
Coates' Canons Blog: More Tax Foreclosure Myths

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Article: <https://canons.sog.unc.edu/more-tax-foreclosure-myths/>

This entry was posted on October 28, 2010 and is filed under Finance & Tax, Property Taxes

Building on this earlier post, here are a few more myths about tax foreclosures that deserve debunking. (This time I promise to avoid bragging on Duke basketball.)

But first allow me to plug two resources that might be of interest to attorneys and tax officials. *The Nuts and Bolts of N.C. Tax Foreclosures*, last week's well received School of Government webinar featuring an expert panel of experienced practitioners, will shortly be available for on-demand viewing; check the left-side menu on the SOG homepage. And here is a link to a new Property Tax Bulletin on tax foreclosures.

Myth #1: IRS tax liens have priority over local property tax liens.

Federal law always trumps state and local law, but in this situation the federal government has graciously deferred to North Carolina's cities and counties.

26 U.S.C. § 6323(b)(6) makes federal tax liens junior to local real property tax liens if the governing state law gives local tax liens priority over previously existing liens on the same real property. Luckily for our local governments, North Carolina law includes such a provision. N.C.G.S. § 105-356(a)(1) gives local tax liens super-priority over all liens on real property except for previously existing state tax liens.

As a result, a local tax lien has priority over a federal tax lien even if the federal lien was recorded before the local tax lien arose on January 1 of the year in which the property tax was levied. If the property is sold in a tax foreclosure, the local taxes will be paid before the federal taxes.

26 U.S.C. § 6323(b)(6) also makes local special assessment liens senior to federal tax liens. But taxes on personal property that are included in the lien on real property are *not* granted the same super-priority under the federal statute.

For example, assume that Carolina County has a tax lien of \$1,500 on Parcel A for 2009 taxes. \$1,000 of this lien represents taxes on Parcel A itself. \$500 of this lien represents taxes on a plane owned by the same taxpayer who owns Parcel A. (N.C.G.S. § 105-355(a) mandates that taxes on personal property other than registered motor vehicles owned by the same taxpayer in the same jurisdiction are a lien on that taxpayer's real property). The IRS recorded a tax lien of \$5,000 on Parcel A in 2007, long before the lien for 2009 local property taxes arose.

If Carolina County were to foreclose on Parcel A, here's how the sale proceeds should be applied. As always, foreclosure costs would be paid first. The \$1,000 Carolina County lien for taxes on Parcel A would be paid next, followed by the \$5,000 IRS lien, and finally the \$500 Carolina County lien for taxes on the plane.

Myth #2: A foreclosure sale completed more than 10 years after the taxes' original due date violates the Machinery Act's statute of limitations.

Although the Machinery Act's limitation on enforced collections is indeed ten years from the taxes' original due date(s), this limitation is satisfied so long as the enforcement action *begins* within that ten-year period. Foreclosures can take months to complete, but so long as the complaint was filed (under N.C.G. § 105-374) or the judgment docketed (N.C.G.S. § 105-375) within ten years from the original due dates of the relevant taxes, the taxpayer will not be able to rely on the Machinery Act's statute of limitations as a defense.

Remember that property taxes become due on September 1 of the year which they are levied. Different due dates apply to taxes on registered motor vehicles, but because those taxes are never a lien on real property the only due date that

matters for foreclosures is September 1.

While the statute of limitations can't stop a foreclosure action once it begins, the automatic stay that arises after a bankruptcy filing can. If a defendant taxpayer files for bankruptcy, that foreclosure action must halt immediately regardless of how close to completion it may be. For example, assume a taxpayer files for bankruptcy after the property is sold to the highest bidder. So long as the sale has not yet been confirmed, the foreclosure must halt and the taxpayer will retain ownership of the property.

Myth #3: Only delinquent taxes may be recovered at the foreclosure sale.

When a foreclosure proceeds to sale *all* taxes that are liens on the property should be recovered from the proceeds. This includes taxes that are not yet delinquent or even due. The only exceptions are taxes that can't be determined at the time of sale—in other words, those taxes for which the tax rate has not yet been set.

N.C.G.S. § 105-374(e) expressly includes all taxes in the judgment of sale for a mortgage-style foreclosure except those that cannot be determined, assuming that the initial complaint included a demand for “all subsequent taxes.” N.C.G.S. § 105-375(a) implicitly suggests the same for in rem foreclosures because it does not limit the docketed judgment to delinquent taxes.

Here's how it works in practice. Assume that on July 1, 2010 Blue Devil City initiated a foreclosure action against Parcel A for delinquent 2009 taxes. In its complaint, the city requested judgment not only for the 2009 taxes but also all subsequent taxes. When the city prepares to request a judgment of sale in December 2010, it should include in the certificate of taxes owed the 2010 taxes on Parcel A even though those taxes are not yet delinquent.

Let's assume that Blue Devil City proceeds with an in rem foreclosure under N.C.G.S. § 105-375 instead of a mortgage-style foreclosure under N.C.G.S. § 105-374. In that case the city should include the 2010 taxes on the certificate of taxes that it docketed as a judgment in July 2010, assuming that the city has already set its 2010 tax rate and those taxes can be definitively determined.

Bonus Myth #4: The Tar Heels will qualify for a bowl game this season.

Six wins gets you a ticket to a bowl game. The Heels already have four wins in their pocket and will get win number 5 next week against Division I-AA William & Mary. But their following three games are against the best teams the ACC has to offer: Florida State, Virginia Tech, and N.C. State. It wouldn't be shocking if the Heels lost all three. Then they would head into the season finale against my Blue Devils in Durham needing a win to make a bowl.

How sweet would it be to watch the Dukies deny the Heels a bowl invitation? Almost as sweet as winning a national championship while watching the Heels in the NIT. (And to think I almost kept my promise.)

Links

- www.sog.unc.edu/
- www.sog.unc.edu/pubs/electronicversions/pdfs/ptb158.pdf
- www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00006323---000-.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-355.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-374.html
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-375.html