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Discharging and Releasing Real and Personal Property from Tax Liens

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The IRS and ODR record thousands of federal tax lien notices and state tax warrants for unpaid tax debts each year. These lien notices and warrants perfect the liens that arise when unpaid tax liabilities are assessed, and cloud the title of real and personal property belonging to taxpayers. Once a tax lien notice or tax warrant has been recorded, a purchaser of the property cannot obtain clear title without obtaining the discharge or release of the property from the tax lien. Federal tax liens can also continue as an encumbrance on title when a purchaser buys real property at a foreclosure sale if the foreclosing entity does not provide a special form of notice to the IRS.

This article discusses the federal and state requirements for the discharge or release of property from federal and state tax liens. It is intended to serve as a guide for practitioners in instances where they are assisting a client with a discharge or release. The related process of applying for the IRS' subordination of a federal tax lien to a competing encumbrance is not discussed herein. However, the application process and principles surrounding subordination parallel the processes and principles for discharge.

Fundamental Lien Concepts

Liens for tax liabilities arise automatically whenever an unpaid tax is assessed. IRC section 6321 and 6322; ORS 314.417. The scope of the general liens established by these federal and state laws is identical: the liens attach to "all property and rights to property, whether real or personal," that belong to the taxpayer. *Id*. The liens empower the taxing agencies to seize, levy, or garnish property to collect the unpaid tax.

The taxing authority may subsequently choose to give public notice of the lien through recordation. Recordation of the tax lien notice in the correct state office "perfects" the lien in the same manner as the filing of a UCC financing statement or a trust deed on real property. The IRS perfects a tax lien on real property in Oregon by filing a notice of federal tax lien with the county where the real property is located. IRC section 6323(f); ORS 87.806 et seq. It perfects its tax lien on personal property by filing a notice with the Oregon Secretary of State's UCC filing office. *Id*. The ODR perfects its tax lien by filing a "tax warrant," rather than a notice of lien. The ODR perfects its tax lien on real property by filing a warrant with the county where the real property is located. ORS 314.423 and 314.430. The ODR perfects its tax liens on personal property by recording the tax warrant in the county of the debtor's residence. *Id*.

The filing of a federal tax lien notice or state tax warrant has two effects. First, it places the government into priority competition with other parties who hold security interests, liens, or other interests in the property. The standard rule of "first in time, first in right" generally applies. The secured creditor who has the earliest recording date has the first priority encumbrance on the property and is entitled to have its debt paid first from available proceeds, and the secured creditor who has recorded second is entitled to second priority. IRC section 6323; ORS 314.413. The second priority creditor can only

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recover anything after the first priority creditor has recovered on its debt in full.[1]

Second, once a federal tax lien notice or state tax warrant has been recorded, a person who purchases the property from the taxpayer without first getting it released or discharged from the lien will generally acquire the property still subject to the lien.[2] This means that the taxing agency can seize, levy, or garnish the property from the purchaser after the property has been sold, and apply the proceeds of a sale of the property to the taxpayer's liabilities. Recorded tax liens will be excepted from the title insurance a title company will provide in a real or personal property sale transaction when the liens are discovered prior to closing. The seller or purchaser will have to obtain a discharge or release of the property from the lien for the purchaser to obtain clear title.

Federal and state statutes and regulations provide authority and procedures for obtaining the discharge or release of property from a tax lien so the property can be sold free and clear of tax liens. The IRS and ODR have personnel dedicated to the process of reviewing and granting applications for discharge or release. The lien discharge and release functions serve two important purposes.

First, the taxing agencies recover significant dollars every year from the discharge or release of property from tax liens. Both federal and state law require the taxing agency's receipt of the value of the tax lien from the proceeds of a sale, or the government's collateralization in other assets for at least the value of its lien on the property to be sold, before the property can be discharged or released.

Second, the discharge and release procedures of the taxing agencies insure that federal and state tax liens do not unduly impede the sale of real and personal property between the taxpayers and other persons. In instances where the taxing agency is not entitled to a recovery from the proceeds of sale because its lien does not attach to any equity in the property (*e.g.*, in instances where the value of the property is fully encumbered by other liens senior to the tax lien), the taxing authorities will usually issue a discharge or release without demanding receipt of any sale proceeds. Both the IRS and the ODR maintain policies of not "ransoming" sale transactions for receipt of proceeds they are not entitled to.

Applications for discharges and releases of property are carefully reviewed. The review focuses on the value of the property and the existence and amounts of senior liens. These two factors determine the value of the tax agency's lien on the property. The party applying for the discharge or release (sometimes the taxpayer, and sometimes the purchaser), is responsible for providing the taxing authority with the documents needed to establish the value of the lien.

Internal Revenue Code sections 6325 and 7425 and the associated Regulations provide the federal rules governing the administrative release of federal tax liens and the discharge of property from a tax lien. IRS Publication 1468 provides an overview of the IRS' tax lien processes, and Publications 783, 784, and 1024 provide instructions on how to apply for certificates of discharge, subordination, and lien non-attachment, respectively. Oregon Revised Statute 305.140 and OAR 150-305.140 provide the parallel state rules.

The Lingo and the Law

The federal and state systems use different terms for their lien relief processes.

Under the Internal Revenue Code, the "release" of a lien is the lien's extinguishment. Section 6325(a) provides that a lien shall be released when:

(1) The liability has been satisfied;

(2) The liability has become legally unenforceable (*e.g.* by reason of expiration of the collection limitations period or a bankruptcy discharge); or

(3) The taxpayer has provided the IRS with an acceptable bond which provides for payment of all liability due.

The removal of property from a federal tax lien's attachment is called a "discharge" of the property from the tax lien. Section 6325(b) provides that a discharge *may* be granted when, to the satisfaction of the IRS:

(1) The taxpayer establishes that the property still subject to the lien has at least twice the value of the tax due;

(2) The IRS receives the value it is entitled to from the liened property and the remaining interest of the IRS in the property is valueless;

(3) A satisfactory agreement provides for the IRS' receipt of a lien on proceeds that will arise from the sale of the property in the same manner and priority as the lien had on the property; or

(4) The taxpayer provides the IRS with a deposit or bond equal to the value of the property.

In federal field collection, the overwhelming majority of discharge applications occur under section 6325(b)(2). This is the provision that authorizes the IRS' issuance of a certificate of discharge that removes property from a lien when the property is sold to a purchaser and the IRS recovers its lien value from the sale proceeds.

Discharges under section 6325(b)(3) occur less frequently, but are important where disputes exist between competing creditors or the IRS and the taxpayer. This statute is designed to accommodate situations where the priority of creditors or the amounts due them are in dispute, and the dispute(s) cannot be resolved before a sale of property should occur. In these instances, the parties can agree to leave some or all of the funds that would be paid to them in escrow after the sale has closed. The sale may go forward, and the dispute(s) can be later resolved through litigation or otherwise. An agreement that each party will have the same rights to the proceeds as they used to have with respect to the property preserves every-

1 IRC section 6323(b) and ORS 314.413(2) establish several "superpriorities" for competing debts which will always be granted priority over a tax lien. Conversely, IRC section 6323 also establishes numerous limitations on the priority granted to competing encumbrances with property acquired by a taxpayer after a federal tax lien notice has been filed.

2 Persons entitled to a super-priority under Section 6323(b) or ORS 314.413(2) may not need to obtain a discharge or release. The purchaser of goods sold at retail, for example, is entitled to a superpriority under section 6323(b) which allows the purchaser to acquire the property free and clear of the lien as long as the purchase transaction is not intended to hinder, evade, or defeat collection of taxes from the seller and the purchaser does not know that the purchase will have this effect. Other superpriorities are granted to purchasers of goods in a casual sale, purchasers of securities, and purchasers of motor vehicles. The conditions required for each of these superpriorities should be carefully reviewed.

one's recovery rights. If litigation is necessary, the escrowed funds can be deposited with a court in an interpleader action, or one or more of the parties can file an action to quiet title.

The Oregon Revised Statutes do not use the term "discharge" with state tax liens. Instead, ORS 305.140, 305.150, and 305.182 use the term "release" interchangeably with both the "release" of real property from an ODR tax lien under specified circumstances (ORS 305.140), and the "release" (extinguishment) of a tax lien. ORS 305.150 and 305.182. Oregon law does not provide a specific process for the release of personal property from a state tax lien, but the ODR will typically accommodate parties who request a release of personal property from a tax lien under the same procedures used for real property.

ORS 305.140 authorizes the release of property under the following conditions:

(1) The ODR ***shall*** release property from the lien if it finds that a sale of property would not result in the satisfaction of any part of the liability;

(2) The ODR ***may*** release property from the lien if it finds that the liability has been satisfied;

(3) The ODR ***may*** release property if it finds that the fair market value of property still subject to the lien is at least double the tax liability due;

(4) The ODR ***may*** release property if it receives a letter of credit or bond which it considers sufficient for payment of all liability due; or

(5) The ODR ***may*** release property if it is paid an amount which it determines to be the value of its lien on the property.

We may observe that in the federal system, the ***release*** (meaning "extinguishing") of a tax lien is mandatory when one of the three identified conditions occur. All federal ***discharges*** of property from a lien, on the other hand, are discretionary. Even if the taxpayer fulfills the required statutory conditions, the IRS may choose not to grant a discharge.

ORS 305.140, in contrast, only mandates the release of property from a state tax lien when the ODR finds that a sale of the property will not result in any payment towards the tax liability. The ODR sensibly deems its mandate under the statute to be narrower than the overly broad statutory language implies. In practice, the ODR will release property from the state tax lien only if the property ***is being sold*** and it is clear that the ODR's lien does not attach to any equity (***e.g.*** because senior encumbrances already exhaust all of the property's value). It will not release property simply because the state lien does not attach to any equity at the time an application for release is made if the property is not actually being sold. Thus, the taxpayer whose $300,000 home is attached by a first priority $325,000 mortgage and a second priority $25,000 state tax lien will not be granted a release of the tax lien unless the home is actually being sold. In the absence of a sale, the ODR deems itself entitled to wait for the day when its lien acquires value through appreciation of the property or the reduction or elimination of senior encumbrances. The word "shall" is only intended to insure that the ODR will not impede the sale of real property in cases where there is an actual sale pending and the ODR's lien has no value.

Conversely, ORS 305.140 states that the ODR "may" release a lien where the lien has been fully satisfied. Clearly, the legislature realized that a tax lien should always be released when the liability has been paid. The "may" would seemingly allow the ODR to leave warrants on record for years after the tax has been satisfied with impunity. The ODR will, however, issue a release of a satisfied lien when the taxpayer or some other party complains about a cloud on title. The permissive "may" was presumably intended to relieve the ODR of having to release every tax warrant it has filed once the underlying liabilities are paid.

IRS Practice

Federal Regulation requires the submission of a written application for the discharge of property from a federal tax lien. In June, 2010, the IRS revised Publication 783 regarding applications for discharges of property, and published the first official form, Form 14135, for discharges. Submission of a properly completed form is now mandatory for all discharge applications.

The documents required by Publication 783 are those any creditor would wish to see in determining whether it will receive appropriate value from a sale of property on which it has a lien. The property's value, less the amounts due senior encumbrances and the reasonable costs of sale, is the "value of the lien" and the amount the IRS is entitled to receive. A sale price for less than full market value or a large broker's commission may result in a proposed distribution to the IRS that is less than ideal. While the IRS will tolerate some reduction in its recovery with bargain sale prices and hefty commissions, the statutory "may" allows the IRS to exercise discretion over how large the reductions can be. It can refuse to grant a discharge, or it can demand that the broker's commission be reduced to a level it deems reasonable, to thereby provide a larger distribution to the IRS.

Form 14135 and the revisions to Publication 783 take much of the guess work out of the documents and information that must be provided for an application for discharge. They require the following information:

1. Identification of the type of discharge being requested.
2. A detailed description of the property and its location. If the property is real, both the street address (if any) and the legal description are required. If the property is personal, an itemization of the particular items to be sold is necessary. The description should be sufficient for the value of the property to be determined (***e.g.*** make, model, age, and condition) of a vehicle or other item of personal property.
3. If the discharge of the property is being requested to facilitate a sale of the property, a description of, and the documents evidencing, the manner in which the taxpayer will be divested of title. This will typically be the sale contract or the earnest money agreement.
4. Copies of the pertinent notices of federal tax lien that are clouding title to the property, or alternatively, either a preliminary title report reflecting the lien notices, or a written description of the taxpayer's name and taxpayer identification number, the date the lien was filed, the IRS office that filed it, and the serial numbers reflected on the notices of lien.
5. A list of the encumbrances on the property which are believed to be senior to the IRS (and thus reduce the value attached by the federal tax lien). The application should specify the name and address of each encumbrance holder, the nature of the encumbrance, the amount presently due, and the family relationships, if any, between the taxpayer and these other

creditors. The IRS will also want the dates on which the senior encumbrance came into existence and was perfected.

6. All proposed or actual costs and commissions associated with the sale of the property.

7. Information, preferably in the form of an appraisal, reflecting the value of the property.

8. Any other information that may have bearing upon the application for discharge.

The most common instances where discharges of property are requested involve situations where the taxpayer is attempting to sell property encumbered by a tax lien. When the property to be sold is real property, all of the information required for IRS review of the application can typically be provided by submitting four items:

A. A preliminary title report reflecting all encumbrances on the property. The report will provide the legal description and street address of the property, the IRS' tax liens, and the vital information regarding both senior and junior encumbrances. Make sure the title company searches for encumbrances under the taxpayer's name as well as under the property's description, because judgments, tax liens, and other statutory liens are recorded against the name of the taxpayer rather than against the property.

B. An appraisal of the property. Proof of the estimated value of the property is essential for most discharges. The new Form 14135 appears to make procurement of an appraisal mandatory. ***See*** item 9 therein. Appraisals can be expensive and time-consuming. In some instances, they are unnecessary; for example, one would hope that the IRS would not demand an appraisal when the proposed sale involves a condominium encumbered by $500,000 of encumbrances senior to the tax lien, and the units in the building typically sell for $200,000 or less. In some instances, the IRS will accept a "comparative market analysis" or other statement from a real estate agent or broker regarding the list price that could be employed for a particular parcel of real property. With personal property, it may accept copies of Craigslist or want ads listings as indexes for market value. However, in many cases, the IRS will hold fast to the appraisal requirement. Consulting the IRS' Lien Advisor about the evidence of value that will be accepted before submitting the application for discharge can insure a faster, more efficient closing process.

C. The sales contract or earnest money agreement. These documents reflect the sale price and the timing of payment.

D. A preliminary or estimated closing statement from the escrow or title company handling the closing. This document will reflect the anticipated distribution of the sale proceeds, and thus, how much will be paid towards senior encumbrances, commissions, and the costs of sale.

The application and documents may be submitted to the Advisory Group Manager for the IRS District area or territory in which the property is located. The documents and transaction will be assigned to a Lien Advisor for review. In Oregon, the application may be submitted directly to soon-to-retire Lien Advisor Lloyd Neal ((503)415-7189, or his intended replacement, Lien Advisor Maria Hayden ((503)415-7190). These individuals handle most of the discharge applications involving Oregon properties. The application may be submitted by mail or fax.

The Lien Advisor must obtain the approval of his or her manager before a discharge will be granted. The Advisor's considerations will include the following:

A. The IRS must be assured that it is receiving the full value of its lien. To recover the full value of the lien, the property must be sold for reasonable value. As noted above, bargain or distress sales for less than full fair market value are a grey area requiring the exercise of discretion. The IRS is generally practical enough to understand that taxpayers cannot always find purchasers willing to pay full market value. Establishing that the property will be foreclosed and sold at auction if a bargain sale is not approved may encourage the Lien Advisor to accept a significant discount in the purchase price. A Lien Advisor's decision to refuse to grant a discharge is appealable to his or her Manager. The statutory "may," however, means that the IRS cannot be forced to accept a bargain sale with a lien discharge.

B. The fair market value of the property must be established through competent evidence. As noted above, Lien Advisors are afforded discretion regarding the proof they will accept of value. Defects with the property (***e.g.*** a leaky roof or dry rot in the basement) or an imminent foreclosure sale can be submitted as bases for a reduced value if the defects were not considered in the appraisal. ***See*** item 14 in Form 14135. Once again, the permissive "may" affords the IRS broad discretion.

C. The IRS will only allow the closing costs and broker commissions it deems reasonable. A real estate commission of 6% is generally deemed reasonable. A proposed 10% commission will probably not fly.

D. The taxpayer (seller) will generally not be allowed to recover any of the sale proceeds, unless the proceeds are sufficient to fully pay the tax liability. In cases where the tax will be paid in full, a lien release should be requested rather than a discharge. The IRS will demand that it recovers every dollar that would otherwise be paid to the taxpayer if the tax will not be paid in full.

E. The IRS is wary of transactions involving related parties. A sale for less than full market value between related parties will be deemed suspect, and a large commission promised to a broker who is related to the seller might not be allowed.

The document the IRS will issue to reflect the discharge of the property from the tax lien is a Certificate of Discharge. The IRS will not transmit a Certificate of Discharge to anyone until it has received the payment it was promised in the application process and the sale proceeds have been properly distributed. If the IRS approves a discharge application, it will send a Conditional Commitment Letter to the escrow company, seller, or buyer. This letter will state that the IRS has approved the transaction and will issue a Certificate of Discharge upon receipt of the promised sum, proof that the sale has closed, and proof that the sale proceeds have been distributed in a manner consistent with the discharge application.

Sale costs sometimes change. Small deviations between the payments actually made and those communicated to the IRS in the review process will be tolerated. Large deviations, however, may result in the IRS' refusal to issue the Certificate. If the IRS refuses to issue a discharge after the sale has otherwise closed, the sale may have to be undone. Accordingly, if sale costs increase significantly after the application for discharge has been given to the IRS, the application should be amended and submitted for re-approval to insure that the IRS will still issue the discharge.

The escrow company or purchaser should immediately record the Certificate of Discharge after it is issued.

Publication 783 recommends that the discharge application be submitted to the IRS at least 45 days prior to the desired closing date. Applications often move faster than this, but filing the application early is advised, especially if the property or circumstances surrounding the sale are novel.

Special Notice Requirements for Non-Judicial Foreclosure with Federal Tax Liens

Section 7425(b) of the Internal Revenue Code establishes a trap for the unwary when a senior creditor forecloses non-judicially on property subject to a junior federal tax lien. The trap lies thusly: assume you represent the creditor who is non-judicially foreclosing a trust deed on a parcel of realty, and before the foreclosure sale, a federal tax lien notice is discovered that was filed after the trust deed was recorded.

The IRS is a junior creditor, since its tax lien notice post-dates the foreclosing party's trust deed. State law says that the foreclosing process passes title to the purchaser that is free and clear of junior liens, as long as junior creditors have been provided notice and the opportunity to cure before the sale. However, it is axiomatic that State law cannot "impair the standing of the federal liens, without the consent of Congress." ***US v. City of New Britain, Connecticut***, 347 US 81, 74 S Ct 367 (1954). Congress has not agreed to allow its tax liens to be removed from property under the dictates of state law.

Instead, section 7425(b) requires transmission of a special form of notice to the IRS when a foreclosing party wishes to pass title free and clear of a junior federal tax lien. Federal law allows a senior creditor to "strip" a junior federal tax lien notice from the property through a non-judicial foreclosure. However, the creditor must jump through this additional, federal hoop to get there. The foreclosing creditor who fails to give the appropriate form of pre-sale notice to the IRS will end up with an unhappy purchaser, who will later discover that the property is still attached by a federal tax lien.

Section 7425(b) states that when a notice of tax lien has been on file for more than 30 days before the scheduled date of a foreclosure sale, the foreclosing creditor must provide the IRS with written notice of the sale at least 25 days prior to the sale date. The notice must conform to requirements set forth in the Regulations. As usual, the pertinent Regulations are lengthy and complex. In substance, the IRS must timely receive sufficient information about the proposed foreclosure sale to investigate whether the IRS may want to exercise the special post-foreclosure redemption right under section 7425(d) the IRS has to acquire foreclosed property on which it had a junior lien. For a period of 120 days following the foreclosure sale, the IRS may use funds specially allocated by Congress to acquire the property from the purchaser by paying the purchaser its purchase price, plus statutory interest, and other specified charges. ***Id***, and IRC section 7810. The required information includes the name and address of the taxpayer, identification of the tax liens on the property, the description of the property, and the amount due the foreclosing creditor. Treas. Reg. 301.7425-3. The IRS will estimate the value of the property from available information, and if it appears that the property might be sold at the foreclosure sale for significantly less than its fair market value (e.g. because the amount due the foreclosing creditor is only 50% of the value of the property), it will monitor the sale to see what the property is sold for. If the property does sell for a low price, the IRS will consider purchasing the property from the purchase with the intent of reselling it for a higher price.

Publication 786 provides a user-friendly guide to the whats, hows, and whens with providing notice of a foreclosure sale with a junior federal tax lien. Make sure you send the special notice to the correct IRS office.

ODR Practice

OAR 150-305.140 states that an application for release must be accompanied by a "statement." The rule provides parameters for the form of the statement, but is less specific than Publication 783 about the documents that are required.

Presently, Lisa Pineda-Volk ((503)945-8146, fax (503)947-8735, lisa.pineda-volk@state.or.us) handles all of the lien release applications submitted to the ODR. Statements for lien releases can be submitted by mail, email, or fax.

You will not go wrong submitting all of the same types of documents to the ODR as you would submit to the IRS if you were applying for a federal discharge. The statement should include the following:

1. A description of the transaction and pertinent surrounding circumstances. If, for example, the transaction is a short sale or deed in lieu of foreclosure which the taxpayer is executing because the first mortgage is already in default, explaining the property's distress will help explain why the property is being sold or transferred for less than fair market value.
2. Sufficient documentation to establish that the taxpayer will not be receiving any funds from the transaction.
3. Identification of the amount that will be paid to the ODR.
4. The Oregon tax liabilities owed by the taxpayer.
5. Contact information for all parties involved in the transaction.
6. Information reflecting the value of the property. At present, the ODR will accept county tax statements reflecting real market value as a reflection of value. The ODR will also accept appraisals and comparative market analyses.
7. If there are federal tax liens at issue, a copy of any filed notice of federal tax lien. As discussed below, special priority rules apply when a federal tax lien competes with a state tax lien.

Sending a copy of the purchase agreement is optional with the ODR.

The ODR's thinking process largely parallels the IRS' thinking process. Ms. Pineda-Volk stresses that the taxpayer cannot receive any funds from the transaction, and the existence of relationships between the seller (taxpayer) and buyer, or the seller and the real estate agent, will receive scrutiny. Any relationship between the seller and other persons in the transaction should be discussed in the explanation submitted.

If the requested release is approved, upon receipt of the agreed amount to the ODR, the ODR will transmit a lien release directly to the person who requested it. That person may be the seller, the buyer, or the escrow company. The ODR is generally successful with reviewing proposed lien discharge transactions within three business days.

The Priority Rules are Different When the IRS and ODR Compete

Taxpayers often owe both federal and state tax debts. In situations where both an IRS notice of federal tax lien and an ODR warrant have been filed against a taxpayer, the person who is applying for a certificate of discharge or lien release must understand the different priority rules that apply when a federal tax lien and state tax lien compete.

When a federal and a state tax lien compete, priority is granted to the taxing agency which assessed its tax liability first, regardless of when and whether either government perfected its lien by filing a lien notice or warrant.[3] *US v. City of New Britain*, Connecticut, 347 US 81, 74 SCt 367 (1954). This rule of law arises because of the supremacy of federal law and the language of IRC section 6323(a), which imposes the perfection requirement for federal tax liens. Section 6323(a), which states that a federal tax lien shall not be "valid" until a notice of tax lien is filed, only applies to four specific types of creditors: security interest holders, purchasers, mechanic lienors, and judgment creditors. Federal law provides the definition for security interests (section 6323(h)). State tax liens invariably arise by virtue of state tax statutes, and do not fall within the definition of security interests. Ergo, the IRS need not have filed a notice of federal tax lien for its lien to be "valid" against a state tax lien, and reciprocally, the state's filing of a warrant is immaterial to its priority against a federal tax lien.

Instead, the *City of New Britain* case holds that priority is determined by the respective dates that the federal and state tax liens became "choate." The dates that both federal and state tax liens become choate is, almost invariably, the dates of tax assessment. Thus, in any instance when property is subject to both federal and state tax liens, the dates of the respective tax assessments must be discovered. The assessment date for a federal tax liability is conveniently located on the notice of federal tax lien itself. This is the reason why the ODR requires a copy of the notice of federal tax lien when the IRS is a competing lienholder.

ODR tax warrants do not similarly reflect the date that any state tax liabilities were assessed. Obtaining this information generally requires procurement of ODR "printouts" for each liability due from a taxpayer. The necessary printouts can be obtained from Ms. Pineda-Volk as part of the lien release process.

The fact that federal law looks to the assessment date when a federal tax lien competes with a state tax lien, but looks to recordation dates when the federal tax lien competes with a judgment lien or consensual security interest, creates the possibility of circular priority conflicts. For example, the IRS may have priority over a judgment creditor, the judgment creditor may have priority over the ODR, and the ODR may have priority over the IRS.

City of New Britain provides the formula for resolving the conflicts between these three creditors. Since federal law is the supreme law of the land, we initially focus on the creditor who primes the IRS. That creditor gets first priority. Federal law similarly dictates that the IRS comes in second. Any balance of funds still remaining after the first creditor and IRS are paid should be distributed to the third creditor.

3 This rule does not apply in bankruptcy proceedings. The federal and state governments believe that 11 USC §506(a) requires recordation of the federal tax lien notice or state tax warrant before the bankruptcy case was commenced for the lien to be valid within the proceeding.

Conclusions

Federal and state law provide clear guidelines and procedures for recovering a certificate of discharge or release when junior tax liens encumber real or personal property to be sold. To obtain the certificate, the purchaser, seller, or escrow company must submit a written application for the discharge or release. The IRS and ODR bear broad discretion with the granting or denial of discharge and release certificates, but they will usually issue the certificate if the applicant establishes that the taxing agency will receive a portion of the sale proceeds that fairly represents the value of its lien on the property. Adequate time should be allotted in the closing process for the submission of the application to the taxing authority and processing of the application. Special priority rules apply in situations where both the IRS and ODR have perfected liens against the seller.

Jeffrey Wong Wins Mentor of the Year Award

Mr. Jeffrey M. Wong was selected as the recipient of the inaugural Mentor of the Year Award given by the New Tax Lawyers Subcommittee.

Mr. Wong was chosen from a select group of outstanding nominees because of his exceptional ability to provide insight and advice about professional development and practice issues. Mr. Wong is known for taking the time to listen to those who seek out his advice and for being generous with his time. He has a reputation for sharing his experiences and knowledge in a way that both encourages and challenges his mentees to be better lawyers and to be more involved in the legal community. This is one of the many reasons that the NTLS has chosen to recognize Mr. Jeffrey M. Wong as the first recipient of its Mentor of the Year Award.

If you are interested in participating in the 2011 NTLS Mentor Program, please complete the Mentor Program Questionnaire and email your responses to NTLSMentorProgram@Gmail.com on or before December 17, 2010. Forms are available on the Taxation Section website at www.orbartax.com.

Expatriating Under the HEART Act: It's Hard to Say Goodbye

By Natalia Yegorova

In 2008, §301 of the Heroes Earnings Assistance and Relief Tax Act ("HEART Act"), added §877A and §2801 to the Internal Revenue Code, overhauling the expatriation regime for American citizens and green card holders who wish to abandon their residency in the U.S. Because the amendments raised too many questions that the new law did not answer, on October 15, 2009, the IRS issued guidance for expatriates clarifying the application of certain provisions of the new expatriation regime.[1] While the expatriation regime has been in place in various forms since 1966 with the enactment of IRC §877, the new law is probably the most aggressive stance that the Congress took towards the perceived "taxpatriates" – U.S. citizens and residents leaving the U.S. for greener - and less taxing-pastures.

To Whom Does the HEART Act Apply?

The HEART Act applies to a "covered expatriate" who expatriates after June 16, 2008. An "expatriate" is a U.S. citizen who gives up his or her citizenship[2], or a long term resident who is a Lawful Permanent Resident ("LPR") for at least eight out of the past 15 years ending with the year that the taxpayer's status as a long term resident ends.[3] A "covered expatriate" is an expatriate who (i) has an average U.S. income tax liability of five years prior to expatriation of more than $145,000 a year (adjusted annually for inflation); (ii) has a worldwide net worth of $2 million of more; or (iii) fails to certify under penalty of perjury that he or she has complied with the U.S. tax laws for the five preceding tax years.[4]

The HEART Act does not apply to dual citizens if they became dual citizens of the U.S. and another country at birth and continue to reside and be taxed in another country; and they were a resident of the U.S. for not more than 10 years during the 15-year tax period ending with the tax year during which the expatriation occurred.[5] Certain minors are also exempt from the application of the HEART Act. The HEART Act does not apply to persons who expatriate before attaining the age of 18.5 years, and who were residents of the U.S. for not more than 10 years before the expatriation occurred.[6]

Case Scenario

Let's meet our clients. Carol is a dual U.S.–Canadian citizen, who is married to Mark, a Canadian citizen. Carol, a native Oregonian, met Mark in Vancouver, B.C. 25 years ago, married him, and obtained Canadian citizenship. Seven years ago they decided to move back to Oregon where Mark received his green card and became an LPR. Even though he was eligible to apply for U.S. citizenship, he never did. They have a 21-year old child, Kristin, who just finished university in New York and wants to stay on the East Coast. Mark and Carol have been quite successful professionally, and have amassed considerable wealth: they have $2 million in real estate in the U.S. (held jointly); a $1 million condo in Vancouver, B.C. (in Mark's name); another $2 million in an IRA account and another $5 million in investment assets, approximately half of which are in the U.S., while the rest are in brokerage accounts in Canada. Because both of them worked in Canada before moving to the U.S., they have about $250,000 in total in their respective Canadian Registered Retirement Savings Plans, ("RRSP"). Mark's and Carol's accountants made sure that Mark and Carol reported any foreign income they earned on their 1040s, as well as filed Forms TDF 90-22.1 (FBARs) reporting their foreign financial accounts.

Both Mark and Carol are in their early sixties, and while they enjoy their life in the U.S., they have been discussing moving back to Vancouver, B.C. Cognizant of the U.S. estate tax that may apply to their assets after their deaths, they would also like to minimize their exposure to the estate tax.

Why Expatriate?

One of the most common reasons for expatriation is U.S. taxation of worldwide income of U.S. residents. Non-residents, in contrast, pay income tax in the U.S. only on U.S.-source income. Mark and Carol could leave the U.S., and live in Canada permanently, but as long as they retain Carol's citizenship and Mark's green card, they will be required to file their 1040 annually, reporting their worldwide income. Mark's mother is elderly, and when she passes away, Mark will inherit about $10 million worth of property. They would like to keep it out of their U.S. estate, if possible.

Mark and Carol may have other legitimate reasons for giving up their residency status that do not involve tax planning. For example, they may desire the Canadian health plan or move closer to Mark's mother.

They heard about the HEART Act and want to know how it will impact their plans to move to Vancouver, B.C., and abandon there residency in the U.S.

What Does the HEART Act do?

Looking at the assets held by Mark and Carol, it is apparent that they meet the net worth threshold of the "covered expatriate" test. Mark, however, had his green card only for seven out of eight years; if he were to abandon his green card before the eighth year anniversary, he should escape the exit tax regime of the HEART Act.

Knowing that, let's explore the consequences of the HEART Act on Mark and Carol, if they decide to expatriate, and do so after Mark's eighth year anniversary as an LPR.

Exit Tax

Section 877A imposes a mark-to-market tax that is applied to the covered expatriate's worldwide assets as if the property was sold for its fair market value on the date before expatriation.[7] Mark and Carol are each given a lifetime exclusion of $600,000 from the gain that they would otherwise recognize, which is annually adjusted for inflation ($627,000 in 2010). The exclusion amount is allocated

1 IRS Notice 2009-85
2 IRC Sec. 877A(g)(2)(A)
3 IRC Sec. 877A(g)(2)(B), Sec. 877(e)(2)
4 IRC Sec. 877A(g)(1)(A), Sec. 877(a)(2)
5 IRC Sec. 877A(g)(1)(B)(i)
6 IRC Sec. 877A(g)(1)(B)(ii)
7 IRC Sec. 877A(a)(1)

pro rata to each item of built-in gain property of the taxpayer.[8] After allocating a total of $1,254,000 of the exclusion among the gain assets, Mark and Carol will report gains and losses on the relevant Schedules of their 1040s, depending on the character of the assets that are deemed sold.[9]

For covered expatriates who owned property before acquiring their LPR status in the U.S., the basis for the property is the fair market value of the property on the date they became U.S. residents unless Mark irrevocably elects otherwise.[10] Therefore, the Vancouver condo that Mark owns in his own name will have the basis equal to the fair market value of the condo at the time he became an LPR.

Special rules apply to eligible deferred compensation plans. Distributions are subject to 30% withholding at the source at the time of any payment.[11] An eligible deferred compensation plan is a plan in which a payor is a U.S. person, or if a payor is not a U.S. person, elects to be treated as a U.S. person for purposes of a payout.[12] (Note that the 30% withholding tax, which normally, under a bilateral tax treaty, would be reduced to 10% or even 5%, cannot be reduced because the covered expatriate must irrevocably waive the reduced withholding benefits of the treaty).[13]

Ineligible deferred compensation plans, such as foreign pension plans, are treated differently: an amount equal to the present value of the accrued benefit is treated as having been received by the covered expatriate on the date before expatriation and must be included on the taxpayer's last Form 1040.[14] Mark will obtain some relief with regard to his RRSP because the withholding regime does not apply to any deferred compensation item to the extent the deferred compensation is attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the U.S.[15] Because Mark's RRSP was accrued before he became an LPR, his RRSP will not be affected by this tax. Carol's RRSP however, will be subject to the deemed disposition rule of §877A(d)(2).

Similar to an ineligible deferred compensation plan, if a taxpayer has an interest in a "specified tax deferred account" (such as an IRA, a qualified tuition plan, a Coverdell education savings plan, a health savings account, or an Archer MSA), the taxpayer is treated as having received a distribution of his or her entire interest in such account on the day before expatriation.[16] This provision will subject both Mark's and Carol's IRA account to the deemed disposition rule and the resulting tax.

Succession Tax

The second consequence of the HEART Act is a transfer tax on gifts and bequests made by the covered expatriate to any U.S. person.[17] In the context of Mark and Carol's situation, if they expatriate, IRC §2801 will impose a tax at the highest marginal rate on any gift in excess of $13,000 a year that Mark and Carol may make to their U.S. resident daughter. Similarly, when they pass away, any assets passing to Kristen will also be subject to an estate tax assessed at the highest marginal estate tax rate in effect on the date of the transfer. Notably, to facilitate collection of the tax, the tax is imposed on Kristen, rather than on the expatriated Mark and Carol.[18] The tax also applies to any transfers made to trust, whether foreign or domestic.[19]

Section 2801 excludes from the transfer tax gifts on which gift tax is paid and gift tax return is filed, or property which would otherwise be subject to U.S. federal estate tax upon the taxpayer's death.[20] Unless Mark and Carol sell their Oregon house, because it is U.S. situs property, federal estate tax will be unavoidable and therefore, not subject to the §2801 transfer tax once it passes to their daughter.

The IRS is yet to issue a notice on reporting and tax obligations under §2801 and until the issuance of a notice, the IRS announced that it has deferring enforcement of this section.[21]

What Planning Can be Done to Alleviate the New Regime?

Understandably, Mark and Carol feel overwhelmed with the sudden realization that leaving the U.S. will be an expensive proposition for them, and want to know if there are any tax minimization strategies they can take.

The obvious option available to Mark, who has not yet been an LPR for eight years, is to surrender his green card immediately; as long as he has not been an LPR for eight years, he will not be considered a covered expatriate and he will escape the application of the HEART Act to him and his property altogether. Carol, who is a U.S. citizen, does not have this option, and her interest in the property will be subject to the HEART Act.

Another possible option is to exhaust their lifetime $1 million gift tax exemptions by gifting their property to their daughter, and try to reduce their assets before they expatriate. While it will ameliorate the situation somewhat, in light of their substantial assets, it will not eliminate the exit tax altogether.

Mark and Carol can also make an irrevocable election to defer payment of the exit tax. The election is done on an asset-by-asset basis, and the taxpayer must provide "adequate security" in a form of a bond or other form of security such as a letter of credit, and irrevocably waive any right under any U.S. treaty that would preclude assessment or collection of a tax imposed under §877A. The latest the tax can be deferred is the year the client dies, the property is sold, or the time that the IRS determines that the security provided for the property is inadequate.

The deferral is not free: interest is charged at the underpayment rate under IRC 6621 (3.53% as of August, 2010) for the period that the tax is deferred.[22] The taxpayer must also appoint a U.S. agent for the purpose of accepting communications regarding the deferral

8 IRS Notice 2009-85, page 6.
9 *Id.*
10 IRS Notice 2009-85, page 10
11 IRC Sec. 877A(c)(1)
12 Sec. 877A(d)(3)
13 IRS Notice 2009-85, page 20
14 Sec. 877A(d)(2)
15 Sec. 877A(d)(5)
16 Sec. 877A(e)(1)(A)
17 Sec. 2801

18 Sec. 2801(b).
19 Sec. 2801(e)(4)
20 Sec. 2801(e)(2)
21 Sec. 2801(e)(2)
22 IRS Notice 2009-85, p. 11

election, and, more ominously, for the purpose of enforcement of the terms of the tax deferral agreement. The IRS Notice 2009-85 provided a sample of the deferral request and instructions on where to file them for the taxpayers who want to defer the recognition of gain.

How to Say Good-Bye

After careful consideration, Mark and Carol decide to go ahead and expatriate. The process for doing so will be different for each of them. Carol, as a U.S. citizen, is considered to have relinquished her citizenship on the earliest of the following:

The date she renounces U.S. citizenship before a diplomatic or consular officer of the U.S.;

The date she furnishes the U.S. State Department a signed statement of the voluntary relinquishment of the U.S. citizenship;

The date the Department of State issues a certificate of loss of nationality; or

The date a U.S. court cancels the certificate of naturalization.

To abandon the green card, Mark will have to file a DHS Form I-407 with a U.S. consular or immigration officer, and get a confirmation that the Department of Homeland Security has determined that he has, indeed, abandoned the residency. Mark can also elect to be treated as a resident of Canada under the tax treaty, which would have the effect of abandoning his LPR status.

Giving up a green card or citizenship with the Department of Homeland Security is not enough for the IRS. To notify the IRS of their intent to expatriate, they will still have to file Form 8854 with the IRS, certifying, under penalty of perjury, that they have complied with all federal tax laws for the past five years. Along filing 8854, Mark and Carol will file a Form 1040 and 1040NR, if they abandon their residency or citizenship mid-year.

Although immigration ramifications of expatriation are outside the scope of this article, Mark and Carol have to be aware of the Immigration and Nationality Act provision, 8 USC §1182(a)(10)(E) which lists people deemed inadmissible to the U.S. Among polygamists, smugglers, and terrorists, the list includes "former citizens who renounced citizenship to avoid taxation." Although the author is not aware of any incident where admission had been denied to an expatriate under this provision, the Attorney General does, indeed, have a right to exclude "any alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the United States is inadmissible." Since Mark and Carol have their daughter in the U.S. whom they intend to visit frequently, they should be aware of the possibility that their expatriation may complicate their ability to cross the border into the U.S.

Conclusion

America has been the shining beacon for many foreigners vying to establish their lives here. They come to the U.S. as students, temporary workers, investors, and after several years, become green card holders, and after a few more years, perhaps citizens. With the privilege of obtaining permanent residency or citizenship in the U.S. come certain obligations and burdens, including a considerable tax cost, both in a form of a relatively high marginal income tax assessed on the worldwide income, gift tax and estate tax. Affluent foreigners with considerable wealth in the U.S. and outside the U.S. need to be aware of the harsh expatriation tax regime that awaits them if, after obtaining the golden ticket that is a green card, or U.S. citizenship, they decide to abandon it.

City of Portland Business License and Multnomah County Income Tax - An Overview

By Scott M. Carter

The City of Portland Business License Tax (BLT) and the Multnomah County Business Income Tax (MCBIT) have been net income taxes on businesses since the mid-seventies. From the mid-seventies to the early nineties, the MCBIT was administered by the Oregon Department of Revenue and the BLT was administered by the City of Portland. Taxpayers would file separate tax forms and mail the forms to separate addresses. The City of Portland began administering both programs in 1993 and reporting for the two programs is now combined onto one tax form.

Filing Requirements

If a taxpayer is doing business in the City of Portland or Multnomah County and is not otherwise exempt under the law, the taxpayer is subject to the City/County tax return filing requirements. For purposes of the BLT and the MCBIT, "doing business" means to engage in any activity in pursuit of profit or gain, including but not limited to, any transaction involving the holding, sale, rental or lease of property, the manufacture or sale of goods or the sale or rendering of services other than as an employee.

Generally, if a taxpayer has people (employees or owners) or property within the City or County at some point during a tax year, it must file a City/County tax return unless it falls under one of the available exemptions in the law. The people do not need to be at a fixed location in the City or County. It doesn't matter if the property is owned or leased. The term "property" includes real property such as bare land or leased warehouse space, and personal property such as photocopiers, computer servers, etc.

One notable exception to the general rule set forth above relates to sellers of tangible personal property. For sellers of tangible personal property located outside the City or County, shipping a product into the City or County does not constitute "doing business" in and of itself. Also, for a service provider located outside the City/County, there must be more than ten contacts in the City/County or at least $2,500 of gross income earned in the City/County in a tax year to create a tax return filing requirement.

Exemptions

Probably the most well known exemption is the gross receipts exemption. This exemption is available for any business whose gross receipts from business activities conducted everywhere is less than $50,000 in any tax year. If the gross receipts earned inside the City/County are $20,000 and the gross receipts earned outside the City/County are $45,000 for a total of $65,000, this exemption would not apply.

An exemption that is only available to an individual (where income is reported directly on a Form 1040) is the residential rental exemption. This exemption is allowed if the only business transactions are exclusively limited to the renting or leasing of residential real property as long as no more than nine dwelling units are rented or leased. Only one of these units needs to be located in the City or County. This exemption is lost when any other business transaction takes place. For example, if the owner of the residential rentals also has a Schedule C business or a commercial rental, the exemption is lost.

There are also exemptions available for certain farming and insurance activities. Also, tax-exempt entities (charitable organizations, etc.) are generally exempt from the BLT and MCBIT.

The Revenue Bureau has the authority to request federal and state tax pages or other verification before granting any exemption. Any gross receipts exemption request will only be granted upon filing the Annual Exemption Request form with the appropriate tax pages attached.

Apportionment

If a taxpayer is doing business both inside and outside the City/County, the taxpayer can apportion its income to potentially reduce the amount of income tax due to the City and County.

Sales of tangible personal property (that has been produced by the seller or purchased for resale) are apportioned to the City/County if the goods are shipped or delivered to purchasers in the City/County (see Administrative Rule 610.93-2 Business Activity and Apportionment of Sales of Tangible Personal Property and Administrative Rule 610.93-3 De Minimus Business Activity). It does not matter if the seller's vehicle or common carrier is used.

Gross income from the performance of personal services is apportioned to the City/County to the extent such services are physically performed in the City/County. If services relating to a single item of income are performed partly within and partly outside the City/County, the gross income for the performance must be apportioned based on the percentage of total time spent in the City/County. "Brokers" who sell something that they do not actually own should be considered performers of personal services for apportionment purposes. When determining where personal services are to be apportioned, the location of the company that is paying for the services is not relevant.

Income from the sale or leasing of real property and the leasing of personal property is apportioned to the physical location of the property. Income from portfolio investments (interest, dividends, gain on sale of stocks and bonds, etc.) and income from the sale of a business is generally apportioned to the commercial domicile (headquarters) of the company. Installment sale gains must be reported and apportioned to the City/County if the property or business activity was located in the City/County at the time of sale. There are special apportionment rules for certain industries, such as banking, freight and passenger carriers and domestic insurers.

Recent Changes to the Structure of the City of Portland Business License

Prior to a August 20, 2008 City Code change, the BLT was a paid-in-advance "fee." The BLT applied to a different period than the MCBIT, even though the same tax year was used to measure the amount due for both jurisdictions. This often created confusion and nonsensical fee calculations in the first and final year of a business.

Effective for tax years that begin on or after January 1, 2008, the BLT is an "after-the-fact" license tax. The BLT is now substantially in conformity with the MCBIT. There is no longer the doubling of the BLT in the first year of business and the BLT is now due in the final year of business. Businesses who had already paid the doubled BLT in their first year of business were entitled to a credit. The credit was refundable and was taken in full on their tax year 2008 return. The Revenue Bureau's administrative rules and policies were updated to reflect the change. As a result of the change, real estate brokers are no longer exempt from the BLT. (They have always been subject to the MCBIT.)

What's New for Tax Year 2009

The Business Retention Credit for Qualifying Investment Management Firms was enacted by the City on November 12, 2009 and enacted by the County on February 11, 2010. This credit is available starting with the 2009 tax year and it applies to firms that meet the definitions in Portland City Code section 7.02.870 and the Diversified Investing Fund Deduction administrative rule (Administrative Rule 110.07-1). This is a "pilot program" intended to retain and attract certain businesses. The credit effectively reduces the combined City/County tax to $10,000 per owner, but the tax for each jurisdiction cannot be reduced by more than 70%. The credit's benefits are phased in over four years.

Presumptive Taxes

In 2004, a new process was implemented to bring non-filing taxpayers into the Revenue Bureau's automated billing system. If a tax return is not received after a series of reminder and warning letters, a "presumptive" tax amount is billed and collected like any other balance due. These presumptive tax billings are simply a means to prompt the taxpayer to file an actual return. The Revenue Bureau would strongly prefer to receive actual tax returns rather than payments of the presumptive tax amount.

Online Filing/Payment Options

From the Revenue Bureau's website (www.PortlandOregon.gov/licenses) taxpayers and paid preparers can currently register a new business, file tax returns and exemption requests, make quarterly estimated tax payments, file extensions (with or without payment) and make billing and payment plan payments. At this website, taxpayers and paid preparers can also perform online account maintenance and view the account history. Payments with tax returns and other payments can be made online from a bank account or with a credit card.

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Strange Bedfellows: For-Profit/Nonprofit Partnerships

By Ronald A. Shellan

Introduction

A partnership is a basic human institution. A partnership brings together people with different skills and resources to achieve the common and individual objectives of each partner. But as this article shows, there are treacherous waters ahead for any tax-exempt[1] organization that wishes to enter into a partnership[2] with a for-profit organization—no matter how valuable the public benefit. This article will also explore why for-profits and nonprofits enter into partnerships. It will then explore rules that a charity must adhere to and how those rules have been applied—with a special emphasis on affordable housing and health care partnerships. Note that this article does not deal with the tax-exempt use rules.[3]

Nonprofit entities can be in for a big surprise. In some circumstances, seemingly innocuous business relationships that would be perfectly acceptable in the business world may not be acceptable for a charitable organization that wishes to keep its tax-exempt status. For example, a charity cannot be organized to provide families who have moderate income with affordable housing that is secure, safe, and sanitary.[4] A nonprofit hospital cannot enter into a partnership with a for-profit partner if control of the partnership has been ceded to the for-profit partner.[5] A charity cannot invest in a limited partnership that will develop, own, and operate housing for low-income tenants if it provides any sort of private inurement.[6] A charity cannot provide down-payment assistance to help a low-income home buyer purchase a home if the program is funded by the property seller.[7] The tax-exempt status of a charitable corporation that developed a low-income housing project can be revoked because it did not have control of the low-income housing tax-credit partnership.[8]

1 The terms "tax-exempt," "nonprofit," "charity," and "charitable organizations" all technically have different meanings. Unless the context is clearly to the contrary, however, this article will use all the terms interchangeably to mean an entity that meets the requirements of Section 501(c)(3) of the Internal Revenue Code.

2 References to partnerships will include general partnerships, limited partnerships, joint ventures, limited liability companies, syndicates, and similar relationships, all of which are treated as partnerships under IRC § 761(a).

3 IRC § 168(h).

4 Rev Rul 70-585, 1970-2 CB 115, Situation 4.

5 *Redlands Surgical Services v. Commissioner*, 113 TC 47 (1999), aff'd, 242 F3d 904 (9th Cir 2001).

6 Priv Ltr Rul 200502046 (Jan. 14, 2005); Rev Proc 96-32, 1996-1 CB 717, provides that a nonprofit organized to help the poor "nevertheless may fail to qualify for exemption because private interests of individuals with a financial stake in the project are furthered. For example, the role of a private developer or management company in the organization's activities must be carefully scrutinized to ensure the absence of inurement or impermissible private benefit resulting from real property sales, development fees, or management contracts."

7 Rev Rul 2006-27, 2006-1 CB 915.

What Are the Benefits of Entering Into a Partnership?

A partnership between a for-profit and a nonprofit provides substantial benefits to both entities. Besides the obvious benefits to the charity of executing on its charitable mission, and to the for-profit entity of making a profit, what are the specific benefits that each brings to the table in a typical partnership or joint venture?

In general, for-profit entities often have greater access to investment capital than nonprofits. Further, for-profit entities can and often do have the resources to induce construction and permanent financing by guaranteeing these obligations. For-profit entities often have expertise that a nonprofit cannot muster in developing a project or operating a business enterprise. This expertise is often greatly valued by nonprofits.

On the other hand, tax-exempt organizations have a great deal of benefits they can provide to their for-profit partners. Gifts to a charity that can fund a new hospital wing can be deducted by donors as a charitable income tax deduction.[9] A nonprofit generally does not need to pay income taxes on its earnings.[10] If a particular project receives a gift, grant, forgivable loan, or similar type of income, the tax on that income can be avoided if the income is received by the nonprofit. Another very practical advantage that nonprofits bring to many real estate developments is that many state and local governments provide a property tax exemption for many types of charitable activities performed by nonprofits.

General Requirements for Tax-Exempt Status

To obtain the benefits of IRC § 501(c)(3), an organization must meet two primary tests. First, it must be "organized and operated exclusively" for certain charitable purposes. Second, no part of the organization's earnings may inure to any person. As will be seen, the absolute language in the tests is not quite as absolute as it may appear. This onion must be peeled away to reveal nuance upon nuance so that the real rules that nonprofits must live by can be revealed.

Organizational test. IRC § 501(c)(3) requires that the organization be "organized exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition." Affordable housing projects generally qualify based on regulations providing that charitable purposes include relief of the "poor and distressed or of the underprivileged."[11] Regulations also include combatting community deterioration and eliminating prejudice and discrimination.

To meet the organization test, the organizational documents establishing the nonprofit must obligate the organization to further its charitable or other purposes. In fact, except for insubstantial matters, the organizing documents must prohibit the nonprofit

8 *Housing Pioneers, Inc. v. C.I.R.*, TCM 1993-120 (1993), aff'd, 49 F3d 1395, amended, 58 F3d 401 (9th Cir 1995).

9 IRC § 170(a)(1).

10 IRC § 501(a). There are exceptions to this general rule, such as the requirement that an exempt organization pay tax on its unrelated business taxable income. IRC § 501(b).

11 Treas Reg § 1.501(c)(3)-1(d)(2).

from pursuing any activities, unless they are insubstantial, that do not promote the organization's exempt purpose. Finally, the organization cannot support or oppose political candidates, and no substantial part of its activities may include lobbying or attempting to influence legislation.

Operational test. The operations test is fairly straightforward. Congress said that a nonprofit cannot just talk the talk; it must also walk the walk. In other words, IRC § 501(c)(3) requires that the entity not only must be *organized* exclusively for an exempt purpose, but also must be *operated* exclusively for that same exempt purpose.

No private benefit or inurement. An organization that wishes to take advantage of the benefits of IRC § 501(c)(3) must not provide any private inurement.[12] This requires that "no part of the net earnings inures to the benefit of any private shareholder or individual." Nonprofits, of course, do not have shareholders. As an example, employees or other "individuals with a close professional working relationship" with a hospital were considered to be persons with a personal and private interest in the hospital's activities.[13] The Service has also found that an investment adviser was subject to the increment prohibition.[14] A similar concept is that a tax-exempt organization cannot provide a private benefit to any person. Thus, a nonprofit can have employees and pay a salary, rent space from a private party, or do other normal commercial transactions, as long as the benefits are insubstantial.[15] Private benefit is measured based on whether it is substantial compared to the benefit to the public as a whole.[16]

So What Are the Rules for Nonprofits Entering Into Partnerships?

The Internal Revenue Service initially determined that an exempt organization could never enter into a partnership with a for-profit entity. The Service in a 1975 General Counsel Memorandum declared that such a partnership was not compatible with an organization's exempt status.[17] Not until five years after the General Counsel Memorandum was the Service forced by the *Plumstead*[18] court to allow partnerships to exist between for-profits and tax-exempt entities. The court laid down a two-prong "close scrutiny" test. The two tests required that (1) the activities of the partnership further the nonprofit's charitable goals and (2) the structure of the partnership protect the nonprofit from conflicts between its charitable goals and its obligations under the partnership agreement, and also minimize the possibility that a private benefit will result from entering into the partnership.

The rules for partnerships between for-profits and nonprofits follow the basic rules of operations for all nonprofits. The organization's documents and its operations must be exclusively for the charitable goals of the nonprofit. There can be no increment and no substantial private benefit given to any person. The following discussion focuses on how these basic rules have evolved in the context of partnerships between nonprofits and for-profits.

This article will review the rules that have emerged by looking at partnership agreement requirements, including the control requirement, guaranty and indemnity requirements, requirements for other agreements, and certain other considerations.

Partnership agreement requirements

Control requirement. To be able to effectively meet charitable goals, the nonprofit organization must be in control of the partnership's day-to-day operations. Plumstead may be the most important case ever handed down in the area of for-profit/nonprofit partnerships. Among other issues explored by the court, it provided guidance as to the requirement that the nonprofit must be in control of the partnership. Plumstead involved a nonprofit established to produce theatrical plays. It formed a limited partnership with several for-profit entities to finance the effort. It was the general partner. The Tax Court ruled against the Internal Revenue Service. The Tax Court made several points in its ruling. First, it found that the other partners, who were limited partners, had no control over the partnership's operations or management. Another significant factor was that the partnership did not make any guaranties to return the investment of the limited partners from Plumstead's assets.

The nonprofit in ***Housing Pioneers***[19] was not so fortunate. This nonprofit entered into a partnership to develop low-income housing. Housing Pioneers was a co-general partner, but apparently in name only. It could not manage the on-site operations, such as renting the units. It did have the obligation to make sure that the requirements for obtaining the low-income housing tax credit[20] were being adhered to. The court found that the "keystone" for Housing Pioneers' being included in the partnership was "achieving the objective of property tax reduction," and that it "has made no attempt to adopt any actual plan by which [it] expects to use its hoped-for share of the property tax reductions to implement its stated objectives." The court ruled that Housing Pioneers had lost its tax-exempt status under IRC § 501(c)(3). The Ninth Circuit agreed and said that it had failed to "materially participate in the development and operation of the project. It has shown no regular, no continuous, no substantial activity in developing or operating the projects."[21]

Rev Rul 98-15 set forth a fact situation in which a hospital partnership with a nonprofit worked and a fact situation in which it did not. What did not work was an arrangement whereby the nonprofit did not have voting control of the partnership. In addition, the "bad partnership" had the following attributes: (1) the management company was a subsidiary of the for-profit partner, which could unilaterally extend its management contract; (2) the actions of the management company could not be reviewed by the entire partnership unless the contracts were unusually large; (3) the upper management of the partnership were former employees of the for-profit entity; and (4) the nonprofit had no enforceable right to force the partnership to serve the nonprofit's charitable mission. On the other hand, the "good partnership" had the following attributes: (1) it divided its profits in proportion to the capital contributions; (2) the nonprofit had two out of the three votes on the partnership's board

12 Treas Reg §§ 1.501(c)(3)-1(d)(1)(ii), 1.501(a)-1(c).

13 GCM 39498 (Apr. 24, 1986).

14 GCM 38905 (June 11, 1982).

15 *Best Lock Corp.*, 31 TC 1217 (1959), held that a loan equal to 15 percent of a charity's expenditures was substantial.

16 Rev Rul 78-85, 1978-1 CB 150.

17 GCM 36293 (May 30, 1975).

18 *Plumstead Theatre Society*, 74 TC 1324 (1980), aff'd, 49 AFTR2d 82-1390, 675 F2d 244, 82-1 USTC ¶ 9358 (9th Cir 1982).

19 See *supra* note 8.

20 IRC § 42.

21 49 F3d at 1398.

of directors; (3) the for-profit could appoint community members with no financial affiliation with the nonprofit; (4) the partnership agreement provided that the purpose of the partnership was to provide health for a broad cross section of the community and that this purpose overrode any duty to create profits for the owners; (5) a management agreement was entered into with an independent third party that was based on gross revenues and could be terminated for cause; and (6) none of the officers of the partnership were previously affiliated with the for-profit partner.

The judicial evolution continued with the 2001 decision in *Redlands*.[22] A nonprofit hospital formed a partnership with a for-profit that had a national reputation of managing ambulatory surgery centers to acquire an existing ambulatory surgery center. According to the court, the problem was that the nonprofit had in fact ceded effective control of the partnership to its for-profit partner. For example, the nonprofit and for-profit each could select two persons to be on the board that operated the partnership. Thus, the for-profit had veto power over any decision. Further, the partnership entered into a long-term management contract with the for-profit. The Tax Court held that by "ceding effective control over its operations to for-profit parties, [the exempt organization] impermissibly serves private interests."

Another decision focusing on control was ***St. David's Health Care System v. United States***.[23] The Internal Revenue Service had stripped the nonprofit of its tax-exempt status under IRC § 501(c)(3). The court indicated that when a tax-exempt organization loses its control of the partnership, it is unable to operate the partnership exclusively to further its charitable purposes. The court explicitly rejected Rev Rul 98-15, which provided that control had to be obtained by having a majority vote on the board that controlled the partnership. It held that other rights, such as the right to dissolve the partnership if the community-benefit standard was not being met, could be sufficient so that St. David's Health Care System should not be stripped of its tax-exempt status.

But can there ever be a resolution of such matters? In Rev Rul 2004-51, 2004-22 IRB 974, the Internal Revenue Service perhaps signaled a slightly different path. It held that a partnership in which the for-profit and nonprofit had equal control over decision-making would not imperil the nonprofit's tax-exempt status because the partnership represented an insubstantial portion of the nonprofit's charitable activities. In this case, the nonprofit apparently was a large university and the partnership was organized to provide teacher training seminars. Further, the nonprofit had exclusive control over the charitable aspects of the partnership.

There is perhaps no easy summary of the control requirement. Control is a requirement for exemption unless the partnership represents an insubstantial part of the partnership's charitable activities. Control must generally be over the day-to-day activities of the partnership. Control can be achieved either by control over the partnership's board of directors or indirectly through contractual provisions, such as the right to liquidate the partnership if the nonprofit's charitable mission is in jeopardy.

Charitable-purpose partnership provision. Curiously, one of the most helpful tools for nonprofits concerned about their tax-exempt status is an Internal Revenue Service memorandum issued in 2007 by Robert Choi, Director of Exempt Organization Rulings and Agreements (the "IRS Nonprofit Partner Memo").[24] The IRS Nonprofit Partner Memo was directed at organizations seeking exempt status whose charitable goal is to develop affordable housing. But it is very helpful for any entity wishing to obtain or retain tax-exempt status. It suggests that the partnership agreement state that "in the event of a conflict between the obligations of the [organization] to operate the [limited partnership] in a manner consistent with such charitable purpose and any duty to maximize profits for the limited partners or other members, the charitable purposes will prevail." The Service has previously required that the partnership's governing documents require that the entity be governed in a way to further its charitable purposes.[25]

For-profit consent. Control by a nonprofit partner can be problematic in many partnership agreements. Sophisticated for-profit partners often generate partnership agreements that run 100 pages or more, and include numerous covenants, conditions, and warranties about the operations of the partnership. Failure to comply with a covenant, condition, or warranty often requires the consent of the for-profit partner. The IRS Nonprofit Partner Memo does provide that the for-profit partner cannot unreasonably withhold its consent to any request of the tax-exempt partner.

Removal of nonprofit. The Internal Revenue Service has also stated in the IRS Nonprofit Partner Memo that the tax-exempt partner cannot be removed from the partnership by the other partners except for cause, with reasonable notice and an opportunity for the nonprofit to cure.

Right of first refusal. The Internal Revenue Service has also stated that in a partnership with a for-profit entity, the nonprofit should have a right of first refusal to purchase the assets of the partnership.[26] In a joint venture to develop an office building, the Service approved the transaction, noting that it provided a right of first refusal to the charity. The IRS Nonprofit Partner Memo also indicated that the nonprofit should have a right of first refusal to purchase the housing project at a "purchase price [that] is reasonable and consistent" with the organization's tax-exempt status.

Allocation of income in proportion to capital. To combat impermissible inurement to for-profit partners, the Internal Revenue Service has indicated that partnership profits should be allocated in the ratio of ownership of each partner's capital account.[27] Special allocations of profit to the for-profit partner or losses to the nonprofit partner are to be avoided. Note that the tax-exempt use rules provide certain restrictions on such nonproportionate allocations when there is a nonprofit partner.[28]

Guaranty and indemnity requirements

Return guaranties. The Internal Revenue Service has a somewhat patronizing view of the management of nonprofits. While it is perfectly acceptable for a nonprofit to rent office space and have an obligation to pay monthly rent, if it issues its guaranty in a business transaction, the guaranty is viewed with great suspicion. In Priv Ltr Rul 9731038 (May 7, 1997), the Service held that a guaranty would

22 See *supra* note 5.

23 349 F3d 232 (5th Cir 2003).

24 IRM Exhibit 7.20.4-6, Low Income Housing Tax Credit Limited Partnership Memorandum, available at http://apps.irs.gov/pub/irs-tege/ex_7_20_4_6_litcrev.pdf.

25 Rev Rul 98-15, 1998-1 CB 718.

26 GCM 39005 (June 28, 1983); GCM 39444 (Nov. 13, 1985); Priv Ltr Rul 8938002 (May 31, 1989).

27 GCM 39444; GCM 39732 (May 19, 1988).

28 IRC § 168(h)(6).

not be acceptable unless the guaranty was restructured as a capital contribution to the partnership, which would in turn distribute the capital contribution to the for-profit partner that did not receive the expected tax credits. This would give the nonprofit at least the possibility of recovering the contribution on liquidation of the partnership. The IRS Nonprofit Partner Memo requires that such a capital contribution have a higher priority of capital return than the capital contribution made by the for-profit partner. Alternatively, under the IRS Nonprofit Partner Memo, the guaranty should be limited "to an amount that does not exceed the aggregate amount of developer and other fees that the [organization] is entitled to receive."

Operating-deficit guaranties. The IRS Nonprofit Partner Memo provides that operating-deficit guaranties (guaranties that the property owned by the partnership will operate with positive cash flow) must be limited for nonprofits to either (1) six months of operating expenses, including debt service, or (2) five years after the project has received break-even operations. The project has broken even when it is 95 percent occupied and for a period of three consecutive months revenues equal or exceed operating expenses plus debt service. Great care must be exercised for any similar guaranty given by a nonprofit.

Repurchase obligations. A provision found in some partnership agreements is that if certain fundamental expectations have not been met, then the investor partner's partnership interest will be acquired by the development partner. Examples of such fundamental expectations in a partnership to develop real estate are that the building is constructed, it is leased up, and a permanent loan is obtained. In effect, this is a guaranty to protect the downside of the investor partner. The IRS Nonprofit Partner Memo allows such a repurchase obligation, but only if the purchase price does not exceed the capital contribution of the for-profit partner. A nonprofit should be advised that it should be extremely cautious in providing for any sort of repurchase obligation.

Requirements for other agreements entered into by partnership

Arm's-length agreements. It is somewhat axiomatic that management fees, development fees, and other types of compensation must be reasonable and that the agreements must otherwise contain arm's-length provisions. Specifically, the nonprofit must receive compensation for its services.[29] The for-profit partner cannot receive unreasonable compensation without creating an impermissible private inurement that could threaten the tax-exempt status of the nonprofit. In a 1989 letter ruling, the Internal Revenue Service stated: "The pursuit of a profit motive cannot be established as a motivating factor for [the nonprofit's] participation in this venture. The management fee arrangement is consistent with the pursuit of exempt purposes and the method of compensation in this case appears to be reasonable because they are related to services rendered."[30]

Management agreements. It is perfectly acceptable for a partnership composed of a for-profit and a nonprofit to provide that management of the partnership's operations is handled by a management company. For operating real estate, a property management company is hired to provide this service. But such an agreement cannot be a subterfuge to shift operational control of the partnership to the for-profit partner. For example, in ***Redlands***,[31] a company related to the for-profit partner managed the partnership under a 15-year management agreement. The Internal Revenue Service has further stated that it approves of management agreements for a five-year term with independent managers that can be terminated for cause, but does not approve of agreements with the for-profit partner or its affiliates that are renewable in perpetuity at the management company's discretion.[32] Not stated in any pronouncements by the Service is whether it would be acceptable for the management company to be an affiliate of the for-profit, but for the management agreement to be terminated for cause and be annually renewable by the partnership, whereby the decision was controlled by either the nonprofit partner or another for-profit partner not affiliated with the management company. "Control" of the "managing" nonprofit partner that was illusory because the duties of the managing partner were set by its for-profit partners will not be approved by the Internal Revenue Service.[33] Another issue is a management agreement that provides too much operating control to the management company, such as giving to the partnership's board of directors the right to make decisions only for obligations requiring payments in excess of $50,000 during any 12-month period.[34]

Construction contracts. Another common guaranty made by a developer partner for an investor partner is that the project can be completed with the sources available to the partnership. The IRS Nonprofit Partner Memo does not specifically mention guaranties. But to prevent the assets of a tax-exempt organization from being dissipated, it does require that any construction contract be "a fixed price construction contract with a contractor that is bonded or that provides a performance letter of credit or adequate personal guarantee."

Financing agreements. It is sometimes unclear whether a particular requirement is just a general desire by the Internal Revenue Service to keep nonprofits from making mistakes, or is somehow generated from the requirements that each charity pursue its charitable goals without providing any private benefit or inurement. For example, the Service has stated that a factor in approving a particular transaction was that the financing was nonrecourse to the tax-exempt organization.[35] The author suspects that a recourse loan supported by industry-standard debt-coverage ratios and loan-to-value ratios will not cause a nonprofit to lose its tax-exempt status because it essentially provides an insubstantial private benefit to the lender. Further, it is virtually unheard of for a development partner, either for-profit or nonprofit, to be able to obtain a nonrecourse construction loan. Thus, the author suspects that such a loan that is supported with industry-standard underwriting, such as a reasonable takeout permanent loan commitment and a fixed-price construction loan secured by a completion bond or other adequate security, will also not cause a nonprofit to lose its exempt status.

29 *Id.*; Priv Ltr Rul 8938002.

30 Priv Ltr Rul 8927061 (undated).

31 See *supra* note 5.

32 See *supra* note 25.

33 Priv Ltr Rul 9736039 (June 9, 1997).

34 *Redlands*, 113 TC 47.

35 See *supra* note 26.

Other considerations

Related officers. One might guess that it would be a bad sign if the joint venture's operating officers were formerly employees of the for-profit partnership. Such a guess would be correct. Rev Rul 98-15 looked negatively at a partnership whose chief executive officer and chief financial officer had previously been employees of the for-profit partner. It was also mentioned that their compensation was comparable to what executives are paid in similarly situated hospitals. Another clear sign of possible abuse is when former directors or officers of the nonprofit become partners with the nonprofit.[36]

Conflict of interest. The IRS Nonprofit Partner Memo also requires that the nonprofit adopt a conflict-of-interest policy. The purpose is to protect the nonprofit from providing any impermissible benefit to its partners, directors, officers, or trustees.

No partnership interest pledge. The Internal Revenue Service has objected to a nonprofit's pledging its partnership interest, including its capital account, to secure the performance of a co-general partner of its obligations under the partnership agreement.[37] In the author's experience, such a pledge is routinely made by a for-profit developer to the for-profit investor in affordable housing tax-credit partnerships.

No other types of private inurement. The partnership structure cannot provide any other types of private inurement to the for-profit partners. For example, the Internal Revenue Service would not approve a hospital that entered into a joint venture with its physician group and contributed the revenue stream from a hospital operating unit to the joint venture.[38]

Conclusion

Advisers must be conservative in advising their nonprofit clients as to what will and will not work. Unfortunately, a mistake in this area leaves the Internal Revenue Service with just one arrow in its quiver, and that is to pull the tax-exempt status of the nonprofit from the date it entered into the partnership. Such a result would normally be a financial and economic disaster for the nonprofit because all its income would become taxable, grants and agreements made with it that were depending on its tax-exempt status may be withdrawn, and charitable contributions made to the entity would not qualify for a charitable deduction.

The rules for nonprofits and for-profits entering into partnership arrangements are both simple and mind-numbingly complex. The standard of organizing and operating the entity exclusively for charitable purposes seems straightforward enough, as is the requirement that the nonprofit cannot be operated so that it provides any private inurement or substantial private benefit. But the requirements quickly spin out of control, and the magical line of what works and what does not work remains an ethereal vision. Thus, it is very difficult for nonprofits to read the string of cases and Internal Revenue Service guidance and know where the line is.

The practical issue can be extremely difficult to resolve. The nonprofit wants capital and expertise to meet its charitable goals. The for-profit partner wants . . . well, profits. But in many situations, for-profits will be unwilling to invest millions of dollars into ventures over which they have no control. And control, especially in a venture with the road that is not well trodden, will often be of such importance to the for-profit investor that it simply cannot find a way to invest in a partnership with a tax-exempt entity. The next new and innovative deal may well not come about because the for-profit will not be willing to invest without more control over the venture.

36 GCM 39444.

37 See *supra* note 33.

38 GCM 39682 (Nov. 21, 1991).

Upcoming Events Calendar

- **OSB Taxation Section Luncheon CLE: Inside the Joint Committee**
  December 9, 2010
  Edward Kleinbard

- **OSB Taxation Section Luncheon CLE: Washington, D.C. Tax Update**
  December 27, 2010
  Mark Prater, Chief Legal Counsel, U.S. Senate Finance Committee

- **Portland Tax Forum: S Corporations**
  January 20, 2011
  Laura MacDonough

- **Estate Planning Council of Portland Annual Seminar**
  February 4, 2011

- **Portland Tax Forum: Estate Tax**
  February 20, 2011
  Samuel A. Donaldson

- **Portland Tax Forum: Ethics Panel**
  May 19, 2011
  Gersham Goldstein, Tyee Carr, Michael Lang, Mona Hymel

- **Oregon Tax Institute**
  June 2 and 3, 2011
  OSB Taxation Section

- **Portland Tax Forum: Partnerships**
  June 16, 2011
  Richard L. Lipton

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