

**Office of Chief Counsel  
Internal Revenue Service**  
memorandum

CC:PA:04:RMFerguson  
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to: Director, Collection Policy  
(Small Business/Self Employed)

from: Chief, Branch 4  
(Procedure & Administration)

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subject: As a condition for issuing a certificate of discharge in a short sale situation, may the Service require that it be paid the sum that otherwise would be applied to junior real estate transfer taxes

For the reasons discussed below, we conclude that where short sale conditions apply, the value of the Service's tax lien interest in the subject property is zero. Accordingly, the Service cannot require payment of the sum that otherwise would be applied to junior real estate transfer taxes as a condition of discharge.

Background

A short sale occurs when a lienholder agrees to accept less than the total amount owed as satisfaction for its lien claim. For example: Bank has a priority mortgage claim for \$600,000.00. Due to the significant decline in the property market, Bank agrees to a sale of the mortgaged property for \$300,000.00. Bank allows sale expenses of \$10,000.00 to be paid from that \$300,000.00, which includes \$2,000.00 for real estate transfer taxes. Thus, the Bank is agreeing to accept \$290,000.00 in satisfaction of its original \$600,000.00 mortgage. The Service has a federal tax lien claim on the property that is second in line to the mortgage.

An issue has come to our attention regarding conditioning the issuance of a certificate of discharge in the short sale scenario per IRM 5.12.3.14.3 (09-07-2006) upon payment of the sum that otherwise would be applied to junior real estate transfer taxes. This IRM provision provides in relevant part as follows:

Applications for Discharge Which Include Requests for Payment of Real Estate Transfer Tax. ...In cases where a filed notice of federal tax lien has perfected the interest of the United States in such property, the Service is asked to issue a certificate of discharge of federal tax lien to allow payment of the state's claim at closing. It is the Service's position that such taxes have no priority status under I.R.C. § 6323(b)(6) against the filed notice of federal tax lien. ... Priority of the

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federal tax lien is defined exclusively in I.R.C. § 6323. Under no circumstances will a discharge of federal tax lien be issued for less than the full value of the Service's claim on the equity in the subject property. The transfer tax will not be accorded priority status or treated as an expense of sale. Applications that include such provisions will be rejected.

This IRM provision does not specifically provide for the short sale scenario. Returning to the facts of the example, however, we understand that this provision has been construed in the short sale context to provide that, following satisfaction of the bank's lien claim for \$290,000.00, and allowing priority for \$8,000.00 as ordinary expenses of sale, the \$2,000.00 attributable to real estate transfer taxes becomes taxpayer equity reached by the federal tax lien. Under this interpretation, the Service can condition discharge of the subject property from the federal tax lien upon payment by the taxpayer of the \$2,000.00. As discussed below, the Service may not condition discharge upon such payment.

### Discussion

The authority of the Service to issue a certificate of discharge of property subject to the federal tax lien is found in I.R.C. § 6325(b). The exercise of that authority is always within the discretion of the Service. However, the Service will generally issue a certificate of discharge where its lien interest is otherwise satisfied, or where the interest of the United States in the property to be discharged has no value. Among other conditions, the Service may issue a certificate of discharge upon receipt of an amount determined to equal the value of the interest of the United States in the property to be discharged (section 6325(b)(2)(A)) or at any time when the interest of the United States in such property is determined to have no value (section 6325(b)(2)(B)). See also Treas. Reg. § 301.6325-1(b)(2).

We disagree with the conclusion that the designation by the senior lienholder of some of its proceeds to be used to pay real estate transfer taxes in connection with short sales of real property somehow creates an equity interest in the property on the part of the taxpayer. Rather, these are expenses that the senior lienholder agrees to carve out of its priority lien claim as a matter of business prudence in order to facilitate the sale. Because this does not create an equity interest on behalf of the taxpayer that is subject to the federal tax lien, the authority of the Service to issue a certificate of discharge is under section 6325(b)(2)(B), where the interest in the United States is valueless. The Service has no authority under section 6325(b)(2)(B) to require payment of the sum that otherwise would be applied to junior real estate transfer taxes as a condition of discharge. Because the interest of the United States is valueless, the result would be the same even if the senior lienholder was choosing to use a portion of its mortgage proceeds to pay a junior creditor of the taxpayer (such as payment of homeowner's association fees). Note that, had the bank requested a discharge prior to sale of the property, discharge would clearly have been authorized under section 6325(b)(2)(B), assuming the taxpayer would be divested of all interests in the property.

The analysis of IRM 5.12.3.14.3 is based upon the assumption that, unlike in the short sale context, the interest of the United States in the subject property has some value, such that issuance of a certificate of discharge can be conditioned upon payment of that value, in accordance with section 6325(b)(2)(A). The IRM provision is correct that the superpriority for certain types of real property taxes and special assessment liens under section 6323(b)(6) does not apply to real estate transfer taxes. The concern about giving real estate transfer taxes improper priority over the federal tax lien is that proceeds that should otherwise be paid to the Service are being diverted to pay a junior lienholder, under the guise of being ordinary expenses of sale. This analysis is inapplicable in the short sale scenario. Where the bank's senior claim is not fully satisfied and the Service's lien interest is zero, none of the proceeds that the bank is allowing from its claim to be used to pay transfer taxes are otherwise payable to the Service, regardless of whether those funds are going to a junior creditor.

In the non-short-sale situation, where the lien claim of the bank is fully paid, and the federal tax lien attaches to the surplus proceeds, the Service's lien interest must be satisfied before it can be discharged from the property, in accordance with I.R.C. § 6325(b)(2)(A). Under these facts, we would agree that a junior creditor of the taxpayer (such as a homeowner's association) is not entitled to payment from these proceeds before the Service's lien interest is full paid.

We will work with your office to revise IRM 5.12.3.14.3 to clarify its application in short sale situations. If you have any further questions, please feel free to call Branch 4, Office of the Associate Chief Counsel (Procedure & Administration), at (202) 622-3630.

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