Infectious Tax Liabilities

By **Neal Nusholtz**

If you acquire property with a federal tax lien attached, it can be levied upon for sale to pay the transferor's taxes. What if you owned property you did not acquire from someone with a tax lien and suddenly your property was to be sold to pay someone else's taxes? Would this surprise you?

A tax liability can migrate like a virus from a delinquent taxpayer to healthy property in one of two ways: (1) situations in which an heir with a tax lien has disclaimed an inheritance causing his or her share of a decedent's estate to be covered by the tax lien[1] or (2) situations involving concurrent ownership where a delinquent taxpayer has an interest in property owned in conjunction with somebody else.[2]

Drye v United States[3]

In *Drye v United States*, an Arkansas woman died in 1994 leaving her son, Rohn Drye, as the sole heir of her $223,000 estate. He had a $325,000 unpaid federal income-tax liability. Drye filed a disclaimer, which meant he received nothing from the estate.

Under Arkansas law—like MCL 700.2907 in Michigan—a disclaimer in the absence of a contrary provision in a will or trust causes property of an heir to pass as if the heir had predeceased the decedent. Drye's inheritance passed to his sole daughter, Theresa, who

took her inheritance and placed it in a trust for the benefit of herself and her parents. The issue in the case was whether Drye's tax lien under IRC § 6321 attached to the property he had disclaimed. The Supreme Court, affirming the Eighth Circuit, decided that a right to an inheritance is sufficient property or rights to property to which a federal lien attaches:

> The control rein he held under state law, we hold, rendered the inheritance "property" or "rights to property" belonging to him within the meaning of § 6321, and hence subject to the federal tax liens that sparked this controversy.[4]

The question is, when and where does the tax lien of the beneficiary of an estate attach? Does it attach at the moment of death or upon receipt by a third party when the share of the delinquent taxpayer heir is actually determined? The Eighth Circuit *Drye* decision implies that the federal lien attaches at the estate level before distribution:

> The liens pass *cum onere* with the estate until they are satisfied or become unenforceable. *See* 26 U.S.C. § 6322 (unless otherwise provided by law, a lien imposed by § 6321 arises at the time of assessment and continues until the liability for the assessed amount "(or judgment against the taxpayer arising out of such liability) is satisfied or becomes unenforceable by reason of lapse of time"). . . . The liens are, therefore, enforceable against the Trust and the trust beneficiaries to the extent that they are heretofore unpaid.[5]

The tax lien also appeared to attach at death in the recent case of *The Estate of Audrey Deinlein v United States*.[6] Audrey Deinlein died on October 4, 2011, with three sons as heirs, one of whom had a tax liability exceeding his share of the estate (with tax liens filed in 2006 and 2007). The tax-delinquent son renounced his share of the estate in a settlement agreement.

The government removed the *Deinlein* estate proceeding to federal court. The estate agreed to sell the condominium, and the Arkansas District Court decided that one-third of the net proceeds from the sale belonged to the government. The *Drye* and *Deinlein* cases create a quandary over whether, against common practice, a federal tax lien discharge is required if the personal representative of an estate sells property when one of the beneficiaries has a tax liability.

United States v Rodgers[7]

The government, under its IRC § 6331 levy power, can only sell the property owned by a delinquent taxpayer. For example, dower rights under MCL 558.1 survive a tax levy.[8] This creates a problem for the government whenever there is concurrent ownership. Purchasers are unwilling to pay much for property they have to share with a stranger.

When an asset is owned partly by a delinquent taxpayer and partly by someone else, the government can request a federal district court order under IRC § 7403 to sell the entire asset and divvy up the net proceeds among the interested parties. Section 7403 allows a federal district court to order the sale of any property in which a delinquent taxpayer "has any right, title, or interest." Therefore, sales of full title to concurrently owned property (when only one co-owner owes taxes) must be done by applying to a federal district court judge for a court order under § 7403.

In *United States v Rodgers*, the Supreme Court held that if two people own a home together, each of them has an interest in the entire home. If just one of them owes federal taxes, the home can be sold under § 7403 even though the delinquent taxpayer, on his or her own, could not have sold or forced a sale of the property. We can extend the concept of selling property in which a taxpayer has an interest to a situation in which a lending company owes federal taxes and is the mortgage holder on the homes of innocent third parties. Under § 7403, since the mortgage holder has an interest in the third-party homes, a federal district court could order the sale of the homes to pay off the mortgages and apply the proceeds to the tax liability of the lending company.

FAST FACTS

The disclaimed property in *Deinlein* was treated for tax lien purposes as if it were distributed to the delinquent taxpayer and then returned back to the estate of the decedent.

Even though the government only stood in the shoes of the husband taxpayer in *Rodgers*, the Supreme Court held that the government could force the sale of a nondelinquent wife's property when her husband could not have done so.

Although the home in *Rodgers* was to be sold to a private individual and the money used to pay someone's taxes, the Supreme Court found a Fifth Amendment public use because the sale would "facilitate the extraction of value" from property that was "properly liable for the taxpayer's debt."

United States v Craft[9]

The application of § 7403 to any property in which a taxpayer has an interest was highlighted in *United States v Craft*, where the Supreme Court reversed a rule that had previously prevented tax liens from applying to entireties property. Justice O'Connor responded to Justice Scalia's dissent in which he argued that entireties property is like a partnership—and the liabilities of a partner do not attach to partnership assets—and the majority opinion was

not treating entireties property like partnership property by permitting tax liens to attach to entireties property. Justice O'Connor said "[t]his is not so"[10] because a partner's interest in a partnership is subject to a tax lien, and permitting a tax lien to attach to a spousal interest puts entireties property on par with partnerships. Justice O'Connor continued:

> There is, however, a difference between the treatment of entireties property and partnership assets. The Federal Government may not compel the sale of partnership assets (although it may foreclose on the partner's interest, 1 Bromberg & Ribstein § 3.05(d)(3)(iv)). It is this difference that is reflected in Justice Scalia's assertion that partnership property cannot be encumbered by an individual partner's debts. See *post*, at 1426. This disparity in treatment between the two forms of ownership, however, arises from our decision in *United States v. Rodgers, supra* (holding that the Government may foreclose on property even where the co-owners lack the right of unilateral alienation), and not our holding today. In this case, it is instead the dissenters' theory that departs from partnership law, as it would hold that the Federal Government's lien does not attach to the husband's interest in the entireties property at all, whereas the lien may attach to an individual's interest in partnership property.[11]

The difference between partnership property and entireties property under *Craft* is that the partner has no interest in partnership property, but a spouse has an interest in entireties property. That difference allows for *Rodgers* to apply—and for a foreclosure to occur—under § 7403. Justice O'Connor indicated that all that is required under § 7403 to apply is for a delinquent taxpayer to have an interest in the property to be foreclosed upon. This means that in any situation in which someone owns property and someone else who owes taxes has an interest in that same property, the property of the innocent owner can be foreclosed upon under § 7403.

In *Drye*, the tax lien jumped from the disclaiming delinquent taxpayer beneficiary to the estate. In *Rodgers*, the delinquent taxpayer's tax liability, which infects the entire concurrently owned asset, served as a basis for § 7403 foreclosure. Both instances involve the possibility of a government-forced sale of property owned by an innocent owner who did not acquire property from a delinquent taxpayer. One possible innocent party protection in the *Rodgers* context is the currently undefined, vague phrase "practical undercompensation."

The *Rodgers* Court provided a four-factor balancing test for lower courts to determine if a forced sale should occur:

(1) Whether the government would suffer prejudice if a forced sale of the entire property did not occur;

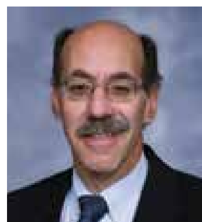
(2) Whether the innocent spouse has a legally recognized expectation that the property will not be sold ("leaving aside § 7403 and eminent domain proceedings, of course");

(3) The "likely prejudice to the third party, both in personal dislocation costs and in the sort of practical undercompensation described *supra*"; and

(4) The relative interests of the innocent party and the government.[12]

The reference in the third factor about practical undercompensation is made to prior language in the *Rodgers* case about how a spouse might not be able to take her just compensation from the forced sale of her home and obtain a "lifetime's interest in an equivalent home."[13] That same language also includes a reference to another Supreme Court case, which holds that a condemnee in eminent domain proceedings does not receive replacement cost.[14] Incidentally, condemnees do not receive "personal dislocation costs" under traditional condemnation law.[15]

It would seem, based on the *Rodgers* definition of practical undercompensation, that under the third balancing factor, if a Court were to determine that the amount of funds an innocent spouse were to receive from the sale of her home were inadequate to put her in the same circumstances she had been in before the sale, it would be a factor weighing against a sale, but this argument has been recently rejected.[16] Without the protection of "practical undercompensation," we have to assume that inadequate compensation for the taking of property in the § 7403 context is justified by the collection of revenue—perhaps in the same way that search and seizure had been justified by the collection of revenue at the time of the formation of our country. ■



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ENDNOTES

1. See *Drye v United States*, 528 US 49; 120 S Ct 474; 145 L Ed 2d 466 (1999).
2. See *United States v Rodgers*, 461 US 677; 103 S Ct 2132; 76 L Ed 2d 236 (1983).
3. *Drye v United States*, 528 US 49.
4. *Id.* at 61.
5. *Drye Family 1995 Trust v United States*, 152 F3d 892, 900 (CA 8, 1998).
6. *The Estate of Audrey Deinlein v United States*, unpublished memorandum opinion of the US District Court for the ED of Kentucky, issued July 23, 2014 (Docket No. 13-45-DLB-JGW).
7. *Rodgers*, 461 US 677.
8. See *In re Wheeler*, 252 BR 420 (Bankr WD Mich, 2000); *United States v Patej*, unpublished order of the US District Court for the ED of Michigan, issued January 17, 2003 (Docket No. 00-71944).
9. *United States v Craft*, 535 US 274; 122 S Ct 1414; 152 L Ed 2d 437 (2002).
10. *Id.* at 286.
11. *Id.* at 286.
12. *Rodgers*, 461 US at 710–711.
13. *Id.* at 704.
14. *United States v 564 Acres of Land*, 441 US 506; 99 S Ct 1854; 60 L Ed 2d 435 (1979).
15. See *Norfolk Redevelopment & Housing Auth v Chesapeake & Potomac Tel Co of Virginia*, 464 US 30, 36–37; 104 S Ct 304; 78 L Ed 2d 29 (1983).
16. See *United States v Davis*, unpublished order of the US District Court for the ED of Michigan, issued April 29, 2015 (Docket No. 13-11245).