Look Before You Leap: A Cautionary Tale for Purchasers.

Parents tell their children to "look before you leap." That is also good advice for adults, as illustrated by a recent tax lien case, *Gregory v. United States,* 2012 U.S. Dist. LEXIS 159307 (W. D. Va. 2012).

The story starts in 2002, when the IRS filed a tax lien against Joe Watson. Mr. Watson and his wife owned real estate as tenants by entireties, and the lien therefore attached to Mr. Watson's one-half interest in the property under *United States v. Craft*, 535 U.S. 274 (2002). A year later, they deeded the property to their daughter, Tammy, who assumed the existing mortgage and took the property subject to the tax lien. The IRS did nothing to enforce its lien at the time of this transfer.

In 2006, Tammy Watson sold the property to Mr. and Mrs. Gregory for $225,000; as part of the sale, the existing mortgage loan was paid off. The IRS did nothing to enforce its lien in connection with this transfer.

After buying the property, Mr. and Mrs. Gregory made $100,000 in improvements. Then they agreed to sell the property to someone who apparently had a sharper title company: the tax lien was found. The IRS, which has ignored the two prior transfers, refused to release its lien for less than one-half of the sales price of $380,000. After posting a bond for $190,000 so that the property could be sold, Mr. and Mrs. Gregory filed suit to be released from the bond.

The Gregorys faced an uphill fight: Section 6323 of the Internal Revenue Code governs the priority of a federal tax lien, and it preserves the priority of a variety of interests that arise *before* a notice of the federal tax lien is filed, such as judgments and mechanic's liens. I.R.C. § 6323(a). Purchasers who provide adequate and full consideration and acquire property *before* the lien is filed are protected. Once the notice of federal tax lien is filed, the categories of interests that have a priority over the tax lien narrows significantly, and the Gregorys could not fit within any applicable category under Section 6323(b) or 6323(c). Consequently, they purchased the property subject to a federal tax lien on one-half of it.

In an effort to escape their predicament, they argued that they were subrogated to the prior lender's lien. The Code does recognize the concept of subrogation, as Section 6323(i)(2) provides for subrogation to the extent available under local law. That local law was the problem: Mr. and Mrs. Gregory were not acting as substitutes for the prior lender; they paid off the loan as a condition of the purchase of the property. *Gregory v. United States,* 2012 U.S. Dist. LEXIS 159307, slip op. at *7. Moreover, the IRS was not paid at the time of the Gregorys' purchase and it would be prejudiced if its lien were again subjected to a senior lien.

As an alternative, the Gregorys sought at least to receive credit for the improvements that they made, but the court rejected that assertion as "without merit," noting that the government's entitlement to recover under a tax lien was not fixed at the time that the property was transferred. *Id.* at *11 (citing *United States v. Avila,* 88 F.3d 229, 233 (3d Cir. 1996)).

The net result: the government got a windfall, recovering far more than it would have if it had promptly enforced its tax lien. The Gregorys, who were complete innocents, wound up walking away from an apparently profitable transaction with a significant loss because the federal tax lien was not identified before the purchased and improved the property. The result is harsh on the facts but consistent with established law.

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