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How to Handle Federal Income Tax Liens in North Carolina Foreclosures

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Sooner or later, lenders who regularly conduct foreclosures of real property in North Carolina will confront the problem of what to do with **real property encumbered by a federal income tax lien**. While foreclosures over federal income tax liens are not common, they appear to be increasing as property owners hit hard by the recession increasingly have trouble paying both their federal income tax liability and their mortgages. This alert explains the interaction of federal income tax liens with recorded security interests on real property. Federal tax liens for gift and estate taxes are treated differently, and are not discussed herein.

Under **federal law, a federal income tax lien is subordinate to the lien created by the lender's deed of trust if the deed of trust is recorded** in the office of the register of deeds before the federal income tax lien is of record. **26 U.S.C. § 6323(a).** Under North Carolina's version of the **Uniform Federal Lien Registration Act,** the proper office for recording a federal income tax lien on real property in North Carolina is the clerk of superior court in the county which contains the property subject to the lien. N.C.G.S. § 44-68.12(b).

In other words, the priority of a recorded deed of trust versus a federal income tax lien on real property in North Carolina will follow the rule of "first in time, first in line" order of priority against the real property. If the real estate secured loan was closed properly by an attorney who searched title to the real estate prior to recording the deed of trust, then the lender should have been told of and not be surprised to find a prior tax lien on the collateral when it is time to foreclose. Prior federal income tax liens should be caught by the closing attorney and rectified by the property owner prior to the loan being made and the deed of trust being recorded. If there is a prior federal income tax lien of record, then the lender still may have recourse against the title insurance policy if a lender's policy was procured in connection with the loan, or against the closing attorney if the attorney provided an incorrect title opinion to the lender and the lender relied on this opinion in making the loan.

Even if the income tax lien is junior to the lien of the deed of trust, however, certain steps must be followed by the lender to ensure the income tax lien does not remain as an encumbrance against the real estate after the foreclosure is complete. Specifically, the lender must: (a) ensure the Internal Revenue Service receives a special notice of the foreclosure sale at least 25 days prior to the date of the sale; and (b) allow a period of 120 days to run from the date of the expiration of the final upset bid period to see if the Internal Revenue Service exercises its statutory right to redeem the property for the amount of the winning bid at the foreclosure sale. 26 U.S.C. § 7425(b). These requirements are explained in more detail below.

The special notice to the Internal Revenue Service must contain: (1) the name and telephone number of the person providing the notice; (2) copy(ies) of IRS Form 668(Y)(c) Notice(s) of Federal Tax Lien affecting the property to be sold; (3) a description of the real estate to be sold (including the complete physical address and legal description); (4) the date, place, terms and time of the sale of the property, or the date the taxpayer's interest in the property is terminated; (5) the approximate amount of the principal obligation, including the principal, interest, fees, and other expenses due the secured lender; and (6) if applicable, a list of the reasons the property is likely to greatly diminish in value if kept for more than 25 days, or reasons why expenses may greatly increase if kept for that period of time. IRS Publication 786.

Federal law gives the Internal Revenue Service the right to redeem the property from the purchaser of the foreclosed property within 120 days of the expiration of the final upset bid period on the property. Essentially, the right of redemption allows the IRS, at any time during this 120 day period, to automatically buy the foreclosed property from the purchaser for the purchase price paid plus statutory interest of 6% per annum and any upkeep expenses actually incurred during the redemption period. 28 U.S.C. § 2410 (d).

Because a purchaser at a foreclosure sale will have no way to confirm whether the Internal Revenue Service will assert this right until after the 120 day redemption period runs, a prospective purchaser should check prior to the foreclosure sale to see if any notices of federal tax liens were filed against the property. If so, the purchaser would be wise to ensure that proper IRS sale notices were sent prior to tendering the full purchase price for the property, and not invest in substantial improvements to the property until after the redemption period expires. Similarly, a lender who purchases property subject to the IRS's right of redemption by credit bid at the foreclosure sale should consider retaining the property for 120 days before selling it to a member of the general public. This strategy may help the lender avoid complaints by a person who purchased the property out of the lender's inventory, only to have the property redeemed by the IRS.

Potential purchasers at a foreclosure sale are advised to follow these steps even where the federal income tax lien is filed against only one spouse and the property is owned by both spouses as tenants by the entireties. While the general rule in North Carolina is that liens against real property owned as tenants by the entireties only attach to the property if the lien is against both spouses, federal law supports the IRS position that an income tax lien attaches to property owned as tenants by the entirety, even when the income tax lien is against only one spouse.

If a lender neglects to provide notice of the foreclosure sale of the property to the IRS or wishes to avoid waiting the full 120-day period, there is a possible remedy. A separate lien release application may be made to the IRS to release the lien on the real estate after the foreclosure. The IRS may agree to release the lien if, among other things, the lender can prove that there is no equity remaining in the property that the IRS may use to satisfy the federal income tax lien. IRS Publication 783. The application usually takes 30 to 45 days for the IRS to process.

In summary, a federal income tax lien on real estate in North Carolina need not be a problem of concern to a lender where the lien arose against the property after the date the lender's deed of trust was recorded. The lender need only provide proper notice of the foreclosure sale to the IRS, and be mindful of the IRS’s 120 day redemption period.

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