SPECIAL REPORT

FEDERAL TAX COLLECTION TRUMPS RIGHTS ACCORDED BY STATE PROPERTY LAWS: FEDERAL TAX LIEN ATTACHES TO ENTIRETIES PROPERTY

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In United States v. Craft, 122 S. Ct. 1414 (April 17, 2002), the Supreme Court held that each spouse's interest in property held as tenants by the entirety constitutes "property" or "rights to property" to which a federal tax lien may attach. *Craft* thus stands for the proposition that a federal tax lien for one spouse's tax liability attaches to entireties property, and furthers a trend to subjugate state law fictions to federal tax law in connection with the collection of federal taxes. Although the case left open the question of valuation of such interests, *Craft* is significant both within and outside federal tax law.

First, *Craft* not only shows that entireties property is not impervious to attachment in satisfaction of the debts of one of the owners, but also cements a trend in this regard. Second, *Craft* suggests that partnerships may be more desirable vehicles for holding property if asset protection is a goal. In addition, the Supreme Court's opinion in *Craft* raises significant issues which are beyond the scope of this Special Report. Those include include whether the principles enunciated by the Court in *Craft* apply equally to all forms of property, real and personal, in states that have adopted some form of a multiple party account act; whether the Court's shift away from the traditional protection of the family home for the stay-at-home spouse (Dissent, Scalia, Slip Opinion at 1) may have been addressed sufficiently by the recent provisions in favor of the "innocent spouse," and whether there is any potential impact on the disclaimer of interests in entireties property as part of a married couple's estate planning.

Craft is procedurally complicated because it resulted from an appeal of a case that went to the Court of Appeals for the Sixth Circuit twice before reaching the Supreme Court, and because both Sixth Circuit decisions were divided. By contrast, the facts of the case are simple. After a Notice of Lien was filed and in connection with their divorce, Don and Sandra Craft jointly executed a quitclaim deed whereby Don purported to transfer to Sandra his interest in a piece of Michigan real property that the two of them had owned as tenants by the entirety. It was Don's interest in that property that was at issue because Don failed to pay federal income tax liabilities assessed against him and a federal tax lien attached to his "rights to property" under section 6321. Section 6321 is the general rule of attachment, and provides that the unpaid amount of tax (after the Service issues a notice and demand and the taxpayer fails to pay), including interest, penalties, and costs "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal."

Tenancy by the entirety is a form of ownership available only to married individuals, and pursuant to it ownership is considered to be vested in the marital unit "as if they were a single personality." *See, e.g.,* Raffaele v. Granger, 196 F.2d 620, 622 (3rd Cir. 1952). Accordingly, such property is not considered to be owned exclusively by either spouse. In the majority of states that recognize entireties ownership, neither spouse has a separate or severable interest that can be reached by creditors, and before the Supreme Court's decision in *Craft,* it was the accepted wisdom that federal tax liens could not generally attach in such states until the entireties form of ownership was broken. *See, e.g.* Internal Revenue Service v. Gaster, 42 F. 3d 787, 791 (3d Cir. 1994)(despite propriety of levy, Delaware law prohibited the Service from using funds from an account held as tenants by the entirety to satisfy tax liability of one spouse); *Raffaele, supra*, (account held as tenants by the entirety under Pennsylvania law renders ineffective the Service's attempt to deal separately with or dispose of the interest of one spouse in derogation of the other spouse's ownership of the entire property). Even under the minority rule, the lien would attach, but the Service had to wait to collect on the lien until the death of one of the spouses. *See, e.g.,* United States v. Avila, 88 F.3d 229 (3d. Cir. 1996) (federal tax lien attaches to taxpayer-spouse's life estate and right of survivorship in the subject entireties property and if taxpayer-spouse predeceases nontaxpayer spouse, lien is extinguished), *citing* Freda v. Commercial Trust Co., 118 N.J. 36 (1990).

When Sandra wanted to sell the property the Service agreed to release the lien and allow her to sell the property, but required that half the net proceeds be held in escrow pending determination of the Government's interest in the property. Don died during the pendency of these various proceedings, and Sandra brought an action to quiet title to the escrowed proceeds. The District Court granted summary judgment for the government, holding that the federal tax lien attached to Don's interest in the tenancy by the entirety at the moment of transfer to Sandra, and that the transfer to the buyers was invalid as a fraud on creditors. Craft v. United States, 94-2 U.S. Tax Cas. (CCH) P50493 (W.D. Mich.1994). The parties cross-appealed, Sandra challenging the lien and the Service challenging the

amount of the invalid transfer. A majority of the Sixth Circuit panel reversed on the issue involving the federal tax lien, holding that no lien attached because Don had no separate interest, or any severable future interest, in the entireties property under Michigan law, and remanded the case to the District Court on the issue of the fraudulent transfer. Craft v. United States, 140 F.3d 638, 644 (6th Cir. 1998)(hereinafter "*Craft I*").

On the fraudulent transfer issue, the court held that Don Craft's action of paying the mortgage while insolvent had effectuated a type of fraudulent conveyance under Michigan law because the payments had placed non-exempt funds beyond the reach of a creditor (the Service), thus enhancing the value of the entireties property by the amount of the payments. 233 F.3d at 371-372. Nevertheless, both the District Court on remand, 65 F. Supp. 2d 651, 657-659 (W.D. Mich. 1999), and the Sixth Circuit, 233 F.3d 358, 370 (6th Cir. 2000)(hereinafter "*Craft II*"), later concluded that since the federal tax lien could not attach to the property under Michigan law, then paying the mortgage on it could not constitute a fraudulent conveyance. This result was described by the Supreme Court as "somewhat anomalous" in light of its holding, which emphasized that in future cases this question would undoubtedly be answered differently. Slip Opinion at 14-15.

Although Michigan considers entireties property to be a form of single ownership and characterizes its tenancy by the entirety as creating no separate or severable individual rights except survivorship, the Supreme Court, validating the District Court and the concurrences in both Sixth Circuit decisions, determined that each spouse had many other kinds of rights under Michigan law in addition to survivorship. In effect, the Court found that the tenancy gave each spouse a bundle of sticks, not just one stick. While the *Craft* court did not address directly the question whether rights held under a state's law which gives the spouse only the right of survivorship would also qualify as "property" or "rights to property" under section 6321, it would be consistent with the Supreme Court's holding that if a spouse has at least one property "stick," such spouse has "rights in property" within the meaning of section 6321, and that the bigger the bundle of "sticks," the more valuable the bundle of rights should be. The emphasis by the *Craft* Court on a spouse's "rights in property" utilized and thus validated the analysis of the District Court, which had initially determined that the lien did not attach to the property per se, but instead attached to the spouse's "rights in property," 65 F. Supp. 2d at 651.

The dissent in *Craft I* had correctly pointed out that the majority of that panel had erred by accepting at face value Michigan's description of the property interests held by a tenant by the entirety, rather than looking at the substance of those interests. The concurring judge in *Craft I* had challenged the majority's reversal of the District Court by agreeing with the District Court that the legal landscape in Michigan had changed since 1971 and that the case of Cole v. Cardoza, 441 F.2d 1337, 1343 (6th Cir. 1971)(federal tax lien against individual taxpayer cannot attach to property held by that individual as a tenant by the entirety), upon which the majority relied, was antiquated because it did not assure the collection of federal taxes. 140 F. 3d at 645. In describing this change in legal landscape, the District Court and the concurring judge in *Craft* I relied upon United States v. National Bank of Commerce, 472 U.S. 713, 105 S. Ct. 2919, 2924, 86 L.Ed.2d 565 (1985)(Service can levy on the joint accounts of a delinquent taxpayer even though state law did not allow ordinary creditors to do so), and emphasized that this changed legal landscape was intended to facilitate the collection of federal taxes despite state laws that might frustrate other types of creditors. When the case returned to the Sixth Circuit on the issue of the lien attachment, the Government argued that the Supreme Court's intervening decision in Drye v. United States, 528 U.S. 49, 120 S. Ct. 474 (1999) should cause the panel to reconsider the result in *Craft I*. *See also*, Brett A. Bluestein, Disclaimers and Federal Tax Liens' Effect on Inheritances, 36 REAL PROPERTY, PROBATE AND TRUST JOURNAL 391 (2001), Claudio Orsorio, *Disclaimer of Intestate's Estate Under Arkansas Law Cannot Prevent Attachment of Federal Tax Lien: Drye v. United States,* 53 TAX LAWYER 951 (2000).

Nevertheless, the determination that no federal tax lien attached to the entireties property was, according to the majority in *Craft II*, the law of the case which it could not reverse. Because the majority of the Sixth Circuit in *Craft II* believed that it was both constrained by the law of the case and the law of the Circuit, and that the government was wrong, it dismissed the Government's claim and, in *Craft II* affirmed its decision in *Craft I*. The concurring judge in *Craft II* correctly pointed out that *Craft I* had reached the wrong result because that result was inconsistent with Supreme Court precedent, including *Drye*, and that the Sixth Circuit should have reversed *Craft I*. The concurring judge emphasized his position by paraphrasing language from *Drye* and stating that he "believed that the majority in *Craft I* was 'struck blind' by Michigan's 'legal fictions." 233 F.3d at 376. The Supreme Court's reversal of the Sixth Circuit's decision in *Craft II* shows that the Supreme Court refused to be "struck blind" in connection with federal tax liens. As the Court itself explained, by deciding as it did it eliminated a perceived abuse detrimental to the collection of federal taxes.

The Supreme Court's analysis in *Craft* was consistent with the two-step analysis it had described in *Drye*. That analysis requires an initial determination of the state-defined rights the taxpayer has in the property the government seeks to attach, followed by an application of federal law to determine whether such state-

defined rights qualify as "property or rights to property" under section 6321. (*See* 120 S. Ct. at 481, 528 U.S. at 58). Accordingly, in *Craft* the Court first looked to Michigan law and found that Michigan law gives an individual spouse, among other rights, the right to use the entireties property, the right to exclude others from it, the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with the other spouse's consent and to receive half the proceeds from such a sale, the right to encumber the property with the consent of the other spouse, and the right to block the other spouse from selling or encumbering the property unilaterally. The Court then determined that the rights granted to a spouse under Michigan law qualify as "property" or "rights to property" under section 6321, Slip Opinion at 8, because the broad statutory language authorizing the tax lien "reveals on its face that Congress meant to reach every interest in property that a taxpayer might have," *citing* United States v. National Bank of Commerce, 472 U.S. at 719-720, the purpose of which was to assure the collection of taxes, *id*. at 8, *citing* Glass City Bank v. United States, 326 U.S. 265, 267 (1945). The Court reasoned that a Michigan spouse's substantial degree of control over the property was sufficient to justify attaching a federal tax lien to it, *citing* Drye v. United States, 528 U.S. 49 (1999), and that a spouse's ability unilaterally to alienate the property was not required for the attachment of a federal tax lien, *citing* United States v. Rodgers, 461 U.S. 677 (1983).

The *Craft* Court further reasoned that excluding such property from the possibility of lien attachment would "exempt a rather large amount of what is commonly thought of as property," Slip Opinion at 10, and would be equivalent to concluding that "the entireties property would belong to no one for the purposes of section 6321," Slip Opinion at 11. This, the majority stated, would be an absurd result and would "allow spouses to shield their property from federal taxation by classifying it as entireties property, thus facilitating abuse of the federal tax system." *Id*. According to the Court, no legislative history evidenced any Congressional intent to exempt entireties property from the attachment of federal tax liens and the common-law background of the tax lien statute was not enough to overcome the broad language actually used by Congress (Slip Opinion at 13-14).

Although the lower courts were aware of the husband's state-defined rights, including at minimum a contingent future interest in the property (which the dissent in *Craft II* had pointed out), those courts had found the entireties property not subject to the attachment of liens under Michigan law because "it is well-established that one spouse does not possess a separate interest in an entireties property," *Craft I*, 140 F.3d at 643-44. *Accord, Gaster* (Delaware), *supra; Raffaele* (Pennsylvania), *supra*. Prior to *Craft*, Michigan law followed the majority rule, whereby the federal tax lien of one spouse resulting from a separate tax liability did not attach to entireties the property, rather, only a joint tax liability would subject such property to a lien.

In states following the minority rule, such as Massachusetts, a federal tax lien for one spouse's separate tax liability attached to that spouse's interest in the property, subject to the other spouse's right of survivorship. Geiselman v. United States, 961 F.2d 1 (1st Cir.1992). *See also Avila*, *supra*. In cases involving such minority-rule states, the Service typically attached the lien and then waited to see if events, such as divorce (which would generally cause the property to be owned as tenants in common, subject to partition) or death (which if the debtor spouse died would cause the lien to be extinguished thus leaving the surviving non-debtor spouse owing the property free and clear of the lien) or if the non-debtor spouse died, the whole property would be subject to the lien as a result of the survivorship rights of the debtor spouse, *Avila, supra*. Alternatively, the Service could commence a judicial proceeding to sell the property and obtain the value of the debtor-spouse's interest.

Because Michigan followed the so-called majority rule, the dispute that the Supreme Court was called upon to resolve was whether the federal tax lien could attach to the entireties property at all. The lower courts in *Craft* had considered persuasive the restraint upon alienation of entireties property under Michigan law, in that one spouse could not alienate the property without the consent of the other. This restraint on alienation proved a double-edged sword when it bolstered the Supreme Court's rationale that, because of it, a spouse thus exercises sufficient control over the disposition of entireties to justify the attachment of a federal tax lien.

Craft, clearly a departure from prior law and policy, was correctly decided and protects the public fisc by facilitating the collection of federal taxes. It creates national uniformity in connection with the attachment of federal tax liens to entireties property. It cements the trend initiated in United States v. National Bank of Commerce, *supra*, of eliminating state law fictions which hinder the collection of federal taxes. After *Craft*, a state law which protects entireties property from creditors no longer affects the federal tax lien. *See also*, United States v. Rodgers, 461 U.S. 677 (1983) (state law exemption applicable to spouse's homestead interest does not prevent attachment of federal tax lien); United States v. Mitchell, 403 U.S. 190 (1971) (state law allowing wife to renounce her community property rights and obligations is ineffective for federal tax purposes); United States v. Heffron, 158 F.2d 657 (9th Cir. 1947) (state exemption not valid once refund is offset by IRS to student loan balance owed by taxpayer); Bosarge v. United States, 5 F.3d 1414 (11th Cir. 1993) (state exemption does not prevent federal interception of federal income tax refund); Cort. v. United

States, 816 F. Supp. 574 (N.D. Cal. 1992) (state law exemption applicable to wife's state retirement account does not prevent levy by IRS for husband's back taxes); United States v. Riggs National Bank, 636 F. Supp. 172 (D.D.C. 1986) (spendthrift trust established under state law may prevent creditors' liens from attaching to trust corpus but is not effective against federal tax lien).

Inadvertently, the Court in *Craft* affirmed the value of placing assets in partnership solution for asset protection, because it compared the attachment of a lien to a partner's interest in a partnership with the attachment of a lien to entireties property. The Court explained that the lien does not attach either to the entire partnership or to its underlying assets, but merely to the offending partner's interest in the partnership, upon which the Service may foreclose but may not compel a sale. Slip Opinion at 11-12.

Three justices in *Craft* separately dissented, but these dissents were explained away by the majority opinion as proceeding from different views of the legislative history of section 6321, and from their disagreement on the question whether interests in property held by a partnership and in a tenancy by the entirety ought to be treated similarly. As the majority explained: "This disparity in treatment between the two forms of ownership, however, arises from our decision in United States v. Rodgers, 461 U.S. 677 (1983) (holding that the Government may foreclose on property even where the co-owners lack the right of unilateral alienation), and not our holding today." Slip Opinion at 12.

It is notable that in *Craft* the Court did not suggest that the value of the attached interest is equal to 50 percent of the value of the entire property (thus the entire amount of the escrowed proceeds), Slip Opinion at 14, but remanded the case to the Sixth Circuit to determine the proper valuation of the attached entireties interest. The valuation of such entireties interests will probably become an important aspect of this body of law, and might be as potentially burdensome to the Service as the dispute over whether such interests were subject to attachment. As one commentator has already suggested:

> [T]he value of the tenancy owned by either spouse may be subject to significant discounting related to the limited rights possessed by either tenant. By analogy, in the context of gift and estate taxes, significant discounts have been allowed for fractional interests related to such factors as lack of marketability, lack of control and other similar factors, which are similar to the attributes of an individual who owns property as a tenant by the entirety.

Mark L. Silow, *Extending Creditor's Reach: United States v. Craft Allows Federal Tax Lien on Entireties,* P3137 LEGAL INTELLIGENCER 5 (Philadelphia, May 14, 2002). It may be that the value of interests in entireties property will be so minimal or speculative, and their valuation so difficult and contentious, that such lien attachments will be impractical in most instances. *Accord*, Freda v. Commercial Trust, Co., 118 N.J. 36, 8 (1990), *citing* King v. Greene, 30 N.J. 413-415, 153 A, 2d 49 (dissent).

I expect that in states where the law is similar to the law of Michigan (such as Pennsylvania and Delaware), the Supreme Court's finding of separate, attachable property rights owned by each spouse will cause creditors to argue that the analysis enunciated in *Craft* regarding entireties ownership permits attachment of state law judgments as well, even as they recognize that federal tax liens maintain favored status, *see, e.g.* United States v. Irvine, *supra*, National Bank of Commerce, *supra*. Although *Craft* addressed only the federal tax law, it opened a Pandora's Box for other creditors. The legal landscape has changed, as reflected by the increasing number of women in the workforce and the increased protection of the innocent spouse provisions of section 6015 of the Code. I predict that the traditional protection of tenancy by the entireties ownership outside the federal tax law will also be eliminated for state law judgments. *Craft* evidences a dramatic shift away from the social policy that sanctified entireties ownership and protected the antiquated values it embodied. ■

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could be subject to a tax lien. Bernice traces the development of the case and analyzes some of the its implications, both within the tax law and beyond it. I am sure we will hear much more about *Craft* in the months and years to come, but Bernice has provided us with an accessible primer.

In the first Point to Remember, Ed Kessel and Kathleen Stephenson remind us of the importance of having the facts—what our clients actually do—match the theory on which our tax planning is based. We would do well to take their advice to heart.

In the second Point, David Silverman gives us a refresher course on tax planning for divorce and discusses the impact of recent guidance on the income and employment tax consequences of transfers of nonqualified stock options and rights to receive nonqualified deferred compensation.

It has been an eventful year for the Section. This issue brings the curtain down on one era, but I look forward to greeting you at the dawn of another, which will begin with the publication of the Fall issue of the *NewsQuarterly* and the Section's meeting in Los Angeles in October. Until then, enjoy whatever easy livin' you can find. ■