CONTINUING EDUCATION

Foreclosures, Short Sales, Tax Liens, and Bankruptcies

6 Hours   Course #120

CALicenseRenewal.com

Kim Nash

Table of Contents

Chapter 1: Introduction

The recent economic downturn has reinforced the importance of understanding the effect financially-distressed homeowners can have on the real estate market, as well as the importance of having a working knowledge of the many different aspects of distressed property sales.

In the recent downturn, the foreclosure rate first began to escalate between 2006 and 2007. While the entire nation suffered from falling housing prices and rising foreclosure rates, several states have consistently ranked high on the list of states with the highest levels. For example, in 2007, the states of California, Florida, Texas, Michigan and Ohio together accounted for more than 50% of all of the country's foreclosures.

What caused this so-called foreclosure crisis? There were several reasons why the foreclosure rate in the country increased so dramatically during the downturn. Many people who purchased their homes prior to the housing crash did so with borrowed money, in many cases 100% financing, often with negative amortization and low if not non-existent underwriting standards. The result? When payments escalated, the borrowers were unable to make the payment. Many lenders issued loans without verifying income. They did not bother to do this because, at the time, it seemed as if prices would only rise.

Many people literally walked away from their homes, either unable or unwilling to make payments on a home worth far less than what was owed. Others listed their homes for short sale. Both tactics resulted in a glut of houses on the market and a further deterioration in housing prices. Many walked away even if they were able to make the payment because, in most circumstances, a home mortgage is considered "non-recourse." That means the bank or other lender's sole recourse is to take the home back and sell it. The lender cannot go after the homeowner personally for damages. The one sticking point in this process for the homeowner has been the possibility of a tax liability. Federal tax law generally provides that the forgiveness of debt, either through a foreclosure or a short sale, is considered taxable income. This tax law has been addressed by Congress, as well as many states that have attempted to help struggling (and inadvertently "non-struggling") homeowners.

I. <u>The ABCs of Foreclosure</u>

While many people are familiar with the term "foreclosure", most do not understand the technical process involved. This section will provide a very cursory overview. Remember, however, that the law of foreclosure is a creature of state law. Therefore, the specific rules in New York will be different than those in Texas, Florida, California and the rest of the nation. Many are similar, but whenever you are looking at specific foreclosure rules, remember to look to the laws of the state in which the property is located.

Simply put, foreclosure is the legal process by which a lender seeks to retake ownership of property when the borrower ceases making payments on their mortgage pursuant to the terms of the note. The lender then sells the property via auction and retains the proceeds to cover the amount of the outstanding loan.

Properties are considered to be in pre-foreclosure from the filing of the initial Notice of Default until the property is sold at auction. During this period investors can purchase the home directly from the owner, realtors can list the home, and lenders can help them refinance.

A. TYPES OF FORECLOSURE

There are two main types of foreclosure, judicial and non-judicial. Keep in mind that this is just an overview, and that the laws of each state govern the foreclosure process.

1. <u>Judicial Foreclosure</u>

The process of judicial foreclosure requires going to court and getting a decree, which therefore takes longer (12 to 18 months) to process than a non-judicial foreclosure (4 to 12 months). States that use judicial foreclosure issue lenders a mortgage. This term is often used generically to refer to any home loan, although in the case of a non-judicial foreclosure, lenders actually receive a deed of trust.

In the case of a judicial foreclosure, the lender files suit in court based on the mortgage. The mortgage is the contract in which the borrower agrees to use the property that is the subject of the loan as collateral. A mortgage is a legal contract in which the borrower secures a loan by using the property as collateral. When the borrower fails to make payments, the lender is forced to take legal action to collect the amount due. The lender will typically send multiple notices to the borrower requesting information about the missed payments in an attempt to work with the borrower to bring the loan current. When these efforts fail, the lender will hire an attorney to initiate foreclosure.

At this stage, the attorney will file several legal documents including a lis pendens, which is a public notice indicating legal action is pending on the property. If the borrower fails to respond to the complaint, the attorney submits a report to the court with the facts of the case. The judge will then issue a Judgment of Foreclosure and Sale in favor of the lender. At this stage, an auction sale is advertised according to the local statutes.

2. <u>Non-Judicial Foreclosure</u>

In the case of a deed of trust, the process of foreclosure does not take as long as its judicial counterpart because title technically remains with a trustee (not the homeowner) until the note has been paid in full. That is where the term “deed of trust” comes from. In addition, the lender has the right to sell the property in the case of a delinquency, so long as specific notice requirements are met. When the borrower fails to make payments as required by the note, the trustee records a Notice of Default, a copy of which must be sent to the borrower. If the borrower fails to catch up within a certain period of time, the trustee will then issue a Notice of Trustee Sale. The Notice of Trustee Sale is advertised to the public for a required period and if the borrower does not bring the loan current, the property is auctioned to the public, normally on the courthouse steps.

Bank owned properties which receive no bids at auction, result in the bank taking ownership. These properties are commonly referred to by the banks as REO's (Real Estate Owned). Investors can purchase these properties directly from the bank; and realtors can solicit the listing, since banks will almost always market the property for sale.

B. THE SECOND STAGE OF FORECLOSURE: HOME AUCTIONS

The home auction is the stage of the foreclosure process in which the default pre-foreclosure phase of the property has ended. The lender is now seeking to recapture its losses by auctioning the property in a public sale to the highest bidder. This event may also be known as a trustee sale.

The proceeds from the real estate auction will be disbursed to the lender who initiated the foreclosure action, which in most cases is the lender holding the first mortgage. Once the first mortgage holder's position has been satisfied, any additional funds will be used to settle any other remaining obligations. If all encumbrances against the property are resolved, any additional funds will be disbursed to the homeowner.

1. Cash for Keys

A buyer or lender at the foreclosure sale may offer cash to the prior owner or renter to move quickly and leave the property clean. Cash for keys arrangements give occupants the resources to find new housing and is a great way to avoid the time and processing of an eviction. This is presumed to be income as it is not forgiveness of debt and, therefore, not encompassed within the tax relief provisions of federal law.

2. The Opening Bid

Prior to the auction, the trustee establishes the opening bid. The opening bid is determined by totaling the remaining loan balance, court costs, interest, back taxes, legal fees, and liens and judgments. The winning bidder will normally satisfy all these expenses at closing. If no one bids above the opening bid, the lender will take back the property at which point it is added to the list of bank foreclosures, also called REO properties. Depending on how the original mortgage was guaranteed by the lender, the property title may instead transfer to a government service enterprise. In this case, it will join the inventory of government repossessed homes and join the list of HUD homes and VA foreclosures.

3. Deficiency Judgment

If the proceeds from the foreclosure sale are not enough to pay off the lender, then the borrower may be liable for any deficiency. Depending on state laws, a deficiency judgment that is not resolved can result in the previous homeowner experiencing garnished wages, seized assets, and even federal income tax levies. California foreclosure laws, particularly the One-Action Rule and the prohibiting of deficiency judgments in non-judicial foreclosures, result in relatively few deficiency judgments. The major exception is when there is a sold-out junior lienholder. Since this lender no longer has a security interest in the property, their primary course of action is to sue the borrower for the unpaid amount.

4. Income Tax

A prior owner may receive a Form 1099 for the *forgiven debt* in the amount of the deficiency between the amount owed and the amount recovered at auction. Though recent changes in the law have eased the burden, this forgiven debt may be treated as income, resulting in state and federal income tax.

The owner may also be responsible for capital gains tax, though, due to the substantial reduction in home prices during the past several years, this is unlikely to affect the majority of borrowers in foreclosure.

Tax implications are a critical consideration for homeowners in foreclosure, or those considering a short sale. Realtors should urge clients to consult a qualified tax professional for advice on their particular situation.

5. Bankruptcy

Many homeowners will find themselves facing bankruptcy after foreclosure, perhaps because the lender received a deficiency judgment against the borrower, or because a second loan remains outstanding against the borrower after the foreclosure of a senior loan (even though that lender lost its secured interest in the property). Borrowers should fully understand these risks prior to allowing a loan to foreclose on their property.

C. BUYING FORECLOSURES FROM BANKS

Another great opportunity to purchase foreclosures is after the real estate auction, when the lender is either the successful bidder or there are no bids at all. In either case, the bank becomes the legal property owner and the property is considered a non-performing asset of the bank. When ownership is transferred to the bank as a result of foreclosure, these homes are classified as bank foreclosures or REO foreclosure properties. They are added to the lender's REO list of homes to sell. At this stage, the key point to remember is that banks typically are not in the business of managing real estate, nor do they want to be. This can create a solid opportunity to buy property at a great price.

D. GOVERNMENT REPOSSESSED HOMES ARE SOLD TO THE PUBLIC

HUD homes and government property are quite similar to bank owned properties. As a result of foreclosure, HUD homes and government repossessed homes have had their title transferred to the government. This inventory of hard assets produces no taxpayer return unless it is liquidated. So, like banks, the government is equally motivated to sell its distressed real estate. Government repossessed homes include residential and commercial property from the federal, state and local governments. The primary government agencies that sell home foreclosures or distressed assets to the public are discussed below.

1. <u>Where Do Government Repossessed Homes Come From?</u>

a. HUD (The U.S. Department of Housing and Urban Development)

The largest number of government foreclosures can be found through HUD. HUD is a federal agency that implements housing policy and was created to increase home ownership across the U.S. HUD accomplishes this by insuring loans for people with low down payments or that don't meet standard credit requirements. The bottom line is that HUD loans are higher risk loans, and therefore have a higher default rate.

When HUD homes are foreclosed, the properties are sold to the public. Since the foreclosure is insured by HUD, the government is required to pay the lender the amount due on the loan. Once the loan is paid off, HUD takes possession of the property and can dispose of it in any reasonable manner. In order to bid on a HUD foreclosure, you must submit the bid through a designated HUD broker. Normally, HUD homes are sold during an Offer Period. At the end of the Offer Period, all offers are opened and, basically, the highest reasonable bid is accepted. If your bid is accepted by HUD, your local agent will be notified, usually within 48 hours.

b. VA Foreclosures (Veterans Administration Loan Guaranty Service)

The objective of the VA Loan Guaranty Service is to help veterans and active duty personnel purchase and retain homes in recognition of their service to the United States. Similar to HUD, the VA guarantees the home loans allowing veterans to purchase on more favorable terms. The VA acquires properties as a result of foreclosure on VA guaranteed loans. Unlike the VA loan program, you are not required to be service personnel to purchase VA foreclosures. In fact, you are not even required to be an owner-occupant, which is beneficial to investors. Once you have found a home that you are interested in purchasing and want to make an offer, you will need to have an agent prepare the "Offer to Purchase and

Contract of Sale" VA form, together with all necessary documentation. In turn, your agent will submit your offer through the listing broker for approval.

c. Fannie Mae Foreclosure (Federal National Mortgage Association)

Fannie Mae's public mission is to help more families achieve the American dream of home ownership. It does this by providing financial products and services that make it possible for low, moderate, and middle-income families to buy homes of their own. A Fannie Mae foreclosure is a home that originally had a conventional mortgage, which was sold to Fannie Mae, and then resulted in foreclosure. At that point, Fannie Mae owns the property and will attempt to sell it to recoup the original mortgage. All Fannie Mae-owned homes are sold through local brokers, so your qualified real estate broker can assist you in submitting a bid.

d. Freddie Mac (Federal Home Loan Mortgage)

Freddie Mac is a publicly traded corporation chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of home ownership and rental housing. Freddie Mac’s goal is to maintain stability and affordability in all the various types of housing markets throughout the U.S. One of the ways that Freddie Mac is able to achieve this is by providing special financing services through a select group of lenders who are skilled at helping buyers find the right financing to meet their needs. The special financing includes low down payment programs as well as reduced closing costs.

e. FDIC (Federal Deposit Insurance Corp.)

The FDIC preserves and promotes public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for up to $250,000. Since the start of FDIC insurance on January 1, 1934, no depositor has lost a single cent of insured funds as a result of a bank failure. When a financial institution does fail, the FDIC steps in as a receiver and services the existing loans of the bank. When a borrower refuses to pay or to provide the necessary financial information, the FDIC has no choice but to seek recovery through foreclosure. All FDIC properties are sold in "As Is" condition. All FDIC properties will include the appropriate contact information for submitting a bid on distressed real estate.

f. GSA (Government Services Administration)

The GSA is responsible for promoting effective use of federal real property assets, as well as the disposal of real property that is no longer mission-critical to federal agencies. This property can include single and multi-family residences, undeveloped land and even commercial and industrial facilities. GSA can dispose of surplus property via a competitive sale to the public, generally through a sealed bid or auction. Since 1987, GSA has sold over $3 billion worth of property across the United States.

II. Deals Involving Tax Defaulted Properties

When a homeowner is delinquent on property taxes owed to the local taxing jurisdiction, the agency will enforce its right to collect the amounts due through a tax sale. Tax sales are a mechanism used to collect delinquent property taxes, so the local government can deliver the services and benefits it has promised to the citizens. This is generally accomplished through a public auction, where the local government sells either a Tax Deed or a Tax Lien.

A. TAX DEED SALE

The first process is called a Tax Deed Sale**,** where after legal requirements are met, the property is offered for sale at a public auction. Generally, minimum bids will be set at the sum of accumulated back taxes, plus interest, and transaction costs associated with selling the tax defaulted properties.

Those states that offer a tax deed sale generally wait a number of years before they sell the property. However, when the property is ultimately sold at auction, the sale is usually final and the owner has no right of redemption. However, there are exceptions to this rule, so it is important to perform proper due diligence in each jurisdiction. For example, the state of Texas provides a 6-month redemption period where the former home owner can reclaim the property by fulfilling certain requirements. Additionally, the state of Tennessee allows a full year of redemption.

Over half of the states in the U.S. use a form of tax deed sale. Those jurisdictions that have tax deed sales will sell fewer properties at the tax deed sale than jurisdictions with tax lien sales. This is due to the fact that tax deed states usually require a much higher price for the property than you would end up paying for the same property in a tax lien state.

Tax deed sales are ideal for investors who want to own real estate. Contrary to a tax lien auction, the winning bidder at a tax deed auction purchases the deed to a piece of property, becoming the new owner and obtaining all rights to the property, clear of any mortgages, liens or deeds of trust. For most people investing in tax properties for sale, the key objective is to buy low and sell high. As with any real estate purchase, it is critical that you research the property and understand the value of the property before submitting a bid. Without the proper analysis, you risk paying more for the property than it is worth.

B. TAX LIENS SALES

Those states that have Tax Liens Sales (sales with a redemption period for the owner) take a different approach. Rather than waiting several years to collect delinquent taxes via a tax deed sale, tax liens states sell tax lien certificates that are investment documents which are transferable to third party investors.

Similar to tax deed sales, tax liens sales are performed through a public auction. The buyer of a tax lien is buying the rights of the taxing jurisdiction to receive interest, penalties and costs. The security for this investment is that the buyer holds the right to acquire the property if he is not paid before the expiration of the redemption period. This makes the potential upside of tax liens a very attractive investment. However, it is important to note that the national tax lien redemption rate is approximately 95%. This means that investors will usually not end up with the property, but will make a return on their investment that is quite attractive.

To summarize the opportunity with tax liens sales, there are generally two ways to profit. The first opportunity is when the property owner redeems the lien and the investor is compensated with interest and penalties. Again, this can be at a very lucrative interest rate depending on the jurisdiction. The second opportunity is when the property owner does not redeem and the investor receives title to the property and becomes the new owner. The opportunity to receive title to the property can make investing in a tax lien property for sale a very exciting and profitable opportunity.

III. <u>Short Sales</u>

A. WHAT IS A SHORT SALE?

A short sale refers to a transaction when a buyer can purchase a home for less than the remaining loan amount. The advantage is the short sale buyer can save a significant amount on the purchase price, as long as the buyer is willing to take part in a more complicated transaction. The transaction is more complicated because it requires both the lender and the homeowner to agree to the purchase price, as opposed to a "normal" sale when the homeowner can make that decision on their own. This is because the lender will receive less money from a short sale than they would have received if the homeowner paid the full amount of the loan.

B. WHO BENEFITS FROM SHORT SALES?

All parties involved in the transaction benefit. The lender benefits by avoiding the costs of foreclosing on the property, which are often higher than taking the loss on the loan. The homeowner benefits by avoiding a foreclosure, which can damage his or her credit history and raise the costs of borrowing money in the future. The buyer benefits by purchasing the distressed real estate at a discounted price, since the homeowner and lender are both highly motivated sellers.

C. WHERE DOES A SHORT SALE BUYER BEGIN?

There are two things to keep in mind when thinking about doing a short sale. As the buyer, you need to approach the homeowner to start the short sale process. This is because the majority of banks will agree to a short sale only after the homeowner has received a formal offer. Also, make sure that there is a pre-workout agreement, or short sale package, between the lender and the homeowner. This agreement helps make sure the short sale negotiations will go smoothly.

D. CREATING A SHORT SALE HOUSE

First, locate a property where the debt of the homeowner is more than the amount the property can be sold for. Approach the homeowner and make a formal offer on the property. Keep in mind a short sale can take anywhere between 1-6 months to complete. You'll need to line up a set of documentation to submit before a short sale can be approved. These documents generally include: a short sale application, tax returns, pay stubs, a hardship letter, a purchase agreement from the buyer, financial statements, and payoff letters from all lenders involved. After submitting the documentation, it generally takes 2-6 weeks to receive lender feedback on the application. Don't be discouraged by the wait. Remember, the goal of the short sale buyer is to obtain property at an amazingly low price. It's worth the wait.

E. PRE-WORKOUT AGREEMENTS

Most lenders require a pre-workout agreement prior to starting workout negotiations. Pre-workout agreements can take a variety of forms that range from a brief letter to a detailed contract that lays the foundation for future negotiations between the defaulting borrower and the lender. A well-written agreement establishes the history of the loan and the procedure for negotiating the short sale. It protects the borrower by preventing the lender from pursuing foreclosure on the property during the workout and allows the lender to avoid potential lender liability claims and defenses against their right to foreclose.

F. SHORT SALES AND TODAY'S MORTGAGE CRISIS

Today's mortgage crisis is leading to an increase in the number of short sales and presenting wonderful buying opportunities for the willing buyer. Declining home values are causing a huge drop off in home equity (the property's market value minus the loan amount) and homeowners are struggling to meet their monthly payments due to mortgage interest rate hikes. Distressed homeowners are no longer able to refinance their way out of unmanageable loans. We are seeing historically high foreclosure rates across the country due to eroding home values and problems in the credit markets.

The Mortgage Forgiveness Debt Relief Act was recently passed by the federal government to help address this growing problem. Prior to its passage, the amount forgiven in a short sale was reported as taxable income. Now, distressed homeowners don't need to worry about income tax liabilities when considering short sales. This legislation is leading more people to take the short sale route and as a result, providing the buyer with a larger pool of discounted properties to choose from.

IV. <u>Actions That Can Delay The Sale</u>

There are several ways that a sale can be delayed. However, no matter what the reason is for the postponement, a new notice of trustee sale must be posted and filed if the sale is postponed for more than 365 days. The following are things that can delay a sale:

A. BANKRUPTCY

When a homeowner files for bankruptcy protection, it puts an automatic stay on all debt collection actions, including foreclosure. Note that bankruptcy does not stop foreclosure, as many believe. Instead, it simply delays the sale of the property until the homeowner resolves the debt, or in many cases, the lender gets approval from the bankruptcy court to continue the sale - an order granting motion for relief from stay. The bottom line is that a home is a secured debt, and the lender has the right to take the security (the home) if the homeowner lacks the ability to pay the debt as agreed. Bankruptcy is only an effective tool against foreclosure if the homeowner will have sufficient income to pay their home loan and make up past due amounts once the bankruptcy plan is completed.

B. BENEFICIARY'S REQUEST

A beneficiary’s request is a decision by the lender (beneficiary) to postpone the sale. It could be for any reason, including that they simply aren't prepared to take the property to sale, or because they have reason to believe they are about to be paid (a closed escrow for which they have not yet received payment, for example).

C. TRUSTEE'S DISCRETION

A trustee, in their discretion, can decide to postpone the sale. The most typical reason is that they are unable to reach the lender for sale instructions.

D. OPERATION OF LAW

This is fairly rare, but used when a court orders the postponement of the sale. The most likely reasons for a court to make such an order would be in cases where there is a plausible allegation of fraud against the lender, or there are questions of material fact around the right of the lender to foreclose.

Chapter 1 – Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive credit. They are included as an additional tool to enhance your learning experience.

1. California, Florida, Texas, Michigan and Ohio were responsible for more than _____ of the foreclosures in the U.S. in 2007.

   a) 30%
   b) 40%
   c) 50%
   d) 60%

2. What is the difference between a judicial foreclosure and a non-judicial foreclosure:

   a) a non-judicial foreclosure generally takes longer than a judicial foreclosure
   b) a non-judicial foreclosure does not involve the filing of legal documents
   c) as long as the required notice is properly accomplished, the lender is able to sell the property in a judicial foreclosure when payment is delinquent
   d) the trustee holds the title instead of the homeowner in a non-judicial foreclosure

Chapter 1 – Review Question Answers

1. C: 50% - see page 3

2. D: the trustee holds the title instead of the homeowner in a non-judicial foreclosure – see page 4-5

Chapter 2: Bankruptcy and Foreclosure

Filing for bankruptcy protection usually gives a debtor immediate relief from all demands for payment and collection enforcement actions. This can have an effect on both foreclosure proceedings and a short sale. We will begin this chapter with an overview of how bankruptcy affects short sales and foreclosures, and then provide an overview of the most common chapters that individuals seeking protection choose when filing for bankruptcy.

Bankruptcy, unfortunately, is not uncommon. For the first half of 2012, there were over 600,000 noncommercial bankruptcy filings in the United States.

Table 2.1 Effect of Filing Bankruptcy on Foreclosure

Foreclosure Proceedings	Will be temporarily stopped
Credit Rating	Bankruptcy will remain on creditor's record for 10 years
Lateness of Mortgage Payment	Even being one day late on a payment can result in the dismissal of the bankruptcy and a lifting of the stay
Repayment or Missed Mortgage Payments	Debtor must still repay

I. Bankruptcy, the Cancellation of Debt and Taxes

As we said at the beginning of this course, the cancellation of debt is normally considered taxable income to the debtor and they are not relieved of the obligation to repay. There are some exceptions.

The exceptions include:

- The cancellation of a student loan for a student required to work for certain employers;
- The cancellation of debt that would have been deductible if paid; and
- The reduction of a debt by the seller of property if the debt arose from the purchase of the property.

Additionally, a taxpayer should not include a cancelled debt in gross income if any of the following situations apply:

- The cancellation takes place in a bankruptcy case under the U.S. Bankruptcy Code;
- The cancellation takes place when the debtor is insolvent;
- The cancelled debt is qualified real property business indebtedness; or
- The cancelled debt is qualified principal residence indebtedness.

In general, therefore, debts discharged through bankruptcy are not considered taxable income.

A. EFFECT ON FORECLOSURE

Can homeowners facing the prospect of losing their property use bankruptcy to prevent foreclosure? Bankruptcy can be used to stop foreclosure, at least temporarily. Bankruptcy only "stops" foreclosure, however; it cannot reverse the process. Also, bankruptcy does not eliminate a lender's right to foreclose if the money owed is not repaid. That means, a homeowner in financial distress who opts for bankruptcy protection may still likely be forced to repay some of the debt. Depending on the type of bankruptcy and the type of property, homeowners may be able to reduce what they owe or reduce their monthly payments.

Remember that home loans are normally secured by a deed of trust. If a homeowner defaults, the owner of the loan may apply to the bankruptcy court for relief of the automatic stay, discussed below. Depending on the specifics of the case, the homeowner/debtor may be able to prevent foreclosure until he or she has received his or her discharge from bankruptcy. This will require the homeowner to work out a plan with the owner of the note. Additionally, while bankruptcy can delay or in some cases prevent foreclosure, it will not undo what has already been done.

B. THE AUTOMATIC STAY

As soon as bankruptcy is filed, all collection efforts are automatically "stayed," or put on hold while the bankruptcy court and the rest of the parties work on a repayment plan or determine that the debtor will liquidate his or her assets. The lender is prohibited from foreclosing on the property while the stay is in effect, no matter how far along in the foreclosure process the lender was. A bankruptcy filing *after* the foreclosure process is complete and title has been transferred will not undo what has already been done.

C. LIMITS TO THE STAY

Eventually, if a debtor does not pay the lender, the lender will have the right to foreclose. The stay does provide the debtor additional time to work out a plan, such as a loan modification, with the lender. In some cases, the lender may prefer to simply allow the home to go into foreclosure and take it back or to authorize a short sale. Every situation is different, i.e., whether or not there is equity in the home, how far behind the debtor is on his or her payments, the state of the real estate market in which the property is located, etc. It is true, however, that in many cases debtors that go through bankruptcy still lose their home to foreclosure.

D. ORDERING OF EXCLUSION

If the cancellation of debt occurs in a bankruptcy case, the bankruptcy exclusion takes precedence over the insolvency, qualified farm debt, qualified real property business indebtedness, or qualified principal residence indebtedness exclusions. To the extent that the taxpayer is insolvent, the insolvency exclusion takes precedence over qualified farm debt or qualified real property business indebtedness exclusions. The principal residence exclusion takes precedence over the insolvency exclusion, unless otherwise elected.

E. REDUCTION OF TAX ATTRIBUTES

If a debtor excludes cancelled debt from income because it is cancelled in a bankruptcy case or during insolvency, he or she must use the excluded amount to reduce certain "tax attributes." Tax attributes include the basis of certain assets and the losses and credits listed later. By reducing the tax attributes, the tax on the cancelled debt is partially postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation. If a separate bankruptcy estate was created, the trustee or debtor in possession must reduce the estate's attributes (but not below zero) by the cancelled debt.

F. SHORT SALES AND BANKRUPTCY

When a borrower files for bankruptcy the lender cannot pursue collection of the debt and it stops the foreclosure process during the bankruptcy. When accepting a short sale, on the other hand, the lender does not have to be concerned with the borrower filing bankruptcy and having to wait an indefinite amount of time for payment or to complete a foreclosure. However, the problem with short sales is that they take substantially more time to complete than traditional sales. This is true because a sale requires approval of both the homeowner and the lender. In some cases, the lender believes it is better to let the home go into foreclosure, try to sell it at auction and, worst case, take the home back and try to sell it again.

G. HOW FORECLOSURE CAN LEAD TO BANKRUPTCY

Remember that not all debt on real property is subject to exclusion from income if it is forgiven. It is for this reason that a debtor who tries to avoid bankruptcy may still be forced into it after he or she is already subject to foreclosure proceedings. Take the following example.

Example 2.1.

Tom began to fall behind on the mortgage of his $500,000 home after he lost his job. He borrowed $400,000 to purchase the house with a traditional deed of trust loan. Soon, he took out a second of $100,000 to put in a swimming pool, pay off credit card debt, and do other home improvements. As home prices continued to rise, he took out another equity line of credit that he used to take an expensive vacation and buy a new car. Then the value of homes in his community began to fall. He was still making all of his payments until he lost his job. With little savings, before he knew it Tom was six months behind in most of his payments. The holder of the deed of trust initiated foreclosure proceedings. Tom tried to modify his loan, but with no income other than unemployment, the bank refused. Tom then tried to short sale the home. Again, the bank refused to accept the offer of $200,000, believing it could get more through a foreclosure sale. The bank began foreclosure proceedings and eventually the home was auctioned off for $300,000. While this amount was well shy of his original $400,000 loan, the remaining balance of $100,000 will not be considered income under the new federal law. However, the holders of loans two and three initiated proceedings to collect what they were owed. When Tom was unable to reach an agreement with the creditors, he filed *for bankruptcy protection. Thus, if a lender elects to pursue a deficiency judgment, a debtor may be forced to declare bankruptcy even after he or she has been subject to foreclosure proceedings.*

H. MISCELLANEOUS PROVISIONS

1. <u>Chapter 13 - “Cram Down”</u>

In Chapter 13 bankruptcy, the court can "cram down" the value of the loan on the property to the then-current value of the property. For example, say a three-family rental home you own is mortgaged for $300,000, but is currently worth $220,000. The court can reduce the principal balance on the loan to $220,000, which may be enough to make it possible for you to pay the loan. Unfortunately, this option is not available for your primary residence.

2. <u>Chapter 7 Reaffirmation: Negotiate a Loan Down</u>

Chapter 7 does not have a mechanism like the “cram down”. What it does offer the debtor, though, is leverage: the debtor must voluntarily "reaffirm" the loan, or recommit him or herself to paying it. If not, the lender can take the property, but the borrower is off the hook for the debt. Since banks don't really want your property, you may be able to convince the bank to let you reaffirm to a lower principal amount, lower interest rate, or more favorable payment schedule or terms.

II. <u>Qualified Principal Residence Indebtedness</u>

A taxpayer may exclude cancelled debt from income if it is qualified principal residence indebtedness. Qualified principal residence indebtedness is any mortgage that the owner took out to buy, build, or substantially improve his or her main home. It also must be secured by the taxpayer’s principal residence. Qualified principal residence indebtedness also includes any debt secured by a principal residence that the taxpayer used to refinance a mortgage he or she took out to buy, build, or substantially improve his or her main home, but only up to the amount of the old mortgage principal just before the refinancing.

Example 2.2.

In 2005, Becky bought a main home for $315,000. Becky took out a $300,000 mortgage loan to buy the home and made a down payment of

$15,000. The loan was secured by the home. In 2006, Becky took out a second mortgage loan in the amount of $50,000 that she used to add a garage to her home.

In 2011, when the outstanding principal of her first and second mortgage loans was $325,000, Becky refinanced the two loans into one loan in the amount of $400,000. The FMV of the home at the time of the refinancing was $430,000. Becky used the additional $75,000 debt proceeds ($400,000 new mortgage loan minus $325,000 outstanding principal balances of Becky's first and second mortgage loans immediately before the refinancing) to pay off personal credit cards and to pay college tuition for her daughter.

After the refinancing, Becky's qualified principal residence indebtedness is $325,000 because the debt resulting from the refinancing is qualified principal residence indebtedness only to the extent it is not more than the old mortgage principal just before the refinancing.

Example 2.3.

In 2004, Steve acquired his main home for $200,000, subject to a mortgage of $175,000. In 2005, he took out a home equity loan for $10,000, secured by his main home, which he used to pay off personal credit cards.

In 2006, when the outstanding principal on his mortgage was $170,000 and the outstanding principal on his home equity loan was $9,000, he refinanced the two loans into one loan in the amount of $200,000. The FMV of the home at the time of refinancing was $210,000. He used the additional $21,000 ($200,000 new mortgage loan minus $179,000 outstanding principal balances on the mortgage and home equity loan) to cover medical expenses.

After refinancing, Steve's qualified principal residence indebtedness is $170,000 because the debt resulting from the refinancing is qualified principal residence indebtedness only to the extent it refinances debt that had been secured by the main home and was used to buy, build, or substantially improve the main home.

A. MAIN HOME

A taxpayer's main home is the home where they ordinarily live most of the time. A taxpayer may have only one main home, or, as it is also called, principal residence. Factors that are used to determine a taxpayer's main home include:

- Place of employment;
- Location of family members' main home;
- Mailing address for bills and correspondence;
- Address listed on taxpayer's:
  - Federal and state tax returns
  - Driver's license
  - Car registration
  - Voter registration card;
- Location of the banks taxpayer uses; and
- Location of recreational clubs and religious organizations of which taxpayer is a member.

B. EXCLUSION NOT APPLICABLE IN TITLE 11 BANKRUPTCY CASE

This exclusion does not apply to a cancellation of debt in a title 11 bankruptcy case. If qualified principal residence indebtedness is cancelled in a title 11 bankruptcy case, the taxpayer must apply the bankruptcy exclusion rather than the exclusion for qualified principal residence indebtedness. If the taxpayer was insolvent immediately before the cancellation, they can elect to apply the insolvency exclusion instead of applying the qualified principal residence indebtedness exclusion.

C. EXCLUSION LIMIT

The maximum amount that a taxpayer can treat as qualified principal residence indebtedness is $2 million ($1 million if married filing separately). Taxpayers may not exclude cancelled qualified principal residence indebtedness from income if the cancellation was for services performed for the lender or on account of any other factor not directly related to a decline in the value of the taxpayer's home or to his or her financial condition.

If only a part of a loan is qualified principal residence indebtedness, the exclusion applies only to the extent the amount cancelled is more than the amount of the loan (immediately before the cancellation) that is not qualified principal residence indebtedness. The remaining part of the loan may qualify for another exclusion.

Example 2.4.

Marvin incurred recourse debt of $800,000 when he bought his main home for $880,000. When the FMV of the property was $1,000,000, Marvin refinanced the debt for $850,000. At the time of the refinancing, the principal balance of the original mortgage loan was $740,000. Marvin used the $110,000 he obtained from the refinancing ($850,000 minus $740,000) to pay off his credit cards and to buy a speed boat.

About three years after the refinancing, Marvin lost his job and remained unemployed. Marvin's home had declined in value to between $700,000 and $750,000. Based on Marvin's circumstances, the lender agreed to allow a short sale of the property for $735,000 and to cancel the remaining $115,000 of the $850,000 debt. Under the ordering rule, Marvin can exclude only $5,000 of the cancelled debt from his income under the exclusion for cancelled qualified principal residence indebtedness ($115,000 cancelled debt minus the $110,000 amount of the debt that was not qualified principal residence indebtedness). Marvin must include the remaining $110,000 of cancelled debt in income on line 21 of his Form 1040 (unless another exclusion applies).

D. QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS

If a taxpayer excludes cancelled qualified principal residence indebtedness from income and the taxpayer continues to own the home after the cancellation, the taxpayer must reduce the basis of the home (but not below zero) by the amount of the cancelled qualified principal residence indebtedness excluded from income.

If the cancelled debt the taxpayer is excluding is a debt other than qualified principal residence indebtedness (such as a car loan or credit card debt) and the taxpayer has no tax attributes other than the adjusted basis of personal-use property he or she owns, the taxpayer must reduce the basis of the personal-use property he or she held at the beginning of the new tax year (in proportion to adjusted basis). Personal-use property is any property that is not used in the taxpayer's trade or business nor held for investment (such as a home, home furnishings, and car).

If the cancelled debt is excluded by reason of the bankruptcy or insolvency exclusions, the taxpayer must use the excluded debt to reduce the following tax attributes (but not below zero) in the order as provided in the Bankruptcy Code unless he or she elects to reduce the basis of depreciable property first. The reduction of tax attributes must be made after figuring his or her income tax liability for the tax year in question.

III. Overview of Personal Bankruptcy Provisions

A. CHAPTER 13 BANKRUPTCY: REPAYMENT OF CREDITORS

1. Eligibility

Chapter 13 is designed for individuals with regular income who desire to pay their debts but are currently unable to do so. The purpose of chapter 13 is to enable financially distressed individual debtors – under court supervision and protection – to propose and carry out a repayment plan under which creditors are paid over an extended period of time.

Under chapter 13, debtors are permitted to repay creditors, in full or in part, in installments over a 3 to 5 year period. Federal law provides a maximum plan duration of 3 to 5 years if the debtor has less income than the median income of the debtor's state of residence, or a maximum duration of 5 years for debtors with greater than the median income of their state of residence.

Any individual, even if self-employed or operating an unincorporated business, is eligible for chapter 13 relief as long as the individual's unsecured debts are less than the applicant amount allowed pursuant to statute (the amount changes periodically).

2. Overview of Process

The process of a chapter 13 case is fairly simple. A debtor must file a petition seeking protection from the bankruptcy court. Creditors are entitled to notice and to meet to consider their options with respect to the debtor. A trustee is appointed to oversee the mechanics of repayment. The debtor files a plan for repayment requiring creditors to be paid all or part of what they are owed out of the debtor’s future earnings. The plan must be confirmed by the court prior to its adoption. It is then up to the debtor to make the plan work. The debtor must make regular payments to the trustee, which will require adjustment to living on a fixed budget for a prolonged period.

Under chapter 13, unlike chapter 7, the debtor may keep all of his or her property (including his or her home), as long as the debtor continues to make payments under the plan. After completion of payments under the repayment plan, the debts are discharged except certain non-dischargeable debts, including alimony and support payments, student loans, certain debts including criminal fines and restitution and debts for death or personal injury caused by driving while intoxicated from alcohol or drugs, and long term secured obligations.

Federal law requires the bankruptcy court, as a condition of confirming a chapter 13 plan, to find that the debtor's action in filing the case was in good faith.

3. Repayment of Unsecured Debt

Under federal bankruptcy law, the bankruptcy court must find, in confirming a chapter 13 plan to which there has been an objection, that the debtor's disposable income will be paid to unsecured creditors. It also amends the definition of “disposable income.” As defined in the law, the term “disposable income” means income received by the debtor (other than child support payments, foster care payments, or certain disability payments for a dependent child) less amounts reasonably necessary to be expended for:

- The maintenance or support of the debtor or the debtor's dependent;

- A domestic support obligation that first becomes due after the case is filed;

- Charitable contributions (as defined in Bankruptcy Code § 548(d)(3)) to a qualified religious or charitable entity or organization (as defined in Bankruptcy Code § 548(d)(4)) in an amount that does not exceed 15 percent of the debtor's gross income for the year in which the contributions are made; and

- If the debtor is engaged in business, the payment of expenditures necessary for the continuation, preservation, and operation of the business.

Federal law also requires the amounts paid under a confirmed chapter 13 plan to be reduced by the actual amount expended by the debtor to purchase health insurance for the debtor and the debtor's dependents (if those dependents do not otherwise have such insurance) if the debtor documents the cost of such insurance and demonstrates such expense is reasonable and necessary, and the amount is not otherwise allowed for purposes of determining disposable income. If the debtor previously paid for health insurance, the debtor must demonstrate that the amount is not materially greater than the amount the debtor previously paid. If the debtor did not previously have such insurance, the amount may not be materially larger than the reasonable cost that would be incurred by a debtor with similar characteristics. Upon request of any party in interest, the debtor must file proof that a health insurance policy was purchased.

4. <u>Credit Counseling</u>

Federal law requires an individual – as a condition of eligibility for bankruptcy relief – to receive credit counseling within the 180-day period preceding the filing of a bankruptcy case by such individual. The credit counseling must be provided by an approved nonprofit budget and credit counseling agency consisting of either an individual or group briefing (which may be conducted telephonically or via the Internet) that outlined opportunities for available credit counseling and assisted the individual in performing a budget analysis.

5. <u>Mandatory Debtor Education</u>

The court may not grant a chapter 13 discharge unless the debtor has completed an education course in personal financial management as approved by the U.S. Trustee. A debtor can be denied discharge under the new law if the debtor fails to complete the course.

6. <u>Serial Filings</u>

A discharge will not be granted in chapter 13 if the debtor obtained a discharge in chapter 7, 11 or 12 within the 4 years prior to the date of filing of the pending case, or in a chapter 13 case filed within 2 years of the pending case. This provision, though, does not prevent the debtor from filing a chapter 13 case, and receiving the benefits of the stay, including the ability to cure arrearages on secured claims over a period of time.

7. Effects of Dismissal

Federal law provides that if a chapter 13 proceeding is dismissed or converted without completion of the plan, the holder shall retain such lien to the extent recognized by applicable non-bankruptcy law.

8. Petition Requirements

A chapter 13 case begins with the filing of a petition with the bankruptcy court serving the area where the debtor lives. In addition to the list of creditors, and schedules of assets, liabilities, income and expenses, the items debtors must provide pursuant to the 2005 Act include:

- Certificate of credit counseling;
- Evidence of payment from employers, if any, received 60 days before filing;
- Statement of monthly net income and any anticipated increase in income or expenses after filing;
- Tax returns or transcripts for the most recent tax year;
- Tax returns filed during the case including tax returns for prior years that had not been filed when the cases began; and
- A photo ID, among other items.

Failure to provide the documents within 45 days after the petition has been filed (with a possibility of a 45-day extension) results in automatic dismissal of the case after the time period has passed.

9. Additional Information

In order to complete the official bankruptcy forms that make up the petition, statement of financial affairs, and schedules, the debtor will need to compile the following information:

- A list of all creditors and the amount and nature of their claims;
- The source, amount, and frequency of the debtor’s income;
- A list of all of the debtor’s property; and
- A detailed list of the debtor’s monthly living expenses, i.e., food, clothing, shelter, utilities, taxes, transportation, medicine, etc.

When a husband and wife file a joint petition or each spouse files an individual petition, they should be sure to gather the above detailed data for both spouses. In order to assess financial responsibilities accurately, however, when only one spouse files, the income and expenses of the non-filing spouse should be included.

10. Attorney Verification Required

Under federal law, attorneys must make “reasonable inquiry to verify that the information contained” in petitions and schedules are “well grounded in fact.” “The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petitions is incorrect.”

11. Chapter 13 Trustee

Upon the filing of the petition, an impartial trustee is appointed by the court or the United States trustee to administer the case. A primary role of the chapter 13 trustee is to serve as a disbursing agent, collecting payments from debtors and making distributions to creditors.

12. Automatic Stay

The filing of the petition under chapter 13 “automatically stays” most actions against the debtor or the debtor’s property. As long as the “stay” is in effect, creditors generally cannot, among other things, initiate or continue a lawsuit, initiate wage garnishment, or make telephone calls demanding payment.

Federal law limits the application of the stay or provides that it does not go into effect, in certain circumstances, where there are serial filings under circumstances that would indicate bad faith or abusive filings. The stay terminates after 30 days if there is a filing by an individual in chapter 7, 11 or 13 (but not chapter 12) within 1 year after the prior case (under any chapter) was dismissed (except for a case refiled in another chapter after a dismissal of a chapter 7 case based on the means test).

A party in interest (including the debtor) may move to extend the stay and show that the filing is in good faith. A case is presumed to be in bad faith for this purpose if more than one case was pending in chapters 7, 11 or 13 (again, not in chapter 12) and at least one such case was dismissed for failure to file required documents without substantial excuse, to provide adequate protection, or to complete a plan, and there is no showing that the debtor's financial situation has changed so as to allow a final discharge or completion of a plan. If two or more cases under any chapter were dismissed during the prior year, the automatic stay does not go into effect at all until the court so orders after a hearing and a demonstration that the filing was made in good faith.

13. Effect on Real Property

By virtue of the automatic stay, an individual debtor faced with a threatened foreclosure of the mortgage on his or her principal residence can prevent an immediate foreclosure by filing a chapter 13 petition. Chapter 13 then affords the debtor a right to cure defaults on long-term home mortgage debts by bringing the payments current over a reasonable period of time. The debtor is permitted to cure a default with respect to a lien on the debtor's principal residence up until the completion of a foreclosure sale under state law.

14. Repayment Plan and Confirmation

The heart of a chapter 13 bankruptcy case is the debtor's plan for repaying his or her debts. The chapter 13 plan must provide for the full payment of all claims entitled to priority under § 5071 of the Bankruptcy Code (unless the holder of a particular claim agrees to different treatment of the claim); if the plan classifies claims, provide the same treatment of each claim within each class; and provide for the submission of such portion of the debtor's future income to the supervision of the trustee as is necessary for the execution of the plan.

Plans, which must be approved by the court, provide for payments of fixed amounts to the trustee on a regular basis, typically bi-weekly or monthly. The trustee then distributes the funds to creditors according to the terms of the plan, which may offer creditors less than full payment on their claims.

As stated earlier, federal law provides for the maximum period for repayment of a plan of three to five years. It is three years if the debtor has less income than the median income of the debtor's state of residence, or a maximum duration of 5 years for debtors with greater than the median income of their state of residence.

a. Objections to Plan Confirmation

If the trustee or a creditor with an unsecured claim objects to confirmation of the plan, the debtor is obligated to pay the amount of the claim or commit to the proposed plan all projected "disposable income" during the period in which the plan is in effect. Disposable income is defined as income not reasonably necessary for the maintenance or support of the debtor or dependents. If the debtor operates a business, disposable income is defined as excluding those amounts that are necessary for the payment of ordinary operating expenses. Within 30 days after the filing of the plan, even if the court has not yet approved the plan, the debtor must start making payments to the trustee.

b. Meeting of Creditors

A §341(a) "meeting of creditors" is held in every case, during which the debtor is examined under oath. The bankruptcy code provides for the timing of such meeting. The debtor must attend this meeting, at which creditors may appear and ask questions regarding the debtor's financial affairs and the proposed terms of the plan. The trustee must specifically ensure that the debtor is aware of the effects of bankruptcy, including the effect of receiving a discharge, the effect of reaffirming a debt, and the right of the debtor to voluntarily repay a debt without reaffirming it.

Notice of the meeting must be provided to all secured and unsecured creditors, appropriate tax agencies and holders of other claims. If a husband and wife have filed one joint petition, they both must attend the creditors' meeting. The trustee also will attend this meeting and question the debtor on the same matters. In order to preserve their independent judgment, bankruptcy judges are prohibited from attending.

c. Confirmation Hearing

After the meeting of creditors is concluded, the bankruptcy judge must determine at a confirmation hearing whether the plan is feasible and meets the standards for confirmation set forth in the Bankruptcy Code. Creditors may appear and object to confirmation. The new law requires that the confirmation hearing be between 20 and 45 days after the creditors' meeting.

d. Effects of Confirmation

Confirmation of the debtor's repayment plan has the following effects:

- The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan;

- Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor; and

- Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor is free and clear of any claim or interest of any creditor provided for by the plan.

Once the court confirms the plan, it is the responsibility of the debtor to make the plan succeed. The debtor must make regular payments to the trustee, which will require adjustment to living on a fixed budget for a prolonged period. Alternatively, the debtor's employer can withhold the amount of the payment from the debtor's paycheck and transmit it to the chapter 13 trustees. Furthermore, while confirmation of the plan entitles the debtor to retain property as long as payments are made, the debtor may not incur any significant new credit obligations without consulting the trustee, as such credit obligations may have an impact upon the execution of the plan.

e. Reaffirmation

As part of a bankruptcy case, a debtor can "reaffirm" his or her legal obligation to pay a debt that the debtor would otherwise no longer be required to pay in whole or in part. The new law contains extensive new disclosures detailing the rights that the debtor has and specifying the amount of debt reaffirmed, rates of interest, when payments will begin, filing requirements with the court, the right to rescind, and a certification that the agreement does not impose an undue hardship on the debtor.

Such agreements are presumed to create a hardship if the debtor’s expenses including the reaffirmed debt exceed income. If there is such a presumption, the debtor must explain to the court why it can, nevertheless, still afford to satisfy the debt (but no such requirement applies if the reaffirmed debt is owed to a credit union). The disclosure requirements are satisfied if “given in good faith.” A creditor can accept payments under a non-compliant reaffirmation as long as the creditor “believes in good faith” that the agreement is effective.

15. Discharge

The bankruptcy law regarding the scope of the chapter 13 discharges is complex and has recently undergone major changes. The chapter 13 debtors are entitled to a discharge upon successful completion of all payments under the chapter 13 plan. The discharge has the effect of releasing the debtor from all debts provided for by the plan or disallowed, with limited exceptions. Those creditors who were provided for in full or in part under the chapter 13 plan may no longer initiate or continue any legal or other action against the debtor to collect the discharged obligations.

a. Hardship Discharge

After confirmation of a plan, there are limited circumstances under which the debtor may request the court to grant a “hardship discharge” even though the debtor has failed to complete plan payments. Generally, such a discharge is available only to a debtor whose failure to complete plan payments:

- Is due to circumstances beyond the debtor's control and through no fault of the debtor;
- Is after creditors have received at least as much as they would have received in a chapter 7 liquidation case; and
- When modification of the plan is not possible.

Injury or illness that precludes employment sufficient to fund even a modified plan may serve as the basis for a hardship discharge. The hardship discharge is more limited than the general discharge described above, and does not apply to any debts that are non-dischargeable in a chapter 7 case.

b. Protection for Lessors

Federal law requires chapter 13 debtors to remain current on their personal property leases and to provide proof of adequate insurance. The Act further specifies that a lessor may condition assumption of a personal property lease on cure of any outstanding default and it provides that a lessor is not required to permit such assumption. The Act also addresses a problem faced by thousands of large and small residential landlords across the nation whose tenants file for bankruptcy relief solely for the purpose of staying pending eviction proceedings so that they can live "rent free."

c. Superdischarge in Chapter 13 Reduced

Debts for trust fund taxes, taxes for which returns were never filed or filed late (within two years of the petition date), taxes for which the debtor made a fraudulent return or evaded taxes, fraud and false statements, unscheduled debt, defalcation by a fiduciary, domestic support payments, student loans, drunk driving injuries, criminal restitution and fines and civil restitutions or damages rewarded for willful or malicious personal actions causing personal injury or death are now excepted from discharge.

B. LIQUIDATION UNDER THE BANKRUPTCY CODE: CHAPTER 7

1. <u>Overview</u>

Chapter 7 of the United States Bankruptcy Code is the Bankruptcy Code's "liquidation" chapter. Lawyers sometimes refer to it as a "straight bankruptcy." It is used primarily by individuals who wish to free themselves of debt simply and inexpensively.[2] In a chapter 7 case, an individual debtor receives an immediate unconditional discharge of personal liability for certain debts in exchange for relinquishing his or her nonexempt assets to a bankruptcy trustee for liquidation and distribution to creditors.

---

[2] This chapter may also be used by businesses that wish to liquidate and terminate their business. In order to qualify for relief under chapter 7 of the Bankruptcy Code, the debtor must be an individual, a partnership, or a corporation. Certain types of entities are, however, ineligible for chapter 7 protection, including railroads, domestic insurance companies and banks.

This "unconditional discharge" in chapter 7 contrasts with the "conditional discharge" provisions of chapter 13, under which a debtor commits to repay some portion of his or her financial obligations in exchange for retaining nonexempt assets and receiving a broader discharge of debt than is available under chapter 7. A straight bankruptcy case does not involve the filing of a plan of repayment as in chapter 13, but rather envisions the bankruptcy trustee's gathering and sale of the debtor's nonexempt assets, from which holders of claims (creditors) will receive distributions in accordance with the provisions of the Bankruptcy Code.

Part of the debtor's property may be subject to liens and mortgages that pledge the property to other creditors. In addition, under chapter 7, the individual debtor is permitted to retain certain "exempt" property. The debtor's remaining assets are liquidated by a trustee. Accordingly, potential debtors should realize that the filing of a petition under chapter 7 can result in the loss of real property.

Prior to major bankruptcy reform legislation in 2005, relief was available under chapter 7 irrespective of the amount of the debtor's debts or whether the debtor was solvent or insolvent. This system has been replaced by the needs-based system. Those debtors who earn more than their state's median income will either have to file chapter 13, which triggers a repayment plan, or find another way to cope with their financial problems.

Present law permits a court, on its own motion, or on motion of the United States trustee, private trustee, bankruptcy administrator, or other party in interest (including a creditor), to dismiss a chapter 7 petition for abuse if it is filed by an individual debtor whose debts are primarily consumer debts. Alternatively, the chapter 7 case could be converted to a case under chapter 11 or chapter 13 on consent of the debtor.

2. Debtor's Expenses

Federal law mandates that the debtor's expenses include reasonably necessary expenditures for the following:

- Health insurance;
- Disability insurance;

- Claims and expenses entitled to priority under §507 of the Bankruptcy Code, such as child support and alimony;

- Housing and utility expenses in excess of those specified by the Internal Revenue Service, under certain circumstances;

- Health savings account expenses for the debtor, the spouse of the debtor or the dependents of the debtor; and

- Reasonable necessary expenses incurred to maintain the safety of the debtor and the family of the debtor from family violence as identified in §309 of the Family Violence Prevention and Services Act or other applicable law.

The Act requires the bankruptcy court to keep confidential the debtor's monthly expenses.

a. Additional Food and Clothing Allowance

If it is demonstrated that it is reasonable and necessary, the debtor's monthly expenses may also include an additional allowance for food and clothing of up to 5 percent of the food and clothing categories (as specified by the Internal Revenue Service, and described below).

b. Expenses for Care of Family Members

Federal law also allows the debtor to consider as part of his or her monthly expenses the "continuation of actual expenses paid by the debtor that are reasonable and necessary for the care and support of an elderly, chronically ill, or disabled household member or member of the debtor's immediate family (including parents, grandparents, siblings, children, and grandchildren of the debtor, the dependents of the debtor and the spouse of the debtor in a joint case who is not a dependent) and who is unable to pay for such reasonable and necessary expenses."

c. Dependent Child Expenses

The debtor's monthly expenses may also include the actual expenses for each dependent child less than 18 years of age, not to exceed $1,500 per year per child, to attend a private or public elementary or secondary school if the debtor provides documentation of the expenses as well as a detailed explanation of why the expenses are reasonable and necessary. The debtor must also explain why the expenses are not already accounted for in the National or Local Standards, described below.

d. Debt Payments

The monthly expenses of a debtor do not generally include any payments for unsecured debts. With respect to secured debts, the Bankruptcy Code specifies that the debtor's average monthly payments on account of secured debts is calculated as the sum of the following divided by 60:

- All amounts scheduled as contractually due to secured creditors for each month of the 60-month period following filing of the case; and

- Any additional payments necessary, in filing a plan under chapter 13, to maintain possession of the debtor's primary residence, motor vehicle or other property necessary for the support of the debtor and the debtor's dependents, that serves as collateral for secured debts.

With respect to priority claims, the Bankruptcy Code specifies that the debtor's expenses for payment of such claims (including child support and alimony claims) is calculated as the total of such debts divided by 60.

3. Internal Revenue Service Manual

In addition to other specified expenses, the debtor's monthly expenses – exclusive of any payments for debts (unless otherwise permitted) – must be the applicable monthly amounts set forth in the Internal Revenue Service Financial Analysis Handbook.

The Internal Revenue Service Manual defines the term “necessary expenses” as expenses that are necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income. The expenses must be reasonable. The total necessary expenses establish the minimum a taxpayer and family need to live. The Internal Revenue Manual's “National Standards” establish standards for five types of expenses:

- Food (includes all meals, home and away);

- Housekeeping supplies (includes laundry and cleaning supplies);

- Other household products such as cleaning and toilet tissue, paper towels and napkins; lawn and garden supplies; postage and stationery;

- Apparel and services (includes shoes and clothing, laundry and dry cleaning, and shoe repair);

- Personal care products and services (includes hair care products, haircuts, oral hygiene products, and electric personal care appliances); and

- Miscellaneous (a discretionary allowance of $100 for one person and $25 for each additional person in a taxpayer's family).

Except for miscellaneous expenses, these expense standards are derived from Bureau of Labor Statistics Consumer Expenditure Survey and are stratified by income and household size. “Local Standards” under the Internal Revenue Manual, establish expense standards for housing (e.g., mortgage or rent, property taxes, interest, parking, necessary maintenance and repair, homeowner's or renter's insurance, and homeowner dues and condominium fees) and transportation expenditures (e.g., vehicle insurance, vehicle payment, maintenance, fuel, state and local registration, parking fees, tolls, driver's license fees, and public transportation). Utilities (e.g., gas, electricity, water, fuel, oil, bottled gas, wood and other fuels, trash and garbage collection, septic cleaning, and telephone) are included under the housing expense category. Housing standards are established for each county within a state. Transportation standards are determined on a regional basis.

The Internal Revenue Manual does not establish monetary amounts with regard to necessary expenses that it characterizes as “Other Expenses.” Rather, it provides a non-exclusive list of these expenses that must otherwise satisfy the “necessary expense test.” The list includes expenditures for certain accounting and legal fees, child care, dependent care for an elderly or disabled person, health care, taxes, court-ordered payments, life insurance, involuntary deductions (e.g., union dues, uniforms, work shoes), charitable contributions, and certain education expenses.

4. Calculating Debtor’s Current Monthly Income

The Bankruptcy Code defines “current monthly income” as the average monthly income from all sources that the debtor receives (or, in a joint case, the debtor and the debtor's spouse receive), without regard to whether it is taxable income, in the six-month period preceding the bankruptcy filing. It includes any amount paid on a regular basis by any entity (other than the debtor or, in a joint case, the debtor and the debtor's spouse) to the household expenses of the debtor or the debtor's dependents and, in a joint case, the debtor's spouse, if not otherwise a dependent.

a. Calculating Period

The Act specifies that the six-month period is determined as ending on the last day of the calendar month immediately preceding the filing of the bankruptcy case, if the debtor files the statement of current income required by Bankruptcy Code. If the debtor does not file such schedule, the court determines the date on which current income is calculated.

b. Inclusions and Exclusions

Current monthly income includes any amount paid by any entity other than the debtor (or, in a joint case, the debtor and the debtor's spouse if not otherwise a dependent) on a regular basis for the household expenses of the debtor or the debtor's dependents (and, the debtor's spouse in a joint case, if not otherwise a dependent).

Current monthly income excludes Social Security Act benefits and payments to victims of war crimes or crimes against humanity on account of their status as victims of such crimes. It also excludes payments to victims of international terrorism or domestic terrorism (as defined in 18 U.S.C. §2331) on account of their status as victims of such terrorism.

c. Joint Bankruptcy

In a case that is not a joint case, current monthly income of the debtor's spouse is not considered if the debtor and the debtor's spouse are separated under applicable non-bankruptcy law or the debtor and the debtor's spouse are living separate and apart (other than for the purpose of evading this provision) and the debtor files a statement under penalty of perjury containing certain specified information.

5. Exception to the Needs-Based Test

An exception to the needs-based test applies with respect to a debtor who is a disabled veteran whose indebtedness occurred primarily during a period when the individual was on active duty (as defined in 10 U.S.C. § 101(d)(1)) or performing a homeland defense activity (as defined in 32 U.S.C. 901(1)).

6. Rebutting the Means Test

The "means test" permits the mandatory presumption of abuse on the part of the debtor filing a chapter 7 petition to be rebutted only if:

- The debtor demonstrates special circumstances justifying any additional expense or adjustment to the debtor's current monthly income for which there is no reasonable alternative; and

- Such additional expense or income adjustment caused the debtor's current monthly income (reduced by various amounts) when multiplied by 60 to be less than the lesser of either: (i) 25 percent of the debtor's nonpriority unsecured claims, or $6,000 (whichever is greater), or (ii) $10,000.

a. Special Circumstances

Special circumstances include such factors as whether the debtor has a serious medical condition or is on active duty in the Armed Services to the extent these factors justify adjustment to income or expenses.

b. Debtor's Obligations

The debtor must itemize and provide documentation of each additional expense or income adjustment as well as explain the special circumstances that make such expense or income adjustment reasonable and necessary. In addition, the debtor must attest under oath to the accuracy of any information provided to demonstrate that such additional expenses or adjustments to income are required.

c. Judicial Considerations

Where the mandatory presumption of abuse does not apply or has been rebutted, the court, in order to determine whether the granting of relief under chapter 7 would constitute an abuse, must consider:

- Whether the debtor filed the chapter 7 case in bad faith; or

- Whether the totality of circumstances of the debtor's financial situation (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection) demonstrates abuse.

7. Safe Harbors

Two types of “safe harbors” apply to the means test. One provides that only a judge, United States trustee, bankruptcy administrator, or private trustee may file a motion to dismiss a chapter 7 case under §707(b) of the Bankruptcy Code if the debtor's income (or in a joint case, the income of debtor and the debtor's spouse) does not exceed the state median family income for a family of equal or lesser size (adjusted for larger sized families), or the state median family income for one earner in the case of a one-person household.

The second safe harbor provides that no motion under §707(b)(2) (dismissal based on a chapter 7 debtor's ability to repay) may be filed by a judge, United States trustee, bankruptcy administrator, private trustee, or other party in interest if the debtor (including the circumstance where the debtor is a veteran) and the debtor's spouse combined have income that does not exceed the state median family income for a family of equal or lesser size (adjusted for larger sized families), or the state median family income for one earner in the case of a one-person household.

8. Conversion and Dismissal

Pursuant to the Bankruptcy Code, a chapter 7 case filed by a debtor who is an individual may be dismissed for substantial abuse only on motion of the court or the United States trustee. It specifically prohibits such dismissal at the suggestion of any party in interest.

9. Responsibilities of Debtor's Attorney

a. Reimbursement for Expenses

Under §102(a)(2)(C) of the Act, a court may on its own initiative or on motion of a party in interest in accordance with rule 9011 of the Federal Rules of Bankruptcy Procedure, order a debtor's attorney to reimburse the trustee for all reasonable costs incurred in prosecuting a section 707(b) motion if:

- A trustee files such motion;
- The motion is granted; and
- The court finds that the action of the debtor's attorney in filing the case under chapter 7 violated rule 9011.

If the court determines that the debtor's attorney violated federal bankruptcy rules, it may on its own initiative or on motion of a party in interest in accordance with such rule, order the assessment of an appropriate civil penalty against debtor's counsel and the payment of such penalty to the trustee, United States trustee, or bankruptcy administrator.

b. Certification Under Penalty of Perjury

Section 102(a)(2)(C) of the Act provides that the signature of an attorney on a petition, pleading or written motion shall constitute a certification that the attorney has:

- Performed a reasonable investigation into the circumstances that gave rise to such document; and
- Determined that such document is well-grounded in fact and warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under §707(b)(1).

In addition, such attorney's signature on the petition constitutes a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with the petition is incorrect.

c. Additional Responsibilities

The Bankruptcy Code requires the United States trustee or bankruptcy administrator in a chapter 7 case where the debtor is an individual to:

- Review all materials filed by the debtor; and

- File a statement with the court (within ten days following the meeting of creditors held pursuant to §341 of the Bankruptcy Code) as to whether or not the debtor's case should be presumed to be an abuse under §707(b).

The court must provide a copy of such statement to all creditors within five days after its filing. Within 30 days of the filing of such statement, the United States trustee or bankruptcy administrator must file either: (1) a motion under section 707(b); or (2) a statement setting forth the reasons why such motion is not appropriate in any case where the debtor's filing should be presumed to be an abuse and the debtor's current monthly income exceeds certain monetary thresholds.

In a chapter 7 case where the presumption of abuse applies, the clerk of the bankruptcy court must provide written notice to all creditors within ten days after commencement of the case stating that the presumption of abuse applies in such case.

10. Additional Grounds for Dismissal

a. Motion for Dismissal by Crime Victims

The Bankruptcy Code permits the court to dismiss a chapter 7 case filed by an individual debtor on motion by a victim of a crime of violence or a drug trafficking crime. The case may be dismissed if the debtor was convicted of such crime and dismissal is in the best interest of the victim, unless the debtor establishes by a preponderance of the evidence that the filing of the case is necessary to satisfy a claim for a domestic support obligation.

b. Failure to Complete Personal Finance Course

The reform act also allows a court to deny a discharge to a chapter 7 debtor who fails to complete a personal financial management instructional course. This provision, however, does not apply if the debtor resides in a district where the

United States trustee or bankruptcy administrator has determined that the approved instructional courses in that district are not adequate. Such determination must be reviewed annually by the United States trustee or bankruptcy administrator. In addition, it does not apply to a debtor whom the court determines, after notice and a hearing, is unable to complete this requirement because of incapacity, disability, or active military duty in a military combat zone.

11. Petition for Discharge

A chapter 7 case begins with the debtor's filing a petition with the bankruptcy court. The petition should be filed with the bankruptcy court serving the area where the individual lives or where the business debtor has its principal place of business or principal assets.

In addition to the petition, the debtor is also required to file with the court other information, including:

- Several schedules of assets and liabilities;
- A schedule of current income and expenditures;
- Certain recent tax returns;
- A statement of financial affairs; and
- A schedule of executory contracts and unexpired leases.

A husband and wife may file a joint petition or individual petitions.

In order to complete the Official Bankruptcy Forms that make up the petition and schedules, the debtor(s) will need to compile the following information:

- A list of all creditors and the amount and nature of their claims;
- The source, amount, and frequency of the debtor's income;
- A list of all of the debtor's property; and

- A detailed list of the debtor's monthly living expenses, *i.e.*, food, clothing, shelter, utilities, taxes, transportation, medicine, etc.

12. Automatic Stay

a. Most Actions Against Debtor Stayed

The filing of a petition under chapter 7 "automatically stays" most actions against the debtor or the debtor's property. This stay arises by operation of law and requires no judicial action. Debtors are typically protected from a number of actions to collect money from them, including from enforcement of a judgment obtained before the commencement of the bankruptcy, any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate, any act to create, perfect, or enforce any lien against property of the estate, or any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title.

Creditors normally receive notice of the filing of the petition from the clerk. One of the schedules that will be filed by the individual debtor is a schedule of "exempt" property, which is discussed below.

b. Discouraging Bad Faith Repeat Filings

The Bankruptcy Code terminates the automatic stay within 30 days in a chapter 7, 11, or 13 case filed by or against an individual if such individual was a debtor in a previously dismissed case pending within the preceding one-year period.

Upon motion of a party in interest, the court may continue the automatic stay after notice and a hearing completed prior to the expiration of the 30-day period if such party demonstrates that the latter case was filed in good faith as to the creditors who are stayed by the filing. For purposes of this provision, a case is presumptively not filed in good faith as to all creditors (but such presumption may be rebutted by clear and convincing evidence) if:

- More than one bankruptcy case under chapter 7, 11 or 13 was previously filed by the debtor within the preceding one-year period;

- The prior chapter 7, 11, or 13 case was dismissed within the preceding year for the debtor's failure to (a) file or amend without substantial excuse a document required under the Bankruptcy Code or court order, (b) provide adequate protection ordered by the court, or (c) perform the terms of a confirmed plan; or

- There has been no substantial change in the debtor's financial or personal affairs since the dismissal of the prior case, or there is no reason to conclude that the pending case will conclude either with a discharge (if a chapter 7 case) or confirmation (if a chapter 11 or 13 case).

In addition, the Bankruptcy Code provides that a case is presumptively deemed not to be filed in good faith as to any creditor who obtained relief from the automatic stay in the prior case or sought such relief in the prior case and such action was pending at the time of the prior case's dismissal. The presumption may be rebutted by clear and convincing evidence. A similar presumption applies if two or more bankruptcy cases were pending in the one-year preceding the filing of the pending case.

13. Exempt Property

Federal bankruptcy law provides that an individual debtor can protect some property from the claims of creditors either because it is exempt under federal bankruptcy law or because it is exempt under the laws of the debtor's home state.

a. State Exemptions

Many states have taken advantage of a provision in the bankruptcy law that permits each state to adopt its own exemption law in place of the federal exemptions. In other jurisdictions, the individual debtor has the option of choosing between a federal package of exemptions or exemptions available under state law. Thus, whether certain property is exempt and may be kept by the debtor is often a question of state law. Legal counsel should therefore be consulted to determine the law of the state in which the debtor lives.

A change made to the Bankruptcy Code in 2006, however, limits the state's powers to provide exemptions for real property. Under previous law, debtors in Florida, Texas, Kansas, Iowa and South Dakota could shield an unlimited amount of home equity from creditors by filing for bankruptcy protection. Under the law, in order to be eligible for a state's unlimited homestead exemption, an individual must own a residence in the state for at least 40 months before declaring bankruptcy. If unable to meet the residency requirement, the debtor will be entitled to take only a $136,875 homestead exemption. The language applies only in states whose homestead cap already exceeds $136,875, such as Florida. The Act will also bar individuals convicted of felonies or securities crimes in the past 10 years from having access to the unlimited homestead exemption. The bankruptcy court will have to find a link between the debtor's crime and the declaration of bankruptcy for this provision to apply.

b. Federal Exemptions

Federal exemptions are set forth in the Bankruptcy Code, 11 U.S.C. §522(d), and includes interests up to a certain dollar value in a variety of property, including property that the debtor uses as a personal residence, a motor vehicle, certain household furnishings and clothing, jewelry, and tools and other property used in the debtor's trade or business.

Also exempted are a debtor's right to receive certain benefits, including Social Security, veterans' benefits, disability or unemployment benefits, and alimony support, or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. Other exempted property includes awards under a crime victim's reparation law or awards on account of wrongful death of an individual of whom the debtor was a dependent. This list is not exhaustive and the particular dollar amounts change from time to time.

The Bankruptcy Code permits a debtor to exempt certain retirement funds to the extent those monies are in a fund or account that is exempt from taxation under certain provisions of the Internal Revenue Code and that have received a favorable determination pursuant to Internal Revenue Code §7805 that is in effect as of the date of the commencement of the case.

If the retirement monies are in a retirement fund that has not received a favorable determination, those monies are exempt if the debtor demonstrates that no prior unfavorable determination has been made by a court or the Internal Revenue Service, and the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code. If the retirement fund fails to be in substantial compliance with applicable requirements of the Internal Revenue Code, the debtor may claim the retirement funds as exempt if he or she is not materially responsible for such failure. This section also applies to certain direct transfers and rollover distributions. In addition, this provision ensures that the specified retirement funds are exempt under state as well as federal law.

14. Role of the Trustee

Upon the filing of the chapter 7 petition, an impartial case trustee is appointed by the United States trustee (or by the court in Alabama and North Carolina) to administer the case and liquidate the debtor’s nonexempt assets. If, as is often the case, all of the debtor’s assets are exempt or subject to valid liens, there will be no distribution to unsecured creditors.

Typically, most chapter 7 cases involving individual debtors are “no asset” cases. If the case appears to be an “asset” case at the outset, however, unsecured creditors who have claims against the debtor must file their claims with the clerk of court within 90 days after the first date set for the meeting of creditors.

In the typical no asset chapter 7 case, there is no need for creditors to file proofs of claim. If the trustee later recovers assets for distribution to unsecured creditors, creditors will be given notice of that fact and additional time to file proofs of claim. Although secured creditors are not required to file proofs of claim in chapter 7 cases in order to preserve their security interests or liens, there may be circumstances when it is desirable to do so. A creditor in a chapter 7 case who has a lien on the debtor’s property should consult an attorney for advice.

The commencement of a bankruptcy case creates an “estate.” The estate technically becomes the temporary legal owner of all of the debtor’s property. The estate consists of all legal or equitable interests of the debtor in property as of the commencement of the case, including property owned or held by another person if the debtor has an interest in the property. Generally speaking, the debtor’s creditors are paid from nonexempt property of the estate.

a. Liquidating Assets

The primary role of a chapter 7 trustee in an “asset” case is to liquidate the debtor’s nonexempt assets in a manner that maximizes the return to the debtor’s unsecured creditors. To accomplish this, the trustee attempts to liquidate the debtor’s nonexempt property, i.e., property that the debtor owns free and clear of liens and the debtor’s property which has market value above the amount of any security interest or lien and any exemption that the debtor holds in the property.

b. Avoiding Powers

The trustee also pursues causes of action (lawsuits) belonging to the debtor and pursues the trustee's own causes of action to recover money or property under the trustee's "avoiding powers." The trustee's avoiding powers include:

- The power to set aside preferential transfers made to creditors within 90 days before the petition;
- The power to undo security interests and other prepetition transfers of property that were not properly perfected under non-bankruptcy law at the time of the petition; and
- The power to pursue non-bankruptcy claims such as fraudulent conveyance and bulk transfer remedies available under state law.

c. Operation of Debtor's Business

If the debtor is a business, the bankruptcy court may authorize the trustee to operate the debtor's business for a limited period of time, if such operation will benefit the creditors of the estate and enhance the liquidation of the estate.

d. Distribution of Property

The distribution of the property of the estate is governed by the Bankruptcy Code, which sets forth the order of payment of all claims.

The debtor is not particularly interested in the trustee's disposition of the estate assets, except with respect to the payment of those debts which for some reason are not dischargeable in the bankruptcy case. The debtor's major interests in a chapter 7 case are in retaining exempt property and in getting a discharge that covers as many debts as possible.

Under the Bankruptcy Code, the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after commencement of the case, are treated as administrative expenses, which are, as a rule, entitled to priority over prepetition unsecured claims.

15. Discharged Debts

Most claims against an individual chapter 7 debtor are discharged. A creditor whose unsecured claim is discharged may no longer initiate or continue any legal or other action against the debtor to collect the obligation. A discharge under chapter 7, however, does not discharge an individual debtor from certain specific types of debts listed in §523 of the Bankruptcy Code. Among the types of debts which are not discharged in a chapter 7 case are:

- Alimony and child maintenance and support obligations;

- Certain taxes;

- Debts for certain educational benefit overpayments or loans made or guaranteed by a governmental unit;

- Debts for willful and malicious injury by the debtor to another entity or to the property of another entity;

- Debts for death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated from alcohol or other substances; and

- Debts for criminal restitution orders under title 18, United States Code.

To the extent that these types of debts are not fully paid in the chapter 7 case, the debtor is still responsible for them after the bankruptcy case has concluded.

The Bankruptcy Code also provides that a "domestic support obligation" is non-dischargeable and that obligations to a spouse, former spouse, or a child of the debtor incurred in connection with a divorce or separation or related action are non-dischargeable irrespective of the debtor's inability to pay such debts. Likewise, a debt for a qualified education loan is non-dischargeable, unless excepting such debt from discharge would impose an undue hardship on the debtor and the debtor's dependents.

Debts for money or property obtained by false pretenses, debts for fraud or defalcation while acting in a fiduciary capacity, debts for willful and malicious injury by the debtor to another entity or to the property of another entity, and debts arising from a property settlement agreement incurred during or in connection with a divorce or separation are discharged unless a creditor timely files and prevails in an action to have such debts declared excepted from the discharge.

Chapter 2 – Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

1. Under chapter 13 bankruptcy, how long does a debtor have to repay his or her creditor:

    a) between one and three years
    b) no more than three years
    c) no more than 18 months
    d) between three and five years

2. What is the legal effect of a discharge in bankruptcy:

    a) it prevents creditors from attempting to collect the debt until the debtor is back on his or her feet
    b) it is a permanent bar on collecting the debt
    c) it prevents creditors from collecting debts in excess of $1,000,000
    d) it prevents creditors from collecting more than 50 cents on the dollar

3. Which of the following debts is most likely <u>not</u> to be discharged in a chapter 7 case:

    a) a car loan
    b) a home mortgage
    c) alimony payments
    d) credit card debt

Chapter 2 – Review Question Answers

1. D: Between three and five years - see page 25

2. B: It is a permanent bar on collecting the debts that was subject to the discharge - see page 33

3. C: Alimony payments - see page 50

Chapter 3: Tax Implications of Various State and Federal Homeowners' Assistance Programs

I. Introduction

This chapter discusses the impact of certain state and federal programs aimed at assisting distressed homeowners on their income tax liabilities. The following is a summary of the rules discussed in greater detail below:

- Disbursements under a forgivable loan or a HUD Note are treated as payments to a homeowner and not as disbursements of loan proceeds;

- A homeowner who receives or benefits from payments made under the State Programs, the EHLP (Emergency Homeowners' Loan Program), or an SSSP (substantially similar state programs) excludes the payments from gross income under the general welfare exclusion; and

- Payments to or on behalf of a homeowner made under the State Programs, the EHLP, and the SSSP are not subject to the information reporting requirements of §6041.

The IRS will not assert penalties under §§6721 and 6722 against a mortgage servicer that reports on Forms 1098 payments received under a State Program, the EHLP or an SSSP during calendar year 2010. Additionally, the IRS will not assert penalties under §§6721 and 6722 against a mortgage servicer that reports on Forms 1098 payments received under a State Program, the EHLP, or an SSSP during calendar years 2011 or 2012 if the servicer notifies homeowners that the amounts reported on the Form 1098 are overstated because they include government subsidy payments.

The IRS will not assert penalties under §§6721 and 6722 against any State HFA (Housing Finance Agency) for failing to file and furnish Forms 1098 for calendar year 2010. In addition, the IRS will not assert penalties under §§6721 and 6722 for calendar years 2011 and 2012 against any State HFA if the State HFA provides each homeowner and the IRS a statement setting forth (1) the homeowner's name and TIN, and (2) the amount of payments the State HFA made to a mortgage servicer under the State Program or the SSSP during that year (separately stating the amount the State HFA paid and the amount the homeowner paid). The statement the State HFA provides to the IRS must be a single statement that separately lists the names, TINs, and relevant payment amounts for each homeowner. For calendar years 2011 and 2012, HUD should provide each homeowner and the IRS a statement setting forth (1) the homeowner's name and TIN, and (2) the amount of payments HUD made to the mortgage servicer under the EHLP during that year (separately stating the amount HUD paid and the amount the homeowner paid). The statement HUD provides to the IRS should be a single statement that separately lists the names, TINs, and relevant payment amounts for each homeowner. The IRS intends to issue future published guidance specifying the IRS office where the State HFAs and HUD should send the single statements.

For taxable years 2010, 2011, and 2012, the IRS has provided a safe harbor method pursuant to which a homeowner may deduct on his or her federal income tax return an amount equal to the sum of all payments the homeowner actually makes during that year to the mortgage servicer, HUD, or the State HFA on the home mortgage, but not in excess of the sum of the amounts shown on Form 1098, Mortgage Interest Statement, in box 1 (mortgage interest received), box 4 (mortgage insurance premiums) for years 2010 and 2011 only, and box 5 (real property taxes). This safe harbor method of computing the homeowner's deduction applies for a taxable year if (1) the homeowner meets the requirements of §§163 and 164 to deduct all of the mortgage interest on the loan and all of the real property taxes on the principal residence, and (2) the homeowner participates in the EHLP, an SSSP, or a State Program described by the IRS in which the program payments could be used to pay interest on the home mortgage.

II. <u>The HFA Hardest Hit Fund Program</u>

A. OVERVIEW

While the federal government has certainly taken the lead in attempting to shore up the sinking housing market nationwide, a number of states have enacted their own programs aimed at stabilizing prices and reducing the number of foreclosures and short sales within their communities. In February 2010, the Department of the Treasury established the HFA Hardest Hit Fund. The HFA Hardest Hit Fund was enacted to provide funds to the State Programs (1) to assist homeowners in preventing avoidable foreclosures, and (2) to stabilize housing markets.

The HFA Hardest Hit Fund was designed to allow each State HFA maximum flexibility in designing locally focused programs to address the needs of financially distressed homeowners within the state or a specific region of the state. Each of the State Programs that receives funding from the HFA Hardest Hit Fund has as its primary objective preventing avoidable foreclosures of homeowners' homes and stabilizing housing markets.

The HFA Hardest Hit Fund is available in states where either housing prices have declined more than 20 percent from peak prices or the unemployment rate equals or exceeds the national average. The states eligible for this funding are Alabama, Arizona, California, the District of Columbia, Florida, Georgia, Illinois, Indiana, Kentucky, Michigan, Mississippi, Nevada, New Jersey, North Carolina, Ohio, Oregon, Rhode Island, South Carolina, and Tennessee.

To receive funding from the HFA Hardest Hit Fund, each of these states submitted proposals describing its programs and verifying that each of the programs would meet the requirements of the federal program. Funding under the HFA Hardest Hit Fund is available for, but not limited to, programs involving the following transactions:

- Mortgage modifications;
- Principal forbearance to facilitate additional mortgage modifications;
- Short sales and deeds-in-lieu of foreclosure;
- Unemployment programs;
- Principal reductions for homeowners with severe negative equity; and
- Second-lien reductions and modifications.

B. APPROVED STATE PROGRAMS AND THEIR COMMON ELEMENTS

Generally, under the State Programs homeowners must demonstrate that they have suffered a financial hardship due to certain events, such as unemployment, underemployment, medical condition, death of a spouse, or divorce, and as a result are in danger of losing their homes in foreclosure or need financial assistance to ensure that their loans become or remain affordable. Although most of the Programs have the goal of helping financially distressed homeowners remain in their homes, some State Programs also help homeowners who can no longer afford their homes to transition to more affordable homes. Some states limit participation in their programs to homeowners whose income does not exceed certain limits.

In some cases, the State Programs assist a homeowner by making cash payments directly to or on behalf of the homeowner without mentioning any repayment obligation. On the other hand, sometimes the governing documents discuss repayment and call the arrangement a “loan” or a “forgivable loan.” Even in these cases, however, the terms of the arrangement generally operate to relieve the homeowner of an obligation to make any repayments. The terms achieve this end by reducing the stated principal amount to zero over time if the homeowner meets certain program requirements. Though State Programs may vary, an arrangement like this is generally secured by a subordinate lien on the home and is documented as a zero-percent-interest, nonrecourse, non-amortizing “loan” to the homeowner with a term ranging from three to 10 years. The Treasury Department calls these arrangements “Forgivable Loans.”

For example, under some programs the unpaid stated principal of a Forgivable Loan declines 20 percent each year for five years if the homeowner remains current on the homeowner’s mortgage loan payments and continues to use the property as a principal residence. In general, no payments are due on a forgivable loan unless:

- The homeowner sells, refinances, or transfers title to the property before the term expires; and

- Equity proceeds from the sale, refinancing, or title transfer are available to pay some or all of the remaining unpaid stated principal balance.

As a result, the Treasury Department and the State Programs do not expect homeowners to make more than a minimal amount of payments on forgivable loans.

III. <u>The Emergency Homeowners’ Loan Program and Substantially Similar State Programs</u>

A. OVERVIEW

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was a broad and far-reaching piece of legislation. One provision of that Act reauthorized and revised the Emergency Homeowners’ Loan Program (EHLP) and provided

$1 billion to the Department of Housing and Urban Development (HUD) to implement the EHLP and existing state programs that are substantially similar to the EHLP (the substantially similar state programs or SSSPs).

The purpose of the EHLP and the SSSPs is to provide assistance to homeowners who are at risk of foreclosure and have experienced a substantial reduction in income as a result of involuntary unemployment or underemployment due to adverse economic or medical conditions. The $1 billion of funding is allocated based on a state's approximate share of unemployed homeowners. The EHLP and the SSSPs complement the HFA Hardest Hit Fund by providing assistance to homeowners in Puerto Rico and the 32 states that did not receive funds from the HFA Hardest Hit Fund.

B. ELIGIBLE PRE-EXISTING STATE PROGRAMS

The Dodd-Frank Act provides that a state may administer EHLP funds if HUD determines that the state program qualifies as an SSSP. An SSSP is a state program existing on July 21, 2010, that provides substantially similar assistance to homeowners. A state with an SSSP may exercise greater flexibility in program design and is not required to modify its program to comply with Title 12 after HUD determines that the program is an SSSP. To receive funding from the EHLP, State HFAs submitted proposals describing how their programs provide assistance to homeowners that are substantially similar to that provided under the EHLP. Only SSSPs are eligible to administer an allocation from the $1 billion provided to the EHLP under the Dodd-Frank Act. Section III.B.2 of the Funding Notice. If a state does not have an SSSP, then HUD administers the state's allocation from the $1 billion of funding in accordance with the EHLP.

C. HOMEOWNERS ELIGIBLE FOR ASSISTANCE

To receive assistance from the EHLP or an SSSP, a homeowner must meet certain eligibility requirements. The homeowner must reside in the mortgaged property as his or her principal residence at the time of application and for the duration of the assistance. The homeowner must also be involuntarily unemployed or underemployed because of adverse economic or medical conditions. The homeowner must have household income equal to or less than 120% of the area median income for the area in which the homeowner resides, and have experienced a substantial reduction in income as a result of involuntary unemployment or underemployment due to adverse economic or medical conditions. The homeowner also must be at least three months delinquent on the homeowner's first mortgage and provide evidence that foreclosure on that mortgage is likely or imminent. In addition, the homeowner must have a reasonable likelihood of being able to (1) resume repayments of the first mortgage obligation within two years, and (2) meet other housing expenses and debt obligations when the assistance ends.

Under the EHLP (but not an SSSP), eligible homeowners must contribute the greater of 31 percent of their monthly gross income or $25 towards the monthly payments on the first mortgage. Under the EHLP, homeowner contributions will be combined with the governmental funds and forwarded to the servicer/lender as the monthly payment on the first mortgage. HUD expects the SSSPs to use their existing procedures for handling borrower contributions.

The EHLP will provide a reasonably necessary amount to assist an eligible homeowner with:

- A maximum of 24 months of monthly payments of mortgage principal, interest, mortgage insurance premiums, taxes, and hazard insurance; and

- Payments of arrearages (mortgage principal, interest, mortgage insurance premiums, taxes, hazard insurance, late fees, and certain foreclosure related legal expenses).

HUD prefers, but does not require, the SSSPs to limit assistance to a 24-month period. The EHLP and the SSSPs must include assistance in making monthly payments to the servicer of the first mortgage and may not restrict payments only to arrearages. If the household's gross income increases to 85% or more of the income prior to the unemployment, underemployment, or medical condition, then the assistance will be phased out over a two-month period.

The assistance that the EHLP and the SSSPs provide to a homeowner must be pursuant to a note with terms and repayment conditions that are similar to the Forgivable Loan described above, except that the homeowner is responsible for repayment of the applicable balance of the note if the homeowner defaults on the homeowner's monthly mortgage payment obligation during the five-year period after the assistance ends. These arrangements are referred to as "HUD Notes." As a result, HUD and the SSSPs do not expect homeowners to make more than a minimal amount of payments on the HUD Notes.

D. APPLICABLE PROVISIONS OF LAW

1. Characterization of Forgivable Loans and the HUD Notes

If assistance to a homeowner under a State Program is structured as a forgivable loan, the Internal Revenue Service will treat the disbursements to or on behalf of the homeowner as payments to the homeowner rather than as disbursements of loan proceeds, and those payments are treated as occurring at the time the disbursements are made. Similarly, if assistance to a homeowner under the EHLP or an SSSP is pursuant to a HUD Note, the IRS will treat the disbursements to or on behalf of the homeowner as payments to the homeowner rather than as disbursements of loan proceeds, and those payments are treated as occurring at the time the disbursements are made.

2. Income Tax Consequences to Homeowners

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived. The Service has consistently held, however, that payments made under governmental programs for the promotion of the general welfare are not includible in an individual recipient’s gross income (general welfare exclusion). An IRS Revenue Ruling recently found that that Pay-for-Performance Success Payments made under the Home Affordable Modification Program to help homeowners who are at risk of losing their homes pay their mortgage loans on their principal residences are excluded from income under the general welfare exclusion.[3]

Similar to the revenue ruling, the payments made under the State Programs with funds from the HFA Hardest Hit Fund and the payments made under the EHLP and the SSSPs with funds authorized by the Dodd-Frank Act promote the general welfare by helping homeowners who are at risk of losing their homes either pay their mortgage loans or transition to more affordable housing and do not involve the performance of services. Therefore, payments made under the State Programs, the EHLP, and the SSSPs to or on behalf of a homeowner are excluded from gross income under the general welfare exclusion.

For taxable years 2010, 2011, and 2012, this IRS provides a safe harbor method pursuant to which a homeowner may deduct on his or her federal income tax return an amount equal to the sum of all payments the homeowner actually

[3] See Rev. Rul. 2009-19, 2009-28 I.R.B. 111. See also Rev. Rul. 76-373, 1976-2 C.B. 16.

makes during that year to the mortgage servicer, HUD, or the State HFA on the home mortgage, but not in excess of the sum of the amounts shown on Form 1098, Mortgage Interest Statement, in box 1 (mortgage interest received), box 4 (mortgage insurance premiums) for years 2010 and 2011 only, and box 5 (real property taxes). This safe harbor method of computing the homeowner's deduction applies for a taxable year if: (1) the homeowner meets the requirements of Internal Revenue Code Sections 163 and 164 to deduct all of the mortgage interest on the loan and all of the real property taxes on the principal residence; and (2) the homeowner participates in the EHLP, an SSSP, or a State Program in which the program payments could be used to pay interest on the home mortgage.

3. Information Reporting Obligations

The Internal Revenue Code requires every person engaged in a trade or business (including state governments and their agencies) to (1) file an information return for each calendar year in which the person makes in the course of its trade or business payments to another person of fixed and determinable income aggregating $600 or more, and (2) furnish a copy of the information return to that person.[4]

Because the payments made under the State Programs, the EHLP, and the SSSPs are excluded from the gross income of the homeowners, they are not fixed or determinable income under §6041. Thus, under §6041 payors do not file information returns or furnish copies to homeowners for payments made under the State Programs, the EHLP, or the SSSPs.

Section 6050H of the Internal Revenue Code requires every person engaged in a trade or business (including state governments and their agencies) to: (1) file an information return for each calendar year in which the person receives in the course of its trade or business payments from an individual of interest on a mortgage aggregating $600 or more, and (2) furnish a copy of the information return to that individual.[5] For purposes of this requirement, interest received from a governmental unit or its agency or instrumentality is not interest received on a mortgage, and thus should not be reported as interest received on a mortgage.[6]

---

[4] See §6041(a) and (d) and §1.6041-1(a)(1) and (b) of the Income Tax Regulations.

[5] See §6050H(a) and (d) and §1.6050H-1(a) of the regulations.

[6] See §1.6050H-1(e)(3)(ii) of the regulations.

As a result, if a person receives payments under a State Program, the EHLP, or an SSSP from a governmental unit or its agency or instrumentality of interest on the homeowner's mortgage, that person should not include those payments in the amount reported as interest received on a mortgage on Form 1098.

Section 6721 of the Code imposes penalties on a person for failing to include all required information or including incorrect information on an information return. Section 6722 imposes penalties on a person for failing to include all required information or including incorrect information on a payee statement. However, the IRS will not assert penalties under §§6721 and 6722 against a mortgage servicer that reports on Forms 1098 payments received under a State Program, the EHLP, or an SSSP during calendar year 2010. Additionally, the Service will not assert penalties under §§6721 and 6722 against a mortgage servicer that reports on Forms 1098 payments received under a State Program, the EHLP, or an SSSP during calendar years 2011 or 2012 if the servicer notifies homeowners that the amounts reported on the Form 1098 are overstated because they include government subsidy payments. In addition, the IRS will not assert penalties under §§6721 and 6722 against any State HFA for failing to file and furnish Forms 1098 for calendar year 2010. Furthermore, the Service will not assert penalties under §§6721 and 6722 against any State HFA for failing to file and furnish Forms 1098 for calendar years 2011 and 2012 if the State HFA provides each homeowner and the IRS a statement setting forth (1) the homeowner's name and TIN, and (2) the amount of payments the State HFA made to the mortgage servicer under the State Program or the SSSP during that year (separately stating the amount the State HFA paid and the amount the homeowner paid).

The statement the State HFA provides to the IRS must be a single statement that separately lists the names, TINs, and relevant payment amounts for each homeowner. In addition, for calendar years 2011 and 2012, HUD should provide each homeowner and the IRS a statement setting forth:

- The homeowner's name and TIN; and

- The amount of payments HUD made to the mortgage servicer under the EHLP during that year (separately stating the amount HUD paid and the amount the homeowner paid).

The statement HUD provides to the IRS should be a single statement that separately lists the names, TINs, and relevant payment amounts for each homeowner. The IRS intends to issue future published guidance specifying the IRS office where the State HFAs and HUD should send the single statements.

Chapter 3 – Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

1. What is a "Forgivable Loan":

   a) it is an agreement that relieves the homeowner from having to pay the loan back
   b) it is when a homeowner stops making his or her monthly mortgage payment and the mortgage company "forgives" these non-payments
   c) it is when State Programs make payments to help homeowners without any arrangement of repayment obligations
   d) it is a loan with an interest rate of 2% or less

2. Which of the following is not a condition of eligibility for a homeowner to receive help from the EHLP or an SSSP:

   a) the property must be the homeowner's principal residence
   b) the homeowner must not be willingly unemployed
   c) the homeowner must owe at least 6 months of back mortgage payments
   d) the homeowner must be able to show that foreclosure is looming but that he or she will be able to pay his or her expenses when the help ends

Chapter 3 – Review Question Answers

1. A: It is an agreement that relieves the homeowner from having to pay the loan back – see page 57

2. C: The homeowner must owe at least 3 months of back mortgage payments, 6 months of back payments is not a requirement – see page 58

Chapter 4: Federal Tax Liens

I. <u>Federal Tax Liens Overview</u>

When a homeowner is delinquent on his or her mortgage, there is a good chance he or she is delinquent on other obligations as well. It could be anything from his or her cable bill to state and federal taxes. This section will focus on the existence of federal tax liens and their impact on the disposition of real property.

A federal tax lien gives the IRS a legal claim to a taxpayer's property for the amount of an unpaid tax debt. Filing a Notice of Federal Tax Lien is necessary to establish priority rights against certain other creditors. Usually the government is not the only creditor to whom the taxpayer owes money.

A lien informs the public that the U.S. government has a claim against all property, and any rights to the property, of the taxpayer. This includes property owned at the time the notice of lien is filed and any acquired thereafter. A lien can affect a taxpayer's credit rating, so it is critical to arrange the payment of taxes as quickly as possible.

Because state law varies so much, state or local tax liens are beyond the scope of this discussion (though not beyond what a practitioner should be familiar with). The IRS issues more than 600,000 federal tax lien notices annually.

Filing a Notice of Federal Tax Lien (NFTL) is a formal process by which the government makes a legal claim to property as security or payment for a tax debt. It serves as a public notice to other creditors that the government has a claim on the property. In some cases, a federal tax lien can be made secondary to another lien, such as that of a lending institution, if the IRS determines that taking a secondary position ultimately will help with collection of the tax debt. That process is called subordination. Taxpayers or their representatives may apply for a subordination of a federal tax lien if they are refinancing or restructuring their mortgage. Without lien subordination, taxpayers may be unable to borrow funds or reduce their payments. Why? Lending institutions generally want their lien to have priority on the home being used as collateral.

When there is a federal tax lien on a taxpayer's home, they must satisfy the lien before they can sell or refinance the home. There are a number of options to satisfy the tax lien. Normally, if someone has equity in their property, the tax lien is paid (in part or in whole depending on the equity) out of the sales proceeds at the time of closing. If the home is being sold for less than the lien amount, the taxpayer can request the IRS to discharge the lien to allow for the completion of the sale. Taxpayers or lenders also can ask that a federal tax lien be made secondary to the lending institution's lien to allow for the refinancing or restructuring of a mortgage. The IRS currently is working to speed requests for discharge or mortgage restructuring to assist taxpayers during the economic downturn. These will be discussed at the end of the chapter.

In the case of a foreclosure where a tax lien has been placed by the IRS on the subject property, the IRS has 120 days in which to demand rescission of the sale at auction. This process is called redemption. 28 USC 2410(c) provides that where a sale of real estate is made to satisfy a lien prior to that of the United States, the United States shall have not less than 120 days from the date of sale within which to redeem. This provision gives the IRS time to investigate and determine whether it would be to the advantage of the United States to redeem the property. Redemption allows the IRS to resell the property for more than the cost of redemption with the resulting benefit to the government. A principal consideration in such an investigation entails a determination as to whether the value of the property sold in the foreclosure proceeding is reasonably in excess of the amount required to effect the redemption. Given the current economic climate, that is rarely the case.

With the number of Americans suffering from economic hardship, including the broad number of foreclosures and short sales, practitioners need to also understand how federal tax liens happen and how they can affect the disposition of their client's real property.

A. THE GENERAL TAX LIEN

The law generally defines a lien as a charge or encumbrance that one person has on the property of another as security for a debt or obligation. In the case of the Internal Revenue Service, they have authority to place a lien, or encumbrance, on the home of a taxpayer in default to the IRS. Liens may be divided into three general categories: common-law liens, consensual liens, and statutory liens. This section deals with the statutory liens provided for by the Internal Revenue Code of 1986. The principal lien considered in this section is the "general" tax lien, sometimes referred to as the *assessment lien*. The general tax lien is provided for by IRC §6321 and is a very broad lien; it generally encompasses all of the taxpayer's property or rights to property as security for a tax liability.

B. HOW AND WHEN TAX LIENS ARISE

The federal tax lien arises when any individual or taxable entity liable to pay any federal tax fails to pay the tax after a demand by the government for payment. For purposes of this course, we will focus on individual taxpayers. The lien is effective from the date the government assesses the tax, even though the notice and demand for payment ordinarily gives the taxpayer an additional 10 days after assessment to pay the tax. Thus, if the taxpayer neglects or refuses to pay the assessed tax, then the lien is deemed to relate back to the assessment date.

C. DURATION OF THE FEDERAL TAX LIEN

The federal tax lien continues until the liability for the amount assessed is satisfied or becomes unenforceable by reason of lapse of time, i.e., the collection period expires. Generally, after assessment, the IRS has ten years to collect the tax liability. However, there are some circumstances which may extend or suspend the ten-year collection period.

IRC §6502 provides for an extension of the collection period in two situations. Collection action may be taken if:

- The statute of limitations was extended at the same time an installment agreement was entered into. In this case, collection action may be taken until the 89th day after expiration of the installment agreement; or

- Release of a levy under IRC §6343 is accompanied by an agreement to extend the statute of limitations to a specific date and that date has not yet passed.

IRC §6503 provides for the suspension of the collection period in several situations. The more common situations are the following:

- Issuance of a statutory notice of deficiency;

- Assets of the taxpayer in control or custody of a court;

- Taxpayer is outside of the United States for a continuous period of 6 months;

- An extension exists for the payment of an estate tax;

- A wrongful seizure of property or a wrongful lien on property; or

- Taxpayer's bankruptcy automatically stays assessment or collection.

If the United States files suit and reduces the tax claim to judgment, then the collection period does not expire until the judgment has been satisfied. State statutes of limitations cannot affect the duration or existence of the federal tax lien.

D. FILING THE NOTICE OF FEDERAL TAX LIEN

The federal tax lien arises when the Service meets the requirements of IRC §6321, i.e., an assessment and a notice and demand for payment. However, the law provides that in order for the federal tax lien to have priority against certain competing lien interests, the Service must file a Notice of Federal Tax Lien (NFTL) pursuant to IRC §6323. Prior to filing a NFTL, the IRS should verify the outstanding liability and determine that the filing of the notice of lien is appropriate under the circumstances.

1. Purpose and Effect of Filing Notice

The filing of a NFTL is not a step required to give rise to or to perfect the lien against the taxpayer. The act of filing protects the Government's right of priority as against certain third parties, typically a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. Generally speaking, unless the IRS first properly files a notice of its federal tax lien, the purchaser will take the property free of the federal tax lien. Similarly, unless the IRS first files a NFTL, the holder of a security interest, mechanic's lienor, and judgment lien creditor will have priority over the federal tax lien.

2. Place of Filing

IRC §6323(f) and state law determine the correct place to file a NFTL. If the IRS files the NFTL in the wrong office, then the NFTL will not have priority over a later purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor.

Different filing rules apply for real property and personal property. For real property, the NFTL is filed in the one office designated by the State where the property is physically located. States generally provide that the one office for filing the NFTL for real property is the county recorder or clerk of the county in the county in which the real property is located.

For purposes of filing a notice of federal tax lien, a taxpayer who resides abroad is deemed to reside in Washington, D.C. Thus, a notice of federal tax lien filed against personal property is to be filed with the Recorder of Deeds for the District of Columbia.

If a state fails to provide an office or designates more than one office for filing a NFTL, then IRC §6323(f) provides that the NFTL is to be filed in the office of the clerk of the United States District Court for the judicial district in which the property subject to the lien is situated. Currently, Massachusetts is the only state where the IRS files a NFTL for personal property in federal district court.

3. <u>Refiling of Notice</u>

All NFTLs must be refiled within the required refiling period to retain priority as of the initial filing date. The NFTL may be refiled during the one-year period ending 30 days after the expiration of ten years after the assessment date of the tax.

> **Example 4.1.**
>
> *The IRS assessed William's liability on March 1, 1993. On July 1, 1993, the IRS filed a NFTL, showing a self-releasing date of March 31, 2003. For all of 1998 and 1999, William's bankruptcy case stayed the running of the collection period. The period for refiling began on April 1, 2002, and continued until March 31, 2003. In this case, the IRS timely refiled on January 2, 2003, so the assessment lien and NFTL filed on July 1, 1993, continue to be valid and have priority as of July 1, 1993.*

If the collection period continues to be suspended or extended after the initial refiling, the IRS may have to refile again. A second refiling must be made in the one-year period ending with the expiration of 10 years after the close of the preceding required refiling period. Frequently, the NFTL is filed in multiple offices. When the IRS refiles, it must refile in each of the offices in which the prior NFTLs were filed. If a taxpayer properly notifies the IRS of a change of residence, the IRS must not only refile in the original offices, but must also refile in the recording office covering the new residence.

4. Contents of Notice of Federal Tax Lien

The Secretary of Treasury is responsible for determining the form and content of the NFTL. State law may not require that the NFTL be in any particular form or contain any particular items to be recordable. The IRS files a paper NFTL on a Form 668(Y), which must identify the taxpayer, the tax liability giving rise to the lien, and the date the assessment arose.

5. Effect of Errors in Notice of Federal Tax Lien

Errors appearing on the face of the IRS's filed NFTL often create problems not only in evaluating the validity of the NFTL, but also in determining relative priorities between the Service's claim and other competing lien claimants. The general rule is that if the name on the notice is not identical to the correct name of the taxpayer, then the NFTL is still valid if the NFTL is sufficient to put a third party on notice of a lien outstanding against the taxpayer. This is known as the substantial compliance test.

When searching for a NFTL in public records, either in a book format or electronic format, the searcher must act reasonably and diligently. The NFTL identifies the taxpayer when it is sufficient to put a third party on notice of a lien outstanding against the taxpayer. Since this is essentially a fact question, however, it is especially important to pay attention to the "details." Thus, for example, if a person is known or suspected to use any aliases or owns property held for him/her by a nominee, agent or trustee, it is desirable to prepare an individual NFTL for filing in all the necessary names.

E. DUE PROCESS

The IRS must generally notify the taxpayer within five business days of filing the NFTL. The notice of lien must be given in person, left at the taxpayer's home or place of business, or sent by certified or registered mail to the person's last known address. The notice must also inform the taxpayer of the amount of the unpaid tax, the taxpayer's right to request a hearing, the available administrative appeals procedures, and applicable procedures for releasing the lien.

1. Appealing Liens

The taxpayer has the right to appeal the lien. Common issues that come up during the appeals process include:

- Whether the taxes were actually paid;
- Whether the assessment was filed while the taxpayer was in bankruptcy and therefore should have been subject to a stay;
- Whether the IRS committed a procedural mistake;
- The time to collect the tax (called the statute of limitations) expired before the lien was filed;
- The taxpayer was not given an opportunity to dispute the assessed liability; or
- The taxpayer wishes to make spousal defenses.

At the conclusion of the Collection Due Process hearing, the IRS Office of Appeals will issue a determination. That determination may support the continued existence of the filed federal tax lien or it may determine that the lien should be released or withdrawn. If the taxpayer disagrees with the Appeal's determination, there is a 30-day period starting with the date of determination, in which the taxpayer may request judicial review in a court of proper jurisdiction.[7]

2. Withdrawing Liens

By law, a filed notice of tax lien can be withdrawn if:

- The notice was filed too soon or not according to IRS procedures;
- The taxpayer entered into an installment agreement to pay the debt on the notice of lien (unless the agreement provides otherwise);
- Withdrawal will speed collecting the tax; or

[7] Refer to Publication 1660, *Collection Appeal Rights*, for more information.

- Withdrawal would be in the taxpayer's best interest (as determined by the Taxpayer Advocate), and in the best interest of the government.

The IRS will give the taxpayer a copy of the withdrawal and make it available to others, including financial institutions, upon request.

F. PROPERTY TO WHICH THE TAX LIEN ATTACHES

The federal tax lien attaches to all property and rights to property of the taxpayer. This is a very broad concept and includes not only items which are typically thought of as property, e.g., tangible items and "things," but also intangible items and "rights" which a taxpayer may have, but are not necessarily marketable. The only exception is that the lien does not attach to any interest of an American Indian in restricted land held by the United States. The courts have interpreted this very broad "all property and rights to property" language to include all real, personal and intangible property of greatly varying natures, as well as future interests, and property acquired by the taxpayer after the lien has come into existence. In other words, unlike a typical mortgage, the federal tax lien attaches to a taxpayer's after-acquired property. If the IRS files a NFTL, it will generally even have priority to a taxpayer's after-acquired property.

G. STATE LAW ISSUES

State law is very significant when considering the property and rights to property to which the federal tax lien attaches. The federal government looks to state law to determine a taxpayer's rights in a particular piece of property, but federal law determines whether such interests qualify as property or rights to property.

1. Joint Ownership

Federal tax lien questions relating to the joint ownership of property generally arise when other parties claim an interest in real property otherwise subject to the federal tax lien. This issue typically arises when the Service asserts a tax lien against only one of the parties having an interest in real property which, depending on state law, is held in one of the following forms:

- Community property;

- Joint tenancy;

- Tenancy by the entirety; or
- Tenancy in common.

a. Community Property

The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Spouses in Alaska may elect to have statutory community property rules apply to some or all of their property. Community property law presents special problems concerning the force and effect of the federal tax lien.

b. Joint Tenancy

A joint tenancy may be created when two or more persons become the owners of property in equal and undivided shares. The interest of each tenant must be created in the same conveyance at the same time and the interests must be equal. Joint tenants have a right of survivorship. Under the right of survivorship, when a joint tenant dies, the surviving joint tenants automatically own a greater portion of the property.

> **Example 4.2.**
>
> *For example, assume A, B, and C own Whiteacre in a joint tenancy. If A dies, B and C automatically own Whiteacre. If B then dies, C automatically is the sole owner. Generally, where only one of the joint tenants owes taxes, the lien attaches to the taxpayer's property interest and the entire property may be sold pursuant to judicial sale under IRC § 7403, although the non-liable joint tenant must be compensated from the sale proceeds. If the Service enforces the tax lien against a taxpayer's interest in a joint tenancy and sells it, the purchaser acquires the taxpayer's partial interest in property, but most states then treat the joint tenancy as having been converted to a tenancy in common.*

In most states, if the individual, against whose property a federal tax lien attaches, dies before any of the other joint tenants, then the lien ceases to attach to the property. However, if the same individual is the last survivor of the joint tenants, the tax lien then attaches to the entire property. In a few states, however, this is not the rule. Wisconsin is an exception to the general rule: if the federal tax lien has attached to the interest of one joint tenant who then dies, the surviving joint tenant takes the property encumbered with the federal tax lien.

c. Tenancy in Common

A tenancy in common, like a joint tenancy, is an undivided interest in property. A tenancy in common, however, is different from a joint tenancy in two important aspects. First, the interest of a tenant in common may be transferred to a third party without destroying the tenancy in common. Second, there is no right of survivorship in a tenancy in common.

> **Example 4.3.**
>
> *Assume A and B own Blackacre in tenancy in common, and A dies. B and A's estate would then own Blackacre as tenants in common.*

Applying the above rules to collection, the IRS may levy and sell a taxpayer's interest in a tenancy in common. Alternatively, the IRS may ask a court to foreclose the federal tax lien and sell the entire property, although the non-liable tenant in common must be compensated from the sale proceeds. Also, if a tax lien attaches to one tenant's interest, it will survive the taxpayer's death and continue to encumber the property in the hands of heirs or legatees.

d. Tenancy by the Entirety

Only a husband and wife can hold property in a tenancy by the entirety. A tenancy by the entirety is similar to a joint tenancy in having a right of survivorship. But the tenancy by the entirety has a restriction not found with a joint tenancy: one spouse cannot transfer his or her interest without the consent of the other spouse. For many years, there was uncertainty as to whether a federal tax lien could attach to the interest of only one tenant. (If both spouses were liable, the general rule was that a federal tax lien could attach to the tenancy by the entirety.) In 2002, the Supreme Court ruled that the federal tax lien may attach to the tenancy by the entirety when only one spouse had a federal tax liability.[8]

---

[8] *United States v. Craft, 535 U.S. 274 (2002).* Notice 2003-60, 2003-2 C.B. 643 addressed the application of Craft to different situations. In summary, the Notice stated the following:

The federal tax lien attaches to all the property and rights to property of the taxpayer. The Court's decision confirms that a taxpayer's property and rights to property have always included any rights that the taxpayer may have in entireties property under state law. The Court's decision, therefore, does not represent new law and does not affect other law applicable to federal tax liens and federal tax collection. For example, the Craft

Because of the potential adverse consequences to the non-liable spouse of the taxpayer, the IRS makes a case-by-case determination as to whether to use a lien foreclosure for entireties property subject to the federal tax lien. As a general rule, the value of the taxpayer's interest in entireties property will be deemed to be one-half.

2. Equitable Conversion

In some states, the doctrine of equitable conversion provides that, prior to the actual sale of property, the seller's rights in the real property change to a right to personality, i.e., the purchase price, while the buyer becomes entitled to the realty. This equitable rule, however, does not override the Internal Revenue Code.

H. PROPERTY HELD BY THIRD PARTIES

Attempting to avoid the federal tax lien, taxpayers have transferred their assets to legal entities that they or their friends or relatives control. This maneuver will generally be unsuccessful because the federal tax lien extends to property held by a third party if that third party is either the alter ego or the nominee of the taxpayer. The factors which are relevant in determining whether such a situation exists are similar to the factors which are used in deciding whether a taxpayer has fraudulently conveyed property to keep it from the reach of creditors.

I. APPLYING FOR A DISCHARGE

If you are giving up ownership of property, such as when you sell your home, you may apply for a Certificate of Discharge. Each application for a discharge of a tax lien releases the effects of the lien against one piece of property. Note that when certain conditions exist, a third party may also request a Certificate of Discharge. If you're selling your primary residence, you may apply for a taxpayer relocation expense allowance. Certain conditions and limitations apply.

---

decision does not change any limitation on the ability of the Service to rescind an accepted offer in compromise or terminate an accepted installment agreement.

II. Priority of Tax Liens: Specially Protected Competing Interests

After notice and demand for payment, the federal tax lien arises and relates back to the assessment date. Congress recognized that it was difficult to conduct business when creditors were unaware of the IRS's assessment lien.[9]

A. PURCHASERS

If a NFTL has not been filed prior to the sale of a taxpayer's property, the purchaser takes the property free of the federal tax lien. A purchaser is a person, who for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law as against subsequent purchasers without actual notice.

A purchaser must acquire the property pursuant to a sale. The amount paid must bear some reasonable relationship to the value of the property acquired. However, this requirement of full and adequate consideration does not preclude a bona fide bargain purchase or a purchaser who has not completed performance of his/her obligation, such as the completion of installment payments. A purchaser is also one who has acquired a lease of property, an executory contract to purchase or lease property, one who has an option to purchase or lease property or an interest in it, or one who has an option to renew or extend a lease on property, if the interest acquired is not a lien or security interest.

B. JUDGMENT LIEN CREDITOR

If a NFTL has not been filed prior to a creditor perfecting a judgment lien, the judgment lien has priority over the federal tax lien. In order to be a judgment lien creditor, the creditor must obtain a valid judgment in a court of record and of competent jurisdiction. In the case of a judgment for the recovery of a certain sum of money, a claimant must have a perfected lien on the property involved. This requires:

---

[9] Consequently, Congress enacted the forerunner of IRC §6323(a) to provide that a NFTL must be filed in order to have priority over certain creditors. Today, IRC §6323(a) provides, in part, that "the lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof has been filed." IRC §6323(a) applies to the IRS in a variety of situations including interpleaders and lien foreclosures. In lien priority disputes, the Service must determine which claims against the taxpayer's property will be satisfied first, which second, and so on down the order of priority until the value of the property is exhausted. If a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor with a claim to the taxpayer's property perfects its claim prior to the filing of a NFTL, then that claim is entitled to priority over the tax lien.

- The identity of the lienor;
- The property subject to the lien; and
- The amount of the lien be established.

If state law requires a recording of the judgment before there is a lien on the real property that is good against third parties, the creditor does not qualify as a judgment lien creditor until that date. If state law requires a levy or seizure of personal property before there is a lien on the personal property that is good against third parties, then there must be a levy or seizure of the personal property before the notice of federal tax lien is filed.

C. MECHANICS LIENOR

If a NFTL has not been filed prior to a creditor perfecting a mechanic's lien,[10] the mechanic's lien has priority over the federal tax lien. For priority purposes, the lien arises on the earliest date such lien becomes valid under local law against subsequent purchasers of the property without actual notice of the tax lien but not before the mechanic begins to furnish the services, labor or materials. Thus a mechanic's lienor, who takes all of the requisite action under local law to perfect and enforce such lien, has a mechanic's lien from a date no earlier than the day on which the mechanic began to furnish the services, labor or materials on the job to which the lien relates.

D. HOLDER OF A SECURITY INTEREST

If a NFTL has not been filed prior to a creditor perfecting a security interest, the security interest has a priority over the federal tax lien. IRC § 6323(h)(1) defines a security interest as any interest acquired by written contract for the purpose of security (payment, performance, indemnity) in existing property for which the holder paid money or money's worth and which has priority under local law over subsequent judgment liens arising out of unsecured obligations.

If a federal tax lien is invalid against an initial holder of a security interest, it is also invalid against another party that acquires the security interest, whether by

[10] IRC §6323(h) defines a mechanic's lienor as a person who, under local law, has a lien on real property (or on the proceeds of a contract relating to real property) for services, labor or materials furnished in connection with the construction or improvement of the property. IRC §6323(h)(2).

purchase or otherwise. A security interest must be in existence to prime a federal tax lien. A security interest exists at any time if, at such time the property is in existence and the security interest has become protected under local law against a subsequent judgment lien and to the extent that, at such time, the holder has parted with money or money's worth.

This priority over a NFTL will occur only if such an interest under local law would prime a judgment lien creditor as of the time of the filing of the NFTL. Thus, where a creditor fails to perfect its security interest as required by the Uniform Commercial Code, the federal tax lien will attach to the property and may be entitled to priority over the creditor.[11]

Local law distinguishes real property from personal property. This is important because the actions required under local law to establish the priority of the security interest against a subsequent judgment lien may differ depending on whether the property involved is real or personal property.

E. SUPERPRIORITIES AND REAL ESTATE TAXES AND ASSESSMENTS

The Internal Revenue Code provides special protection for limited interests by giving them priority over the federal tax lien even though the interests come into existence after the filing of a NFTL.[12] These special interests are called "superpriorities." There may be some overlapping among categories of "superpriorities" in which event federal law provides protection if any category applies even though another may also be relevant. Should two categories of "superpriorities" apply to an interest, then the Service should use that category which gives the greatest protection to the private interest.

This "superpriority" protects certain specified state and local tax liens against real property. IRC §6323(b)(6) applies if state or local law entitles such liens to take priority over security interests in such property which are prior in time, and such lien secures payment of one of the following three types of taxes or charges:

- Real estate taxes (i.e. property taxes);

- A special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the

[11] United States v. Trigg, 465 F. 2d 1264 (8th Cir. 1972), cert. denied, 410 U.S. 909 (1973).

[12] IRC §6323(b).

cost of any public improvement. For example, sewers, streets, or sidewalks;

- A charge for utilities or public services furnished to such property by the United States, a state or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

If real estate taxes (whenever they accrue) are ahead of mortgages under local law, they will also be ahead of federal tax liens. The result will be the same if a special assessment lien arises after the federal tax lien is in existence. The same priorities apply in the case of charges for utilities or public services. This superpriority category does not include other state and local tax liens arising for personal property taxes, state or local income taxes, franchise taxes, etc.

F. SEIZURE OF A RESIDENCE

If a taxpayer has an IRS lien on his or her home, the ultimate worst-case scenario is to have that home seized and sold by the government to recoup the taxes. Even a principal residence can be sold for this purpose. To protect taxpayers, however, the Internal Revenue Code provides that the amount owed be in excess of $5,000 before a home can be seized. In addition, IRC §6334(e)(1) requires a court order before administrative seizure of certain principal residences owned by the taxpayer when seizure is otherwise permissible. These include the principal residence of:

- The taxpayer;

- The taxpayer's spouse;

- The taxpayer's former spouse; and

- The taxpayer's minor child.

1. Administrative Requirements

Although not legally required, written approval by the Area Director of the IRS is required administratively before seizure of any property used by any person as a principal residence. After the required approval is obtained, a suit recommendation package should be prepared for Area Counsel as set forth in the Internal Revenue Manual. In addition, IRC § 6334(e)(1) provides that there will be no levy on a principal residence unless approved by a judge or magistrate (in writing). At this hearing, the IRS will be required to demonstrate that: (1) the requirements of any applicable law or administrative procedures relevant to the levy have been met, (2) the liability is owed, and (3) no reasonable alternative for the collection of the taxpayer's debt exists.

2. Redemptions

The person whose property has been seized may redeem both real and personal property at any time before its sale by paying the taxes due and any expense incurred in connection with the seizure and contemplated sale. The amount of the tax due must be paid, and not merely an amount equal to the value of the property seized or the value of the government's interest in the property.

Real property may be redeemed within 180 days from the date of sale by the taxpayer, his/her heirs, executors, or administrators, or any person having an interest in or a lien on the property, or any person on their behalf.[13]

When a certificate of sale is tendered after the expiration of the redemption period, the deed should be issued even if there is a contention that a qualified party has offered to redeem and been refused, since that party's remedy is to seek judicial enforcement of the right to redeem. The amount to be paid to the purchaser to redeem is the purchase price, together with interest at the rate of twenty percent (20%) per annum.[14]

G. EFFECT OF BANKRUPTCY

Under the Bankruptcy Code, the statute of limitations on collection is suspended for the period during which the IRS is prohibited by reason of the bankruptcy case from collecting the liability, plus six months thereafter.[15] The IRS may be prevented from collecting the liability for any one of several reasons, including the automatic stay imposed by section 362 of the Bankruptcy Code (11 USC), because it is bound by the terms of a repayment plan pursuant to Chapter 11, 12 or 13 of the Bankruptcy Code, or because the court has issued an order prohibiting the Service from exercising its collection powers.

[13] Once personal property is sold, the taxpayer no longer has any right to redeem the property.

[14] IRC §6337(b)(2).

[15] IRC §6503(h).

The IRS is automatically stayed from taking any act to perfect or enforce a lien against property of the estate or to collect a claim against the debtor upon the filing of a bankruptcy petition.

If levied-upon property has not been sold or credited to the taxpayer's account before the taxpayer files for bankruptcy, the trustee can obtain an order directing the IRS to turn over property to the trustee if it provides adequate protection for the Service's interest in the seized property. The revenue officer should, pursuant to the Internal Revenue Manual, work with Area Counsel to determine whether the government will seek relief from the automatic stay or negotiate for an adequate protection agreement before returning the property. In these cases, time is of the essence because inaction might subject the government to monetary sanctions for violating the automatic stay.[16]

III. Adjustments to IRS Lien Policies

In 2008, at the height of the financial crisis, the IRS announced an expedited process that will make it easier for financially distressed homeowners to avoid having a federal tax lien block refinancing of mortgages or the sale of a home.

A. REQUEST FOR LIEN PRIORITY CHANGE

If taxpayers are looking to refinance or sell a home and there is a federal tax lien filed, there are options. Taxpayers or their representatives, such as their lenders, may request that the IRS make a tax lien secondary to the lien by the lending institution that is refinancing or restructuring a loan. Taxpayers or their representatives may also request that the IRS discharge its claim if the home is being sold for less than the amount of the mortgage lien under certain circumstances.

The process to request a discharge or a subordination of a tax lien takes approximately 30 days after the submission of the completed application, but the IRS will work to speed those requests in wake of the economic downturn.

"We don't want the IRS to be a barrier to people saving or selling their homes. We want to raise awareness of these lien options and to speed our decision-making process so people can refinance their mortgages or sell their homes," said then-IRS Commissioner Doug Shulman in 2008.

[16] For a more complete discussion of the effect of bankruptcy, see IRM 5.17.8, *General Provisions of Bankruptcy*; IRM 5.17.9, *Chapter 7 Bankruptcy*; IRM 5.17.10, *Chapter 11 Bankruptcy*; and IRM 5.17.11, *Chapter 13 Bankruptcy*.

B. CERTIFICATE OF DISCHARGE

Taxpayers or their representatives may apply for a certificate of discharge of a tax lien if they are giving up ownership of the property, such as selling the property, at an amount less than the mortgage lien if the mortgage lien is senior to the tax lien. The IRS may also issue a certificate of discharge in other circumstances if the taxpayer has sufficient equity in other assets, can substitute other assets, or is able to pay the IRS its equity in the property. Without a tax lien discharge, the taxpayer may be unable to complete the home ownership change and the ownership title will remain clouded.

To apply for a tax lien discharge, applicants must follow directions in Publication 783, Instructions on How to Apply for a Certificate of Discharge of a Federal Tax Lien. There is no form but there must be a typed letter of request and certain documentation. The request should be mailed to one of 40 Collection Advisory Groups nationwide.

C. SUBORDINATION

In some cases, a federal tax lien can be made secondary to another lien. That process is called subordination. For more information on this topic, refer to *Publication 784, How to Prepare Application for Certificate of Subordination of Federal Tax Lien*.

D. IRS REFORMS TO HELP TAXPAYERS

In 2011, the IRS announced a series of new steps to help taxpayers dealing with liens and other financial problems.

The changes include:

- Significantly increasing the dollar threshold when liens are generally issued, resulting in fewer tax liens;
- Making it easier for taxpayers to obtain lien withdrawals after paying a tax bill;
- Withdrawing liens in most cases where a taxpayer enters into a Direct Debit Installment Agreement;

- Creating easier access to Installment Agreements for more struggling small businesses; and

- Expanding a streamlined Offer in Compromise program to cover more taxpayers.

In 2008, the IRS announced lien relief for people trying to refinance or sell a home. In 2009, the IRS added new flexibility for taxpayers facing payment or collection problems. And in 2010, the IRS held about 1,000 special open houses to help small businesses and individuals resolve tax issues with the Agency.

1. <u>Tax Lien Thresholds</u>

The IRS will significantly increase the dollar thresholds when liens are generally filed. The new dollar amount is in keeping with inflationary changes since the number was last revised. Currently, liens are automatically filed at certain dollar levels for people with past-due balances. The IRS plans to review the results and impact of the lien threshold change in about a year.

2. <u>Tax Lien Withdrawals</u>

The IRS will also modify procedures that will make it easier for taxpayers to obtain lien withdrawals. Liens will now be withdrawn once full payment of taxes is made if the taxpayer requests it. The IRS has determined that this approach is in the best interest of the government. In order to speed the withdrawal process, the IRS will also streamline its internal procedures to allow collection personnel to withdraw the liens.

3. <u>Direct Debit Installment Agreements and Liens</u>

The IRS is making other fundamental changes to liens in cases where taxpayers enter into a Direct Debit Installment Agreement (DDIA). For taxpayers with unpaid assessments of $25,000 or less, the IRS will now allow lien withdrawals under several scenarios:

- Lien withdrawals for taxpayers entering into a Direct Debit Installment Agreement;

- The IRS will withdraw a lien if a taxpayer on a regular Installment Agreement converts to a Direct Debit Installment Agreement; and

- The IRS will also withdraw liens on existing Direct Debit Installment Agreements upon taxpayer request.

Liens will be withdrawn after a probationary period demonstrating that direct debit payments will be honored. In addition, this lowers user fees and saves the government money from mailing monthly payment notices. Taxpayers can use the Online Payment Agreement application on IRS.gov to set-up with Direct Debit Installment Agreements.

4. Offers in Compromise

The IRS is also expanding a new streamlined Offer in Compromise (OIC) program to cover a larger group of struggling taxpayers. This streamlined OIC is being expanded to allow taxpayers with annual incomes up to $100,000 to participate. In addition, participants must have tax liability of less than $50,000, doubling the current limit of $25,000 or less.

OICs are subject to acceptance based on legal requirements. An Offer in Compromise is an agreement between a taxpayer and the IRS that settles the taxpayer’s tax liabilities for less than the full amount owed. Generally, an offer will not be accepted if the IRS believes that the liability can be paid in full as a lump sum or through a payment agreement. The IRS looks at the taxpayer’s income and assets to make a determination regarding the taxpayer’s ability to pay.

Chapter 4 – Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

1. If the IRS is first to file its lien, which types of creditors will have priority over a federal tax lien:

   a) mechanic's lienor
   b) holder of a security interest
   c) judgment lien creditor
   d) none of the above

2. What effect do superpriority interests have on federal tax liens:

   a) although they are filed before federal tax liens, federal tax liens take priority
   b) superpriority interests are filed after federal tax liens, however, the superpriority interests take priority
   c) when both a federal tax lien and superpriority interest are filed simultaneously, the federal tax lien always takes priority
   d) superpriority interests have no effect on federal tax liens

Chapter 4 – Review Question Answers

1. D: - see page 69

2. B: - see page 79

End of Study Materials

The exam for this course can be accessed by logging in to your account at CALicenseRenewal.com.

Exam Information

- Number of questions: 20
- Time limit: 20 minutes
- Passing Score: 70%

CalBRE Regulations Regarding Exam Availability

The California Bureau of Real Estate strictly regulates the timing of when exams can be taken for continuing education courses. Exams will only be available when the following two conditions are met:

1. **The corresponding number of study hours have been accumulated.**

   a. 8 hours of study time is granted automatically every 24 hours starting at the time of purchase.
   b. This course is worth 6 hours of CE credit and therefore requires 6 hours of unused study time credit.
   c. Your currently available study hours are listed on the My Account page.

2. **Taking this exam will not put the licensee over the CalBRE limit of 15 credits of final exams in any 24-hour period.**

   a. This course is worth 6 CE Credits so no more than 9 credits of exams can be taken in the 24 hours before taking this exam.
   b. The number of credits of exams you have taken in the last 24 hours is listed on the My Account page, as well as the time each of those exams was completed.

Glossary

Automatic stay: The injunction issued automatically upon the filing of a bankruptcy case which prohibits collection actions against the debtor, the debtor's property, or the property of the estate.

Bankruptcy estate: The estate is all of the legal and equitable interests of the debtor as of the commencement of the case. From the estate, an individual debtor can claim certain property exempt; the balance of the estate is liquidated in a Chapter 7 to pay the administrative costs of the proceeding and the claims of creditors according to their priority.

Chapter 7: The most common form of bankruptcy, a Chapter 7 case is a liquidation proceeding available to individuals, married couples, partnerships and corporations.

Chapter 11: A reorganization proceeding in which the debtor may continue in business or in possession of its property as a fiduciary. A confirmed Chapter 11 plan provides for the manner in which the claims of creditors will be paid in whole or in part by the debtor.

Chapter 13: A repayment plan for individuals with debts falling below statutory levels which provides for repayment of some or all of the debts out of future income over 3 to 5 years.

Creditor: The person or organization to whom the debtor owes money or has some other form of legal obligation.

Discharge: The legal elimination of debt through a bankruptcy case. When a debt is discharged, it is no longer legally enforceable against the debtor, though any lien which secures the debt may survive the bankruptcy case.

Emergency Homeowners' Loan Program (EHLP): The purpose of the EHLP is to provide assistance to homeowners who are at risk of foreclosure and have experienced a substantial reduction in income as a result of involuntary unemployment or underemployment due to adverse economic or medical conditions.

Fannie Mae (Federal National Mortgage Association): A government sponsored enterprise with the goal to help more families achieve home ownership.

Federal Deposit Insurance Corporation (FDIC): A U.S. government corporation created by the Glass-Steagall Act of 1933, which preserves and promotes public confidence in the financial system of the United States by insuring deposits in banks and financial institutions.

Foreclosure: The legal proceedings initiated by a creditor to repossess the collateral for a loan that is in default.

Government Services Administration (GSA): They are responsible for promoting effective use of federal real property assets as well as the disposal of them.

HFA Hardest Hit Fund: The purpose of the HFA Hardest Hit Fund is to provide funds to the State Programs: (1) to assist homeowners in preventing avoidable foreclosures, and (2) to stabilize housing markets.

Housing Finance Agency (HFA): An agency that supervises Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to promote and support housing finance and affordable housing.

Insolvency: Having negative net assets – in other words, liabilities exceed assets.

Judicial foreclosure: This type of foreclosure involves the sale of the mortgaged property under the supervision of the court.

Lien: An interest in real or personal property which secures a debt; the lien may be voluntary, such as a mortgage in real property, or involuntary, such as a judgment lien or tax lien.

Mortgage Forgiveness Debt Relief Act: This Act offers relief to homeowners who would formerly owe taxes on forgiven mortgage debt after facing foreclosure.

Non-judicial foreclosure: This type of foreclosure involves the sale of the mortgaged property without court supervision. When there is a deed of trust instead of a mortgage, title remains with the trustee and not the homeowner.

Priority: The Bankruptcy Code establishes the order in which claims are paid from the bankruptcy estate. All claims in a higher priority must be paid in full before claims with a lower priority receive anything. All claims with the same priority share pro rata. Claims are paid in this order: 1) costs of administration, 2) priority claims, and 3) general unsecured claims. Secured claims are paid from the proceeds of liquidating the collateral which secured the claim.

Priority claims: Certain debts, such as unpaid wages, spousal or child support, and taxes are elevated in payment hierarchy under the Code. Priority claims must be paid in full before general unsecured claims are paid.

Qualified principal residence indebtedness: Any mortgage that an owner took out to buy, build, or substantially improve his or her main home. It also must be secured by his or her main home.

Secured debt: A claim secured by a lien in the debtor's property by reason of the debtor's agreement or an involuntary lien such as a judgment or tax lien. The creditor's claim may be divided into a secured claim, to the extent of the value of the collateral, and an unsecured claim equal to the remainder of the total debt. Generally a secured claim must be perfected under applicable state law to be treated as a secured claim in the bankruptcy.

Short sale: When the holder of a mortgage agrees to allow the owner of the home to sell it for less than what is owed on the mortgage. The owner of the mortgage thereby takes a loss on the transaction.

Substantially similar state programs (SSSP): The purpose of SSSPs is to provide assistance to homeowners who are at risk of foreclosure and have experienced a substantial reduction in income as a result of involuntary unemployment or underemployment due to adverse economic or medical conditions.

Tax deed sale: It is the forced sale, conducted by a governmental agency, for nonpayment of real property taxes.

Tax lien sale: It is the sale, conducted by a governmental agency, of tax liens for delinquent taxes on real estate.

U.S. Department of Housing and Urban Development (HUD): A federal agency that implements housing policy and was created to increase home ownership across the U.S.

Veterans Administration Loan Guaranty Service: In recognition of service to our country, this program helps veterans and active duty personnel purchase and retain homes.