

Foreclosure of IRS Lien on “Mixed” Property By Charles Pulman¹

A recent tax case, *United States v. Orr*, decided on August 28, 2018, by the US District Court in San Antonio, involved the foreclosure of an IRS lien on a tract of real property to satisfy the separate tax liability of the husband. [2018 WL 4134703 \(USDC, W.D. 2018\)](#)

What makes this case interesting is the analysis that the Court used to arrive at the conclusion that the foreclosed property was community property in its entirety and that the net proceeds from the sale of that property, after closing costs and other amounts, would be applied to the husband’s tax liability with any remaining proceeds being paid to the wife for her interest in the property. Apparently, the property was the Texas homestead of the parties.

On the characterization of the foreclosed property, the Court found that the consideration given to the seller in an exchange transaction for the acquisition of the foreclosed property (being 101.595 acres that was deeded to the wife in her name) consisted of the following: 35.293 acre tract in the wife’s name gifted to the wife by her parents that the Court found to be wife’s separate property, 1.33 acre tract that was quitclaimed by a third party to the husband and wife that the Court determined was community property, and a small cash down payment by husband that the Court found to be husband’s separate property. On this basis, the Court determined that the entire foreclosed property was community property because of commingling of separate and community property.

In reaching its conclusion that the foreclosed property was community property, the Court cited [Morch v. Collins, 174 S.W. 3d 849, 855 \(Tex. App.—Dallas 2005, pet. denied\)](#), for the position that “when property that was separate at its inception is so commingled with community ‘as to defy resegregation and identification, the community presumption prevails.’” The Court acknowledged that the foreclosed property was acquired with a mixture of the wife’s separate property, the husband’s separate property and a portion of community property. The Court went on to state that because the husband and wife “commingled their property when acquiring” the foreclosed property, the foreclosed property “itself is community on which the IRS may foreclose to satisfy” the husband’s tax debt.

The Court did not engage in an analysis of the relative values of the separate real property of the wife and of the community real property of the husband and wife in reaching its conclusion. The Court found that the husband and wife had failed to trace the origin of the foreclosed property solely to the wife’s separate property and that the husband and wife used a mix of the wife’s separate property, the husband’s separate property and community property of both the husband and wife. Because of the mix of property used to acquire the foreclosed property, the Court concluded that the foreclosed property was purchased with commingled funds and, therefore, the foreclosed property was community property.

The Court’s conclusion with regard to the character of the foreclosed property is contrary to Texas case law and the Court should have concluded, based on Texas case law, that the husband and wife each had a separate property interest and a community property interest in the foreclosed property based on the relative values of the properties and cash that were used to acquire the foreclosed property. This position is supported by a long line of Texas cases including the 1937 case of [Gleich v. Bongio, 128 Tex. 606](#) (Commission of Appeals of Texas, Section A, 1937), wherein the Court concluded that property that was acquired with separate property cash and community property credit was a mixture of both separate and community property and as such was a “kind of tenancy in common” between the separate estate and community estate under Texas law. In addition, the case of [Cook v. Cook, 679 S.W.2d 581 \(Tex. App.—San Antonio 1984, no writ\)](#) reached a similar conclusion on property that had been purchased with the proceeds of wife’s separate real property, the proceeds of wife separate property vehicle and community property cash. The *Cook* court also stated that in this circumstance the purchased property had a mixed character of separate and community with a result of a “sort of tenancy in common” property between the community estate and the separate estate.

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The *Orr* court concluded that because the foreclosed property was community property in its entirety, the IRS was entitled to foreclose its lien against the entire property, with the proceeds of the sale being used to pay the federal tax liabilities (including interest and penalties) of the husband, the reasonable expenses of sale and unpaid ad valorem taxes and costs of the United States. The remaining proceeds of the sale of the foreclosed property were to be paid to the wife to compensate her for her interest in the foreclosed property.

The Court's application of the sale proceeds from the sale of the foreclosed property was also contrary to existing tax case law. The IRS is authorized under the Internal Revenue Code ("**Code**") to impose a tax lien on the liable party's interest in property but not on the interest of a non-liable party in the property. However, such foreclosure can be made against the entire property under Section 7403 of the Code even though non-liable parties also own an interest in the same property if the United States District Court orders such foreclosure. In that event, the proceeds are to be allocated among the parties owning an interest in the foreclosed property in accordance with their interest in the property and, to the extent that a party owns a separate property interest in the property, the portion of the proceeds of sale allocable to that interest are not subject to use to pay the tax liability of a liable party but are to be paid directly to the party owning the separate interest in the property. This result applies, for example, to property owed in a joint tenancy and in a tenancy in common. See, [United States v. Kocher, 468 F.2d 503 \(2d Cir. 1972\)](#). Unfortunately, because the Court in *Orr* concluded that the entire property was community property, the Court never reached this result which would have paid to Mrs. Orr her percentage interest in the property based upon the proportion of the property that her separate property interest bore to the entire property interest of all parties.

Even if the Court in *Orr* was correct that the foreclosed property was community property, the Court also failed to recognize that the wife's homestead interest in the property had a separate value for which she was entitled to be compensated. Courts have recognized that the Texas homestead interest of a non-liable spouse has value and is to be separately valued in the event of a foreclosure of property, with the proportionate value of that interest to be paid separately to the non-liable spouse. See, [Rodgers v. Rodgers, 461 U.S. 677 \(1983\)](#).

An interesting aspect of this case, and one that may help in explaining the conclusion of the *Orr* court, is that the *Orr* court apparently did not believe the testimony of the Orrs. For example, the Orrs tried to argue that they had an agreement that would have characterized the foreclosed property as separate property. The Court stated in its Opinion that the Court believed that the agreement that was proffered by the Orrs was backdated and was fraudulent. In addition, the *Orr* Court in several places in its Opinion expressed skepticism as to the Orrs' testimony and in one place the Court expressed doubt as to credibility of the Orrs as witnesses.

Apparently, the Orrs and the IRS reached a settlement subsequent to the issuance of the decision in the *Orr* case and this case will not be appealed. Thus, the *Orr* case is on the books as a case where separate and community property are used to acquire property that is characterized by the court as community property in its entirety, with the Court concluding that the mixture of property used to acquire property resulted in commingling of property to cause the acquired property to be community property. Clearly an incorrect result but one that now exists.
