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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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MEMORANDUM FOR ASSOCIATE AREA COUNSEL - LAGUNA NIGUEL  
CC:SB:8:LN  
Attn: Miriam A. Howe

FROM: Alan C. Levine  
Chief, Branch 1 (Collection, Bankruptcy & Summonses)  
CC:PA:CBS

SUBJECT: IRS Claims to Proceeds of Foreclosure Sales

This advice is in response to your e-mail and attached advisory opinion concerning the above subject. This document is advisory only and is not to be relied upon or otherwise cited as precedent.

ISSUE:

Whether the Internal Revenue Service ("Service") can use an escrow demand under California state law to request payment of surplus proceeds from a trustee after a foreclosure sale, or whether the Service must use a Notice of Levy.

CONCLUSION:

The Service may use an escrow demand under California state law to request payment of surplus proceeds from a trustee after a foreclosure sale.

FACTS:

Prior to the enactment of the Restructuring and Reform Act of 1998 ("RRA 98"), the Service had often collected surplus proceeds from foreclosure sales in California by submitting an escrow demand to the trustees. Many trustees responded by requesting a Notice of Levy, since the levy gave them the protection of I.R.C. § 6332(e), whereas an escrow demand did not. The Service would issue a Notice of Levy if the trustees so requested. Now, however, pursuant to I.R.C. § 6330 the Service cannot levy without giving the taxpayer his rights to a Collection Due

Process (“CDP”) hearing. 1/ At the same time, the new provisions of California state law have imposed strict time constraints on the trustees for determining the priority of claims to the surplus proceeds. 2/ Because of the time necessary to afford taxpayers their CDP rights before a levy can be made, the Service cannot send the trustees a Notice of Levy that would permit a trustee to make a timely determination. 3/ Consequently, the trustees interplead the surplus proceeds.

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1/ Section 3401 of RRA 98 added I.R.C. § 6330 which gives the taxpayer certain CDP rights where the Service seeks to levy the taxpayer’s property.

2/ Cal. Civ. Code § 2924j(a) provides that if a trustee's foreclosure sale of real property results in surplus proceeds remaining in the hands of the trustee after the foreclosing entity is paid, the trustee must send notice to all parties who had a record interest in the property that was sold. The notice must be sent by first class mail within thirty days after the execution of the trustee's deed. In general, the notice must inform the record owners that there are surplus proceeds, and that record owners who desire to be paid their share of the surplus proceeds must submit a written claim to the trustee within thirty days of the date on which the notice is sent. In turn, Cal. Civ. Code § 2424j(b) provides as follows:

The trustee shall exercise due diligence to determine the priority of the written claims received by the trustee to the trustee's sale surplus proceeds from those persons to whom notice was sent pursuant to subdivision (a). In the event there is no dispute as to the priority of the written claims submitted to the trustee, proceeds shall be paid within 30 days after the conclusion of the notice period. If the trustee has failed to determine the priority of written claims within 90 days following the 30-day notice period, then within 10 days thereafter the trustee shall deposit the funds with the clerk of the court . . . or file an interpleader action . . . . Nothing in this section shall preclude any person from pursuing other remedies or claims as to surplus proceeds.

3/ Pursuant to section 6330(a)(1), the Service must give a pre-levy CDP Notice to the taxpayer of its intent to levy on property or rights to property, other than State tax refunds and in jeopardy levy situations, at least 30 days prior to the first such levy with respect to a tax and tax period. Temp. Treas. Reg. § 301.6330-1T(a)(3), Q&A-A5. A taxpayer must submit a written request for a CDP hearing with respect to a CDP Notice issued under section 6330 within the 30-day period commencing the day after the date of the CDP Notice. Temp. Treas. Reg. § 301.6330-1T(c)(2), Q&A-C3. If the taxpayer does not request a CDP hearing with Appeals within the 30-day period, the taxpayer will forgo the right to a CDP hearing and the Service will be free to pursue collection action

(continued...)

LAW AND ANALYSIS:

The question addressed in your advisory opinion to Compliance Services, Insolvency, is what method of collection should the Service use when trustees inform the Service that they hold surplus proceeds from the foreclosure sale of real property that was subject to a recorded federal tax lien. In essence, you concluded that the Service may not collect the surplus escrow proceeds through the use of an escrow demand, but rather that a levy must be used to obtain surplus escrow proceeds so that it does not appear that the Service is trying to circumvent the taxpayer's CDP rights under section 6330. Compliance disagrees with your conclusion and instead believes that an escrow demand should be used in lieu of a levy. Accordingly, Compliance has requested that you reconsider your advisory opinion.

Your conclusion is based on question and answer (Q&A) 3.2.4 which is posted on the National Resource Center RRA '98 Support homepage. <sup>4/</sup> Q&A 3.2.4 reads as follows:

**Q. 3.2.4:** Often in foreclosure sale cases the sale of the property produces excess proceeds and we receive requests from the trustee for a demand for payment. We used to make our demand in the form of a levy. We understand that levies are third party contacts and now wish to make our demands informally, through a written request we call an escrow demand. We have two questions. 1. Must we use a levy to make the demand or may we simply write the trustee and ask for the money? 2. If we may do as the trustee asks and simply

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<sup>3/</sup>(...continued)

at the conclusion of the 30-day period following the date of the CDP Notice. Temp. Treas. Reg. § 301.6330-1T(c)(2), Q&A-C7. If the taxpayer requests a CDP hearing under section 6330(a)(3)(B), the CDP hearing will be held with Appeals. There is not a time limit on the CDP hearings or on when Appeals must issue a Notice of Determination, however, Appeals will attempt to conduct the CDP hearings as expeditiously as possible. Temp. Treas. Reg. § 301.6330-1T(e)(3), Q&A-E8. The taxpayer may appeal determinations made by Appeals within 30 days after the date of the Notice of Determination to the Tax Court or a district court of the United States, as appropriate. Temp. Treas. Reg. § 301.6330-1T(f)(1). Section 6330(e)(1) suspends levy actions for the period during which the CDP hearing and any appeals therefrom are pending.

<sup>4/</sup> In your advisory opinion you quote Q&A 9 which was dated May 21, 1999. It has since been renumbered to Q&A 3.2.4 and the text in the answer was revised on September 3, 1999. The revision does not affect your conclusion, nevertheless, your advisory opinion should be updated accordingly.

submit a written request (or claim) for the money, is that request a contact within the meaning of section 7602(c)?

**A. 3.2.4 (rev. 9/3/99):** As to the first question, a levy must be used to obtain the money from the third party trustee. Using a levy gives the taxpayer rights to a due process hearing (assuming it is the first levy) and therefore not using a levy in situations where a levy has previously been used gives the appearance that the Service is trying to circumvent the taxpayer's rights under the new due process provisions. Using a levy also protects the rights of other third parties who may have a claim to the proceeds because it allows them to bring a wrongful levy action. Since a levy must be used, the second question is moot.

When question 3.2.4 was posed it dealt with situations where prior to the enactment of section 6330 a levy had been used to reach surplus escrow proceeds. The amended answer, after the effective date of the CDP provisions, advised that a levy be used in these situations in order to avoid the appearance that the Service was trying to circumvent the taxpayer's CDP rights under section 6330. <sup>5/</sup> However, from a legal standpoint, an escrow demand may be used if permitted under state law. Section 6330 added notification and appeal rights to the filing of liens and decisions to levy; it was not intended to foreclose the Service from exercising the rights of any other creditor under state law procedures, as opposed to procedure

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<sup>5/</sup> At the same time, we held the position that an escrow demand be used in situations where the administrative practice prior to the enactment of section 6330 was to use an escrow demand.

under federal law. 6/ Nonetheless, except as provided below, we advise that a levy still be used in these situations for the reasons stated in answer 3.2.4.

In the instant case, we recognize that using a levy to reach the surplus proceeds within the time constraints imposed by section 2924j is not feasible because of the time required to afford the taxpayer his CDP rights. As noted above, pursuant to section 6330, the Service cannot issue a Notice of Levy to the trustee during the 30-day period commencing the day after the date of the CDP Notice. If the taxpayer requests a CDP hearing, then levy action continues to be suspended for an indefinite time during which the CDP hearing and any appeals therefrom are pending. At the same time, pursuant to section 2924j, if the trustee cannot determine the priority of claims to the surplus proceeds within 90 days following a 30-day notice period, then within 10 days thereafter the trustee must file an interpleader action or deposit the funds with the clerk of the court. The discord between the suspension on levy pursuant to section 6330 and the time constraints of section 2924j has led to an increase in interpleader cases. 7/

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6/ The Senate Committee Report addressing the reasons for section 3401 states:

The Committee believes that taxpayers are entitled to protections in dealing with the IRS that are similar to those they would have in dealing with any other creditor. Accordingly, the Committee believes that the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property.

...

The provision establishes formal procedures designed to insure due process where the IRS seeks to collect taxes by levy (including by seizure).

Senate Committee Report (S. Rep. No. 105-174).

7/ To avoid any potential liability trustees have been filing interpleader actions in cases where the Service has a tax lien on foreclosed property and fails to respond in a timely fashion with a Notice of Levy or written claim. However, pursuant to section 2924j(b), the trustee is only required to file an interpleader action where it has failed to determine the priority of "written claims." Thus the Service gives up its claim to the surplus proceeds where it fails to submit a written claim to the trustee and where there is no dispute as to the priority of the "written claims" submitted to the trustee.

The use of escrow demands by the Service will reduce the number of interpleader cases and protect the Service's claims to surplus proceeds. For these reasons, using an escrow demand to collect the surplus proceeds is permissible. 8/ The Service is not attempting to bypass the taxpayer's CDP rights because the Service has a legitimate business reason for using an escrow demand rather than a levy. Although an escrow demand does not provide third parties with the same rights as a levy (wrongful levy action), third parties will have a remedy under state law in the event of a dispute over the funds. 9/ Cal. Civ. Code § 2924j(b)-(d).

If you have any further questions, please contact Branch 1, Collection, Bankruptcy & Summonses, at (202) 622-3610.

cc: Area Counsel, Los Angeles (CC:SB:8)

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8/ An escrow demand constitutes a third party contact under section 7602(c) because it is a communication to a person other than the taxpayer seeking information with respect to the collection of the taxpayer's liability.

9/ The Service will also have to avail itself of a state law remedy rather than the more desirable remedy under the Internal Revenue Code (action to enforce a levy) if the trustee refuses to comply with the escrow demand.