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John Varella - IRS Tax Lien trumped by bank mortgage with rental clause

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In a significant victory for mortgage companies, the Seventh Circuit Court of Appeals determined that a mortgage assigning future rental income to the mortgagee created a security interest for the lender that took priority over a federal tax lien. Amazingly, the court's ruling appears to be the first reported appellate decision on the issue- an issue that frequently arises.

In 2004, bank made a loan in Indiana that was secured by a mortgage on the borrower's real estate plus all rents derived or owned by the mortgagor directly or indirectly from the real estate. In 2007 the mortgagor defaulted. The Internal Revenue Service recorded a tax lien on the real estate. The bank requested a receiver for the real estate, and, the following year, the receiver rented the real estate and collected rents.

The IRS claimed that its tax lien took priority over the mortgage on the rental income because the rental income was not in existence at the time that the mortgage was recorded. On the other hand, the bank claimed that the rental income was generated from real estate that was in existence at the time the mortgage was recorded. The court sided with the bank.

The court noted that in order to have a perfected security interest that would have priority over a federal tax lien, the property had to be in existence and the interest protected under state law prior to the tax lien. The court had no problem determining that Indiana law recognized that the mortgage created a security interest in rentals received at any time. But was the rental income in existence prior to the tax lien?

The court determined that the rental income was in existence prior to the tax lien, stating that the property that must be in existence is the property that, by virtue of the security interest, is the source of value for repaying a loan in the event of default. The Court pointed out that, if the receiver had sold the real estate, no one would doubt that the bank, rather than the IRS, would have priority over the sale proceeds. The fact that the receiver rented the property, rather than selling it, was not significant. Rental income, just like sales proceeds, is a source of value arising from real estate that existed at the time the mortgage was recorded.

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