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MEMORANDUM FOR DISTRICT COUNSEL, SOUTHERN CALIFORNIA DISTRICT

FROM: Alan C. Levine
Chief, Branch 1(General Litigation)

SUBJECT: Priority of Third Party Advances to Taxpayer

We are responding to your September 17, 1998, inquiry. This document is not to be cited as precedent.

ISSUE:

Whether a third party who advances funds to the taxpayer has priority over federal tax liens.

FACTS:

The fact pattern that you have described to us is as follows. The taxpayer has a mortgage on a home and is in arrears with his mortgage payments. After the mortgage was placed on the home, the Service filed a Federal Tax Lien against the taxpayer's property. The taxpayer desires to voluntarily sell his home, to a particular buyer, because of the possibility of a foreclosure sale. In order to get additional time for the sale process the buyer advanced money to the bank to postpone the foreclosure sale. The payment was considered a partial reinstatement payment. The buyer's intention in advancing the money was to prevent or delay foreclosure. At the time of the advancing of the money a formal escrow was not opened and the buyer did not execute any documents. Also, the buyer claims that he advanced the funds without knowledge of the Federal Tax Lien. When the house is sold to the buyer, the bank clearly has first priority to the funds; however, the question remains whether the buyer has priority over the government as to the amount of funds that the buyer advanced.

LAW AND ANALYSIS:

You suggested two theories that may give the third party buyer priority over the

government, the doctrines of equitable subrogation and equitable liens. However, you dismissed them as not being applicable. The following discussion first addresses those theories and then examines whether there are any other theories that may give the third party taxpayer buyer priority over the government.

Equitable Subrogation

Priority of a federal tax lien is determined by the common law rule of "first in time, first in right." United States v. New Britain, 347 U.S. 81, 85 (1954). However, federal law recognizes state law subrogation rights. Where there is a claim of subrogation to the lien priority of a secured creditor as is the situation in the instant scenario, federal lien law provides that the issue of subrogation is controlled by local law. 1/ See I.R.C. § 6323(i)(2). In the scenario that you provided the third party would have priority over the government if it was subrogated to the rights of the bank under the common law rule of "first in time is first in right."

Under California law it is appropriate for the court to apply the doctrine of equitable subrogation where the court finds that the creditor satisfies the following prerequisites:

1) payment must have been made by the subrogee to protect his own interest;
2) the subrogee must not have acted as a volunteer;
3) the debt must be one for which the subrogee was not primarily liable;
4) the entire debt must have been paid; and
5) subrogation must not work an injustice on the rights of others.

See Han v. United States, 944 F.2d 526, 528 (9th Cir. 1991); Simon v. United States, 756 F.2d 696, 698 (9th Cir. 1985); Caito v. United California Bank, 20 Cal. 3d 694, 704, 576 P.2d 466, 471, 144 Cal. Rptr. 751, 756 (1978); In re Forrester, 524 F.2d 310, 315 (9th Cir. 1976).

It seems clear that elements three and five are met. The buyer was not primarily liable for the mortgage and the government, the junior lienholder, will not suffer an injustice as a result of the subrogation. The government will recoup as much as it would if the sellers still owned the property. Element four is not met because the buyer paid only part of the existing mortgage. However, the California courts apply the doctrine of equitable subrogation liberally and do not limit its application to situations where only the five factors are met. Rather, the rule is appropriate where

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1/ The scenario that you provided involved a transaction that occurred in California and Californian taxpayers. Therefore, it is governed by California law. If the party is subrogated to the rights of the mortgagee bank under California law then the third party will have priority over the government for the amount that the third party advanced to the bank.

"one person, not acting as a mere volunteer or intruder, pays a debt for which another is primarily liable, and which in equity and good conscience should have been discharged by the latter." Han, 944 F.2d at 529, quoting Caito, 20 Cal.3d at 704. 2/ Elements one and two are the most instrumental in determining whether equitable subrogation is appropriate, see Han; therefore, they must be examined to assist in the determination of whether equitable subrogation is appropriate.

Element one: Payment must have been made by the subrogee to protect his own interest

To subrogate to the rights of the senior lienholder the subrogee must have acted to protect his own interest rather than simply meddling officiously in the taxpayer's relations with the senior lienholder. See Han, 944 F.2d 530. "Officiously" is defined as: "1. Kind; obligating; dutiful. 2) Volunteering one's services where they are neither asked nor needed; meddlesome." WEBSTER'S NEW COLLEGIATE DICTIONARY (1960). The alleged subrogee, in this case, does not fit the definition of an officious intermeddler. Nor was he acting in the capacity of a friend or Good Samaritan to the taxpayer. Rather, the buyer advanced the money to the mortgagor to protect his future property interest. The money was advanced to preclude a foreclosure. If the money was not advanced, the bank could have foreclosed and the buyer's desired result, that he purchase the property, would have been at risk. Therefore, to protect his interest, the buyer advanced the money to the bank.

Element two: The subrogee must not have acted as a volunteer

The instant scenario should be distinguished from two California cases where the court determined that new purchasers of property were volunteers for the purpose of equitable subrogation. Simon, 756 F.2d 696; Fidelity National Title Insurance Co. v. United States Department of the Treasury, 907 F.2d 868 (9th Cir. 1990). Rather, it should be compared with Han, where the purchasers were found not to be volunteers. In Simon, the encumbered property was purchased at a county tax sale, and in Fidelity, the encumbered property was bought at a foreclosure sale. "In both of those cases the purchases were made at forced sales and the purchasers were not paying off existing debts, but simply extinguishing all liens by obtaining the property at any price." Han at 529 FN2. These purchasers were not acting to

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2/ A limitation on equitable subrogation is California is where the party alleging subrogation has "actual" knowledge of the existing encumbrance. Smith v. State Savings & Loan Association, 175 Cal. App. 3d 1092, 1098 (1985). However, a filed lien does not provide the party with actual notice but rather constructive notice. Cal Civ. Code 18 (West 1982). Therefore, the fact that the tax lien was filed prior to the third party advancing the money to the bank does not bar the third party from being subrogated to the rights of the bank. See Han, 944 F2d 529.

protect an existing interest and did not advance money to pay the debt of another. Simon, 756 F2d. 698. Rather, "what is important is that [the purchasers] knew that the forced sale of the property would extinguish any lien regardless of how much they paid as a purchase price. Therefore, neither [of the purchasers] paid money to satisfy the debt of another." Fidelity 907 F.2d at 870.

The purchasers in Simon and Fidelity should be contrasted with the situation in Han. The sale in Han was not a forced sale but a sale in the ordinary course of business like the sale in our case. The Hans purchased property that at the time of sale was encumbered by a first deed of trust that was recorded prior to a federal tax lien's recordation. The Hans "were well aware that the Home Savings lien needed to be paid off from the purchase price, and would not be extinguished automatically by virtue of a sale." Id. at 529 FN2. The court ruled that the Hans were not volunteers as were the purchasers who purchased the property at a foreclosure sale. Id. The Hans were equitably subrogated to the priority position of the lender whose existing lien they paid off when they purchased the property.

The only difference in the fact pattern between Han and the facts in this case is that in our case the buyer did not pay the bank lien at the same time as the purchase of the property but paid it in part before the sale of the house. There is no evidence in Han that the timing of the payment would change the buyer's status to volunteers.

In 58 Cal. Jur. § 6, the following is stated regarding the prerequisite to being a volunteer (footnote citations omitted).

§ 6 Volunteers or strangers–

> Regardless of the category into which a person seeking subrogation may fit, the doctrine of subrogation is not applicable in favor of one who has officiously and as a mere volunteer paid the debt of another, without any duty, moral or otherwise, to do so. Generally speaking, it is only in cases where advancing money to pay the debt of another stands in the situation of a surety, or is compelled to pay to protect his own rights, that a court of equity substitutes him in place of the creditor as a matter of course, without any agreement to that effect. The right of a surety or guarantor to be substituted in the creditor's place with reference to the debt when he pays the principal's debt does not depend on any contract, express or implied, but grows out of the relation of surety and creditor and principles of natural justice.

"The doctrine (equitable subrogation) is also justly extended, by analogy, to one who, having no previous interest, and being under no obligation, pays off the mortgage, or advances money for its payment, at the instance of a debtor party and for its benefit, such a person is in no true sense a mere stranger or volunteer." Grant v. De Otte, 265 P.2d 952, quoting POMEROY'S EQUITY JURISPRUDENCE, Fifth Ed., Vol. 4, pages 640-641, § 1212.

More facts must be given to determine whether or not the third party purchaser in the instant scenario is a volunteer. Presumably, the taxpayer requested the buyer to advance the payment to the bank and it was part of the overall negotiations that occur in the sale of a home. In that case, the buyer would not be a volunteer for the purposes of equitable subrogation.

Equitable Subrogation - Conclusion

The only element that is clearly not met under the five elements test for equitable subrogation, is element four -- the buyers did not pay the taxpayer's entire debt. While the taxpayer had an outstanding obligation to the bank, even after the buyer advanced the money, the buyer paid enough of the debt so that the mortgage was not foreclosed. As mentioned above, California courts apply equitable subrogation liberally and do not limit its application to situations where only the five factors are met. Rather, it is appropriate where "one person, not acting as a mere volunteer or intruder, pays a debt for which another is primarily liable, and which in equity and good conscience should have been discharged by the latter." Han, 944 F.2d at 529, quoting Caito, 20Cal.3d at 704. Therefore, in a situation where a third party purchaser advances money to a mortgagor bank, to delay foreclosure of the taxpayer's property, California courts might recognize such purchasers as subrogated to the rights of the bank, the senior lien holder, for the amount of the advancement.

Equitable Lien

A precise and inclusive definition of an equitable lien is difficult to give because of its varying nature as a device of equity. See Farmers & Merchants Bank v. Comm., 175 F.2d 846 (8th Cir. 1949). It may arise either from an express contract, where the contract shows the intention to create a security obligation, or by implication evidenced by the relationship and dealings of the parties whose interests are involved. 51 Am Jur 2d § 24. The right to an equitable lien arises "when a party, at the request of another, advances him money which applied to the discharge of a legal obligation of that other, but owing to the disability of the person to whom the money was advanced. No valid contract is made for its repayment. However, a lien may not be based upon the payment of another's debts by a mere volunteer . . . " 51 AM JUR 2D § 32.

A court is likely to recognize an equitable lien where the lien claimant's expenditure benefits the property that he now claims security in, under circumstances that in equity should entitle the claimant to restitution. See McColgan v. Bank of California Assn., 208 Cal. 329, 338 (1929). The courts application of the equitable lien theory, in the majority of cases, indicates that it is necessary that the claimant's investment be spent on the expected security that the lien is sought. See, e.g., A-1 Door and Materials v. Fresno Guar. Sav. & Loan Assn. , 61 Cal. 2d 628 (1964); Jones v. Sacramento Sav. & Loan Assn., 248 Cal. App. 2d 522, 529 (1967); Nibbi Brothers v. Home Fed. Sav. & Loan Assn., 205 Cal. App. 3d 1415, 1419 (1988). In

the instant scenario, there was neither an express contract nor an advancement of money that benefitted the property. Rather, the money was advanced to protect the lien claimant's own interest. Therefore, the lien claimant/purchaser will not have priority over the government by means of an equitable lien.

Other Theories

Section 6323 provides for situations that would give an interest holder in property priority over a federal tax lien. None of the statutorily provided priorities apply to the scenario that this advisory is addressing. Also, we were unable to develop any other legal basis that would enable the buyer, who advances money to delay a possible foreclosure on property that is encumbered with a federal tax lien, to have priority over the government for the amount of money advanced.

Conclusion

In conclusion, we believe that the purchaser's only argument for successfully asserting priority over the government's tax lien, based on the facts given, is based on equitable subrogation. A more definitive answer may be determined if more specific facts are discovered, specifically, whether the purchaser was asked by the seller to advance the money. However, on the facts presented, depending on whether a court deems the purchaser a volunteer, we believe it would be difficult, but perhaps possible, for the buyer to satisfy the elements of equitable subrogation. We know of no other theories that permit the buyer to assert a priority over the liens of the government. We suggest that you contact Branch 1 for an evaluation if this fact pattern presents itself.

If you have any further questions please call (202)622-3610.

cc: Assistant Regional Counsel (GL), Western