



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SMALL BUSINESS / SELF-EMPLOYED DIVISION

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MEMORANDUM FOR DIRECTORS, COLLECTION AREA OPERATIONS
DIRECTOR, ADVISORY, INSOLVENCY, AND QUALITY

FROM: Frederick W. Schindler /s/ **Frederick W. Schindler**
Director, Collection Policy

SUBJECT: Certificates of Discharge in Short Sale Situations

The purpose of this memorandum is to issue interim guidance for processing and approving requests for certificates of discharge in short sale situations. The impacted section of IRM 5.12.3, Certificates Relating to Liens, will be revised to include the information in this memorandum. Please ensure that this information is distributed to all affected employees in your organization.

The authority of the Internal Revenue Service (IRS) to issue a certificate of discharge of property subject to the federal tax lien is found in Internal Revenue Code (IRC) section 6325(b). Among other conditions, the IRS may issue a certificate of discharge when the interest of the United States in the such property is determined to have no value (section 6325(b)(2)(B)).

A short sale occurs when the senior lien holder agrees to accept less than the total amount owed as satisfaction for its lien claim. For example, a bank has a priority mortgage claim for \$600,000, but, due to the significant decline in the real property market, the bank agrees to a sale of the mortgaged property for \$300,000. Because the senior lien attaches to all the equity in the property, generally the lien interest of the United States in short sale properties is valueless. Therefore, applications for discharge for properties subject to short sales should be considered under IRC 6325(b)(2)(B).

To facilitate the sale of the property in these situations, the senior lien holder might negotiate the payment of expenses to be taken from its settlement amount. In certain situations, these expenses might be greater than normal closing costs allowed by the IRS and might include creditors that would otherwise be junior to

the IRS. This action by the senior lien holder to carve proceeds out of its priority claim to pay these expenses does not create an equity interest on the part of the taxpayer which may be reached by the IRS lien. Provided there is no fraudulent aspect to the payment distribution and the lien interests of the IRS in other properties of the taxpayer is not being harmed, the IRS has no authority to require payment of the sum that otherwise would have gone to the senior lien holder.

Following the previous example, the bank determines that out of the \$300,000 sales price, it will allow \$15,000 of expenses to be paid. Most of the \$15,000 is for normal closing costs, but \$5,000 of it is for a homeowner's association fee, which is junior in priority to the IRS, and \$2,000 is for state transfer taxes. Because the payments made for the homeowner's association fee and the state transfer taxes are made from proceeds attributable to the bank's priority lien interest and the interest of the IRS in the property to be discharged is valueless, the IRS cannot condition discharge upon payment of any part of the amount going to these expenses.

Therefore, upon receiving an application for discharge of a property subject to a short sale, follow standard procedures outlined in IRM 5.12.3 to investigate the statements made in the application regarding the transfer, encumbrances on the property, property values, and proposed distribution of the proceeds. Additional documentation to complete the investigation may be requested if the information has not otherwise been provided. Presuming no issues are identified, the discharge application can be approved following existing IRM procedures.

In normal (non-short) sale situations, where the lien claim of the bank is fully paid and the federal tax lien attaches to surplus proceeds, the IRS's lien interest must be satisfied in accordance with IRC 6325(b) before the property can be discharged from the lien. Creditors junior to the IRS interest are not entitled to payment from the proceeds before the IRS lien interest is fully paid.

If you have any questions, please contact me, or a member of your staff may contact Kyle Romick, Senior Program Analyst.

cc: www.irs.gov