New Jersey N2K Hour:

Need To Know Dealing with Federal Taxation Issues in Title and Closing

Webex Presentation:
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The Nature of Federal Tax Liens:

- A Federal Tax Lien arises when a taxpayer fails to pay taxes owed to the United States ("U.S.") or when the Internal Revenue Service ("IRS") determines that the taxpayer's tax return is deficient in the amount paid.
- When a taxpayer fails to pay taxes or a deficiency occurs, a "secret" lien arises upon all the taxpayer's property whether personal or real property and on all after acquired property. This "secret" lien arises regardless of whether a Notice of Federal Tax Lien ("FTL") is filed or not.
- As a result, a grantee who pays nominal consideration to a taxpayer-grantor who has failed to pay taxes is not a bona fide purchaser for value ("BFP") and takes title subject to the lien.

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The Nature of Federal Tax Liens: (cont'd)

- Originally, a BFP who took title from a delinquent taxpayer was not protected from the secret lien. They would take title subject to an FTL, even if they had no notice.
- To overcome the effects of this rule, Congress, pursuant to 26 U.S.C. §6323, enacted a revision to the Internal Revenue Code ("IRC") that provided for the filing of an FTL which provided constructive notice.
- As a result, if the IRS fails to file an FTL, a BFP "without notice" will **<u>not</u>** take title subject to the lien of Seller's unpaid federal taxes.

The Nature of Federal Tax Liens (cont'd)

- IRS liens are general liens; thus, they attach to all property of the taxpayer, not just the address listed on the FTL. The address given on the FTL is for informational purposes only. The lien also attaches to inherited property which the taxpayer attempts to disclaim.
- If it is determined that an entity is the alter-ego of a taxpayer, the IRS can enforce a lien against the assets of the entity.
- So, for example, Limited Liability Companies ("LLC") are not liable for income taxes and are considered disregarded entities; however, an FTL against a single member LLC may be a lien on the single member personally.

The Nature of Federal Tax Liens (cont'd)

- A FTL filed against one spouse, where the spouses hold title as tenants by the entirety or against one joint tenant where there are two or more joint tenants, will be extinguished upon the death of the taxpayer-debtor spouse or taxpayer-debtor joint tenant.
- A FTL filed against one tenant in a property held as tenants in common where the debtor tenant dies will not result in the extinguishment of the lien.
- The lien will continue against the deceased tenant's interest, heirs and devisees.

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Filing the Federal Tax Lien and the Duration of the Lien

- FTL are filed with the Clerk or Register's Office in the County where the real property is located.
- An FTL is a lien for a period of 10 years, 30 days from the date of assessment and not from the date of filing, unless the FTL is refiled. Prior to 1990, the lien of a FTL was 6 years, 30 days.
- Generally, FTL are self-releasing, unless refiled by the last day for refiling as shown in the FTL notice. The IRS and the taxpayer may agree to extend collection of the debt beyond the lien period or by prolonged absence by the taxpayer from the United States.

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Release of a Federal Tax Lien

- A filed FTL document contains specific language authorizing the release of the FTL after the last day for filing has expired.
- Upon payment, the IRS may issue a release which may then be recorded. The IRS may also withdraw the FTL. Once withdrawn, it is as if the withdrawn FTL was never filed.
- The withdrawn FTL does not affect the statutory lien provided under the IRC but relinquishes any lien priority established by the IRS when the FTL was filed.
- IRS is also empowered to file “Certificates of Non-Attachment” where confusion or error has occurred because of the filing of an FTL.

The FTL as an Objection to Title

- You must take exception in your commitment to any FTL found in the County search where less than 10 years 30 days have elapsed from the date of assessment. If the FTL is against the Seller, the lien must be paid.
- A FTL always requires a written payoff letter from the IRS prior to closing. Unless approval is granted from your underwriter, you should never hold escrow funds from closing for an open FTL pending receipt of the payoff letter.
- The IRS will often require that additional IRS debt be paid for possible other liens that are not recorded and there may be additional interest and penalties due. An escrow may not be enough to pay the additional debt.

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The FTL as an Objection to Title (cont'd)

- When clearing a FTL one may look to the information listed in the "notice of lien" itself to assist in the process; thus, the lien will contain a portion of the taxpayer's tax identification number ("TIN") or social security number ("SSN"). One should not rely on the address listed on the FTL for the purpose of clearing the lien.
- An innocent spouse defense may be available when the IRS has filed a lien against both spouses, but one spouse can demonstrate that they are not liable for the debt. In this scenario, the IRS may issue a release for the innocent person's interest.

The FTL as an Objection to Title (cont'd)

- When a lien is filed against one spouse holding title as tenants by the entirety, and the delinquent taxpayer spouse dies, the surviving spouse takes title free from the FTL. The same holds true for joint tenants with the right of survivorship.

- If the property subject to an FTL is underwater and the IRS determines its lien is of no-value, the IRS may agree to discharge the lien or may do so in a short sale situation if the delinquent taxpayer can demonstrate or provide proof of the hardship.

Enforcement of the FTL

- 1. Seizure and sale of the property: This process is considered a “secret” process because there will be no notice of same in the record, i.e., no lis pendens. The US is required to follow the law as set forth in 26 U.S.C. §6331 et seq. If the law is followed, it may be possible to insure a deed out of the IRS’s seizure of the property.
- An IRS deed will proport to convey all the “right , title and interest” of the taxpayer debtor as long as the proceedings have been in accordance with 26 U.S.C. §6331 et seq. One must obtain and review the Record of Seizure and Sale of Real Estate from the IRS and determine if the US Code provisions were complied with.

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Enforcement of the FTL (cont'd)

- If requested to provide insurance for a deed out of the IRS, one must be certain that not only has relevant U.S. Code sections been compiled with, but that the taxpayers have vacated the property and that exception has been taken in the commitment for all senior liens, including real property taxes and municipal liens.
- The deed from the IRS must be recorded.
- In a seizure and sale of property, the taxpayer enjoys a 180-day post-sale right of redemption.
- Some underwriters may require a judicial determination, such as a quiet-title action, before agreeing to insure a deed out of the IRS.

Enforcement of the FTL (cont'd)

- 2. Judicial Foreclosure under 26 U.S.C. §7403: This is a procedure similar to a mortgage foreclosure. Under this procedure, anyone having a lien or an interest in the property must be made a party defendant and served.
- Like a mortgage foreclosure, any lien or interest that attaches after the filing of the FTL, made a party defendant, and properly served will be divested.
- Liens filed prior to the FTL must continue to be set-up as exceptions to title in the commitment because they are senior liens. A chancery abstract will need to be ordered and reviewed if this procedure was used by the IRS.

Divesting of FTL in Foreclosures: Mortgage and Tax Sale Foreclosures

- Mortgage foreclosure in New Jersey is a non-summary judicial form of foreclosure; as a result, one that requires a judicial sale, i.e., a Sheriff's sale. The process of divesting a FTL in a mortgage foreclosure is straight forward:

  1. The US must be joined as a party defendant;
  2. The US must be properly served;
  3. The complaint must contain a specific allegation as to the FTL; or

- In the alternative, the FTL must be filed subsequently to the lis pendens.

Divesting of FTL in Foreclosures: Mortgage and Tax Sale Foreclosures (cont'd)

- Tax sale foreclosure in New Jersey is in the form of a strict foreclosure; thus, it is a summary proceeding and no sale occurs. May a tax sale foreclosure divest an FTL?
- The standard view is that an FTL is not divested in a summary proceeding. However, the foreclosing party may demand a judicial sale to divest the FTL.
- If this is done, procedural requirements must be strictly adhered to, i.e., such as notice requirements, etc.
- Regarding a FTL, the U.S. enjoys a right of redemption for a period of 120 days from the date of the foreclosure sale.

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Federal Estate Taxes

- The federal estate tax, is a tax imposed under the IRC on a decedent's estate based upon the value of the decedent's entire estate.
- The tax only affects large estates that exceed the exclusion amount. For 2021 the exclusion was $11,700,000.00.
- If the tax is unpaid a "secret" lien arises in favor of the U.S. and attaches to the property of the estate as of the date of death.
- Use of a disclaimer may be used to minimize the effect of the tax.

Federal Estate Taxes (cont'd)

- The lien of the tax is for a period of 10 years from the date of decedent's death.
- In determining if the estate is subject to the tax, an estate questionnaire is a good tool to make the assessment.
- If subject to the tax, one may require proof that a Federal Estate Tax Return was filed and the tax paid, but ultimately an IRS Estate Closing Letter must be presented.
- One may rely upon the IRS Estate Tax Closing Letter from the IRS as proof of payment.
- The lien may be released or discharged via a certificate of discharge from the IRS.

Foreign Investment in Real Property Tax Act ("FIRPTA"): What is FIRPTA?

- FIRPTA is a mechanism whereby the U.S. ensures the collection of taxes from the gain or profit made by foreign individuals and corporations, i.e., foreign investors or foreign persons, on the sale of a U.S. real property interest.
- In order to accomplish the collection of this tax, the Act imposes a withholding requirement upon the proceeds of the Seller in the sale of a real property transaction.
- The tax will guarantee that the foreign person files a U.S. income tax return and either gets credit for the tax held under FIRPTA or is subject to additional taxation.

Foreign Investment in Real Property Tax Act: What is FIRPTA? (Cont'd)

- A FIRPTA issue is not a title issue and any possible tax liability under the Act is not a lien on real property. As such, one should not set-up any requirements or exceptions related to compliance with same in the commitment.
- Additionally, you may not provide affirmative coverage related to compliance with the Act or whether the Act is or is not related to a particular transaction.
- FIRPTA, although not a title issue, is an issue related to settlement and disbursement, and a settlement agent in a closing transaction, will eventually be called upon to deal with FIRPTA issues.

Foreign Investment in Real Property Tax Act: What is FIRPTA? (cont'd)

- FIRPTA is part of the federal tax code and will apply to most "closings" wherein the Seller is a foreign person. Thus, the Act applies to anyone who is neither a U.S. citizen nor a resident alien.
- The term "foreign person" refers to both natural persons and entities as well. The Act does not apply, however, to transactions where the sale price does not exceed $300K, and the Buyer intends to use the property as a residence.
- The Act uses the terms Transferor for the Seller and Transferee for the Buyer.

Foreign Investment in Real Property Tax Act: Who Is the withholding agent?

- The IRS looks to the withholding agent as the party responsible for compliance with the Act. The tax is a withholding tax and not an escrow.
- In most situations, the Buyer of property is the withholding agent. If the Seller of the property is a foreign person and the Buyer fails to hold the appropriate withholding tax, the Buyer may be held liable for the tax.
- The Buyer, as the withholding agent, must withhold the tax on the gross amount realized by the Seller, i.e., on the total amount of the sale.
- The amount to be held will typically be 15% of the sale price of the property; however, in certain situations the amount will be 10% of the sale price. The FIRPTA collected at closing must be sent to the IRS within 20 days of settlement.

Foreign Investment in Real Property Tax Act: Who Is the withholding agent? (cont'd)

- While the settlement agent will often handle the collection of the funds, collect the required paperwork from the Buyer and Seller, and disburse the tax to the IRS, federal law makes the Buyer responsible for the compliance with the Act.
- Under IRS regulations, a title company acting as settlement agent is not a "withholding agent" and is not responsible for FIRPTA compliance.
- In any case, FIRPTA is a complex law, and you should not attempt to interpret it for the parties, and it may often prove difficult to determine its applicability to any particular transaction.

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Foreign Investment in Real Property Tax Act: Who Is the withholding agent? (cont'd)

- FIRPTA compliance must remain in the hands of the Buyer. Although the Buyer and Seller will often look to the settlement agent for guidance, the settlement agent must decline to give it. The settlement agent must insist that the parties seek guidance from legal counsel and tax experts, such as their CPA.
- The settlement agent should only be involved in the ministerial or administrative acts required to collect and distribute the funds and to collect the documents necessary for compliance with the Act.

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Foreign Investment in Real Property Tax Act: Co-Tenants

- When you have co-owners, one foreign and one U.S. citizen seller, the entire transaction is <u>NOT</u> exempt. In a co-ownership situation, the amount of the sale price is allocated based upon each person’s capital contribution.

- In this situation, the Buyer will hold the amount of tax based upon the amount allocated to the foreign person. The U.S. citizen’s portion would be exempt.

- When a married couple holds title as tenants by the entirety and consists of one person who is exempt from FIRPTA and one person who is not, the amount allocated for FIRPTA purposes is considered as 50% each.

Foreign Investment in Real Property Tax Act: Exemption and Partial Exemption

- 1. Sellers can sign the *Certificate of Non-Foreign Status*, or also known as the FIRPTA Affidavit. If all the Sellers are able to sign the Certificate, they are exempt from FIRPTA, and you do not need to consider it as an issue. Make sure you are getting this document signed at every closing and keep a copy in your file.

- 2. If the Sellers obtain a *Withholding Certificate*, the Sellers may be entitled to zero withholding or to a reduced withholding below the 15% threshold. This form may be submitted to the IRS in advance of closing for the Sellers to obtain a reduced withholding.
- Unfortunately, this is rarely done because it may take the IRS up to 90 days to respond.

Foreign Investment in Real Property Tax Act: Exemption and Partial Exemption

- 3. Foreign Sellers may be exempt from withholding tax based upon the *Substantial Presence Test*. This a convoluted and complex formula for foreign persons who have been present in the US for a certain period of time and as a result, the IRS says that based on the formula, they are not subject to FIRPTA withholding.
- 4. Another exemption is the *Buyer's Declaration of Intent to Reside* for a complete exemption. This exemption exists when two conditions are in place:

  a. the sales price of the property does not exceed $300,000.00; and

  b., the Buyers agree to and are legitimately able to sign the *Declaration of Intent to Reside in the Property* certification.

Foreign Investment in Real Property Tax Act: Exemption and Partial Exemption

- 5. Finally, the Seller may be entitled to a reduced withholding based upon the *Buyer's Declaration of Intent to Reside for Reduced Withholding*.
- In this situation, the Seller may be able to reduce the amount withheld from 15% to 10% if the sale price is between $300,000.00 to $1,000,000.00 and the Buyer intends to live in the property as a residence.
- Buyer must sign the *Declaration of Intent to Reside* to certify same.

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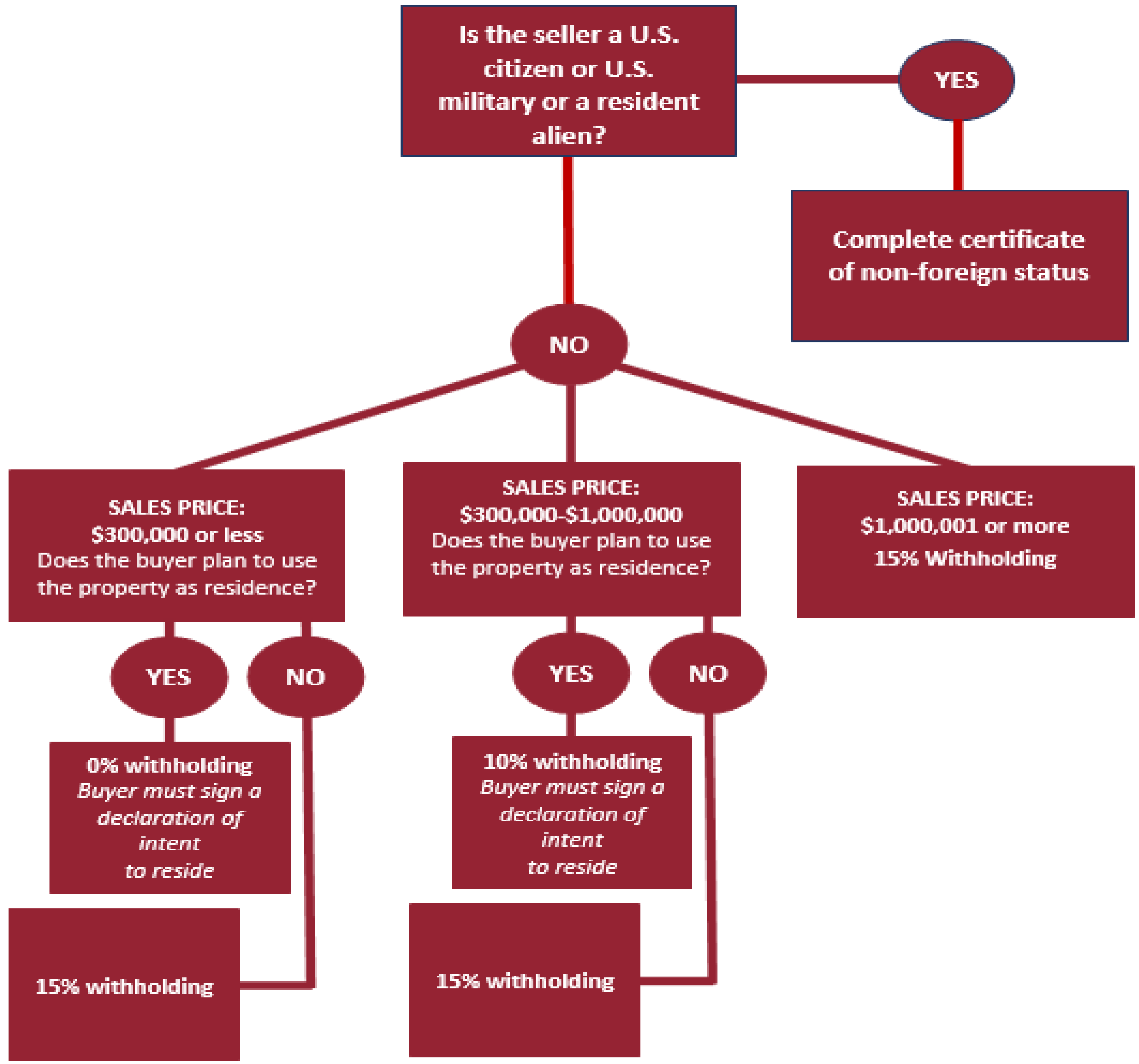
FIRPTA Flow Chart:



Certificate of Non-Foreign Status:

CERTIFICATE OF NON-FOREIGN STATUS

(FIRPTA AFFIDAVIT)

Section 1445 of the Internal Revenue Code provides that a transferee (buyer) of a U.S. real property interest must withhold tax if the transferor (seller) is a foreign person.

To inform ____ (the "Transferee") that withholding of tax is not required upon the disposition of a U.S. real property interest by (the "Transferor"),the undersigned hereby certifies the following on behalf of the Transferor:

1. That the Transferor is the owner of the following described property, to wit:

Block: ___________ Lot: _________ County:_____________________ State:_______

Premises:____

2. The Transferor is not a non-resident alien for purposes of the U.S. income taxation (as such term is defined in the Internal Revenue Code and Income Tax Regulations).

3. The Transferor's U.S. taxpayer identification number (Social Security Number) is _____________________

4. The Transferor's address is:____

5. The Transferor understands that this certification be disclosed to the Internal Revenue Service by the Transferee and that any false statement contained herein could be punished by fine, imprisonment or both.

UNDER PENALTIES OF PERJURY, I DECLARE THAT I HAVE EXAMINED THIS CERTIFICATION AND TO THE BEST OF MY KNOWLEDGE AND BELIEF IT IS TRUE, CORRECT AND COMPLETE, AND I FURTHER DECLARE THAT I HAVE AUTHORITY TO SIGN THIS DOCUMENT ON BEHALF OF THE TRANSFEROR.

Signed and Sworn before me on this

______ day of _____________, 20 _____

____

Notary Public

By: ____________________________________

By: ____________________________________

By: ____________________________________

By: ____________________________________

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FIRPTA NOTICE TO BUYERS:

FIRPTA NOTICE REGARDING SETTLEMENT AGENT RESPONSIBILITY

Date:
File No:
Seller:
Purchaser:
Property:

The Foreign Investment in Real Property Tax Act (FIRPTA), Title 26 U.S.C., Section 1445, and the regulations there under, provide in part, that a transferee (Buyer(s)) of a U.S. real property interest from a foreign person must withhold a statutory percentage of the amount realized on the disposition, report the transaction, and remit the withholding to the Internal Revenue Service (IRS) within twenty (20) days after the transfer.

____________________________________will not determine nor aid in the determination of whether the FIRPTA withholding provisions are applicable to the subject transaction, nor act as a Qualified Substitute under state or federal law, nor furnish tax advice to any party to the transaction.

_________________________________will not determine nor aid in the determination of whether the transaction will qualify for an exception or an exemption and is not responsible for the filing of any tax forms with the IRS as they relate to FIRPTA, nor responsible for collecting and holding of any documentation from the Buyer(s) or Seller on the Buyer(s)'s behalf for the of supporting a claim of an exception or exemption.

_________________________________is not an agent for the Buyer(s) for the purposes of receiving and analyzing any evidence or documentation that the seller in the subject transaction is a U.S. citizen or resident alien. ____________________________is not responsible for the payment of this tax and/or and penalty and/or interest incurred in connection therewith and such taxes are not a matter covered by the Owner's Policy of Title Insurance to be issued to the Buyer(s).

_________________________________ is not responsible for the completion of any IRS documents or related forms related to the referenced statute. The Buyer(s) is/are advised: they must independently make a determination of whether the contemplated transaction is subject to the withholding requirement; bear full responsibility for compliance with the withholding requirement if applicable and/or for payment of any tax, interest, penalties and/or other expenses that may be due on the subject transaction; and they are responsible for the completion of any and all forms, including but not limited to applicable IRS documentation, and the mailing of those forms.

The Buyer(s) is advised any forms, documents, or information received from___________________ is not tax or legal advice and should not be construed as such nor treated as a complete representation of FIRPTA requirements. Buyer(s) should seek outside counsel from a qualified individual to determine any and all implications of the referenced statute.

BUYER(S):

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1099 Reporting Requirements

- In the sale of a residence, the Seller is required to report the amount of proceeds from the sale to the IRS using form 1099-S to report possible capital gains.

- The reporting is required for improved and unimproved land, permanent structures, including both residential and commercial buildings, condominium units, and shares in co-ops.

- If the property sold is the primary residence and the Sellers are married and the gain from the sale is less than $500K, the sale is exempt from reporting; for an unmarried Seller the reporting exemption is $250K.

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1099 Reporting Requirements (cont'd)

- If the settlement is an attorney-controlled closing, and the attorney is disbursing the funds, the attorney is responsible for the reporting. In a title company-controlled closing, the responsibility falls upon the title company.
- The responsible party will be required to collect all the information from the Seller in order to comply with the law. This includes obtaining the Seller's forwarding address.
- Professional "1099" services are available that will provide the reporting requirement. This is an excellent means to making sure that this important requirement is met.

Wrap Up and Review

- FTL liens are general liens; thus, they attach to all property of the taxpayer, including after acquired property.
- FTL are filed with the Clerk or Register's Office in the County where the real property is located.
- An FTL is a lien for a period of 10 years, 30 days from the date of assessment and not from the date of filing, unless the FTL is refiled.
- A FTL may be enforced through IRS seizure and sale of the property and by judicial foreclosure under 26 U.S.C. §7403 They are also subject to divestment in a foreclosure, but the IRS enjoys a 120-day right of redemption period.

Wrap Up and Review (cont'd)

- Federal estate taxes are imposed under the Internal Revenue Code on a decedent's estate based upon the value of the decedent's entire estate.
- If the tax is unpaid a "secret" lien arises in favor of the US and attaches to the property of the estate as of the date of death for a period of 10 years.
- FIRPTA is a withholding tax on the gain or profit made by foreign individuals and corporations on the sale of a U.S. real property interest.
- A FIRPTA issue is not a title issue and any possible tax liability under the Act is not a lien on real property.

Wrap Up and Review (cont'd)

- The Buyer, is the withholding agent, and as such must withhold the tax in the amount of 10% or 15% of the gross amount realized by the Seller where a person is designated as a foreign person.
- The settlement agent must collect and submit the funds, along with the documents, to the IRS within 20 days of settlement.
- The Seller of a residence is required to report the amount of proceeds from the sale to the IRS using form 1099-S to report possible capital gains. The responsibility for reporting must be carried out by the settlement agent.

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NJUWing@Stewart.com