a retirement plan, the IRS can collect dischargeable liabilities from the exempt retirement plan, as long as there is a valid pre-petition NFTL filed for the dischargeable liabilities.²² The taxpayer's options are narrower and may be limited to the following: (1) proving that the taxpayer's conduct has not been flagrant and therefore the IRS should not levy on the retirement accounts; or (2) offering a short-term payout agreement of six months.

For example, suppose the taxpayer in the aforementioned hypothetical example had a retirement plan worth \$150,000 as of the bankruptcy petition date. The taxpayer made contributions to the plan of \$25,000 after the petition date, and the current fair market value is \$200,000. The tax lien attaches to the value of the retirement plan as of the petition date and to any post-appreciation of the plan, so the lien attaches to \$175,000 (\$200,000 fair market value less \$25,000 post-petition contributions).

The IRS will likely request copies of the most recent brokerage account statements to determine the fair market value of the retirement plan. Counsel should realize that the IRS's information about the retirement plan may be limited to the information disclosed in the bankruptcy petition. There is risk in providing copies of the statements, because they provide a road map to collection should negotiations fail.

The IRS may begin discussions with a firm indication that it plans to levy the retirement accounts, but it cannot proceed with collection actions without first complying with all pre-levy guidelines in the IRM. Counsel should recognize this and politely push back when appropriate. The IRM provides that "[g]enerally, attempts to collect from retirement plans should be made only when attempts to collect from non-retirement plan assets have not been productive."²³ Further, the IRM provides that the following considerations must be weighed before proceeding with collection activities: (1) the debtor's current overall financial situation; (2) other assets available for paying the liabilities; (3) the debtor's current or imminent dependence on the retirement assets; (4) the debtor's age and health; (5) the debtor's employment history and prospects for accumulating additional assets for retirement; and (6) payment proposals submitted by the debtor.²⁴

The IRS often might not have thoroughly evaluated the above-stated factors because they handle a large volume of cases and have limited time to spend on each case. The burden falls on the taxpayer to submit a formal written statement with facts supporting his/her position.

21 I.R.M. 5.9.17.5.3(9) (10-10-2019).

22 I.R.M. 5.9.17.5.4(1) (10-10-2019).

23 I.R.M. 5.9.17.5.4(4) (10-10-2019) (insolvency levy procedures for excluded retirement plans).

24 *Id.*

Taxpayer's Flagrant Conduct

To mitigate the risk of collection, a strategic move is to prove that the taxpayer's conduct has not been flagrant. The IRS's position is that if the taxpayer has not engaged in flagrant conduct, it is not to levy on the retirement accounts.²⁵ In the example, counsel should examine the circumstances behind why the taxpayer has had a balance due for four consecutive years, 2016-19. The root cause is often a failure to adjust withholding or make timely and adequate estimated tax payments to prevent future delinquencies. The IRM states that this is an example of "flagrant conduct."²⁶ However, the IRM also notes that extenuating circumstances may exist that mitigate the taxpayer's flagrant conduct. These events could include illness, loss of employment and/or loss of a loved one, among other reasons.²⁷

Short-Term Payout Agreement

If a taxpayer is unsuccessful in stopping the IRS from collecting on an excluded retirement account, the debtor should submit a payment proposal to the Field Insolvency caseworker. The IRS must consider the information provided by the debtor showing the following: (1) the current valuation of the retirement account; and (2) that the retirement account assets are currently being applied toward necessary living expenses.²⁸ If the IRS accepts the debtor's proposal, the debtor makes the monthly installment payments until the agreed-upon amount is fully paid.

Release of Notice of Federal Tax Lien

The final step is for the IRS to file a Form 668 (Certificate of Lien Release). The taxpayer should carefully review the lien release to make sure that it covers all years. Once the lien release has been filed, the IRS will close the bankruptcy case. Consider the following: (1) obtain a copy of the certificate and verify that the tax years listed on the release are correct; (2) confirm that the IRS properly recorded the certificate in the county recorder's office; and (3) obtain the IRS account transcripts for the tax periods at issue and confirm that the transcripts show that the lien was released or reversed on the account (look for a Transaction Code 582).

Conclusion

Counsel should advise a client of the risks of IRS enforcement if a bankruptcy case involves exempt, abandoned or excluded assets. Discharging the taxes might not fully protect the debtor from future collection efforts, especially if the IRS has filed a tax lien. **abi**

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25 I.R.M. 5.11.6.3(3) (05-26-2021).

26 I.R.M. 5.11.6.3(6) (05-26-2021).

27 I.R.M. 5.11.6.3(5) (05-26-2021).

28 I.R.M. 5.9.17.5.4(9) (10-10-2019).