

IRS attachment to tenancy by the entirety interests

By ERIC L. MORGENTHAU

Asset Protection Advisors beware! Your entire world is about to turn upside down, particularly if your clients have properties in multiple states. Traditionally, property ownership through tenancy by the entirety (TBE) has provided a certain level of protection to married couples. Currently, 26 jurisdictions recognize property ownership by TBE. It should be noted that New York State is one of those jurisdictions.¹ TBE property is held through a unique single ownership via a unity of the tenants. Assets owned as TBE were considered held by the marital unit and were thus deemed protected from the third party creditors of one spouse. That was until April 2002, when the U.S. Supreme Court handed down its decision in *United States v. Sandra L. Craft*.²

In *Craft*, the high court held that a federal tax lien attaches to both a taxpayer's property and rights to property,³ irrespective of the state-defined rights set forth under the law of that jurisdiction. The court stated that while state law establishes what rights a taxpayer has in property, federal law determines whether the state-defined rights are "property" or "rights to property" under Section 6321.⁴ In other words, federal law may determine if sufficient state-defined interests can expose the property to a federal tax lien. The parameters of property ownership acknowledged under state law now face the scrutiny of federally applied attributes in measuring

the attachment potential of liens to the TBE interest of the individual creditor. In effect, *Craft* permits a federal analysis of state law for the intended purpose of furthering the federal government's tax collection efforts.

IRS guidance

This past month, the IRS released Notice 2003-60⁵ which set forth their procedural standards for collection efforts from delinquent taxpayers holding TBE interests when only one spouse carries the outstanding tax deficiency. In addition, Notice 2003-60 also provided nine explanatory questions and answers which indicate how the IRS will be applying the holding in *Craft*. The IRS has explicitly stated that neither *Craft* nor Notice 2003-60 will impact the IRS's determination of whether to remove an installment agreement or to accept an Offer in Compromise.

The IRS contends that *Craft* is not new law because IRC Section 6321 had already permitted automatic IRS attachment and accrual to both "property" and "rights to property" when a taxpayer refuses to pay his/her federal taxes upon demand.⁶ From a statutory standpoint this is true. However it would be wrong to ignore that post-*Craft* enforcement can deviate from

therein. Purchasers who acquire their interest in property subject to an existing tax lien may either post a bond or tender a deposit for the value of the lien to obtain a Certificate of Discharge from the IRS. Likewise, Notice 2003-60 indicates that the value for the required deposit or bond would be for one-half of the property's value.

Subordination issues

Procedurally, the IRS issues a Certificate of Discharge for property encumbered by a federal tax lien upon the receipt of payment for the value of the government's interest in that property. As per Notice 2003-60, the value of this required payment will generally be deemed to be one-half of the proceeds of sale for TBE interests.

With interest rates at historical lows, many homeowners are refinancing their primary mortgages. In instances of a streamline refinance, the IRS would agree to maintain their status as a junior lien holder (by issuing a Certificate of Subordination) so long as the increased cash flow improves the taxpayer's ability to repay the underlying deficiency. However, with a home-equity loan, the IRS would require payment for one-half of either the

amount to which it will be subordinated or the tax lien amount in order to issue a Certificate of Subordination.



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past collection practices, principally because *Craft* would now permit a federal attachment in spite of existing state-defined standards.

Notice 2003-60 designates each state as either a "Full" or "Partial" Bar Jurisdiction. Full Bar Jurisdictions do not allow creditors to attach to TBE property to satisfy either spouse's debts. Partial Bar Jurisdictions, like New York,⁷ permit attachment but only to the extent of the creditors' interest in the property while retaining consideration to the survivorship rights held by the non-liable co-owner spouse. (The service has indicated that they will assume that the TBE interest is to be valued at one-half). For policy reasons, the IRS indicated that they may prospectively forego their right to attach to TBE interests in Full Bar Jurisdictions if doing so would impose harm upon third parties who have placed reliance upon pre-*Craft* state law. However, because there are no "settled expectations" under state law in Partial Bar Jurisdictions, the IRS stated that the property interest merely had to be obtained "after a notice of federal tax lien had been filed."⁸

Liens and levies

Notice 2003-60 indicates that lien foreclosures, although permissible under *U.S. v. Rodgers*,⁹ will be considered by the IRS on a case-by-case basis because of the potentially harmful impact upon the non-liable spouse.¹⁰ The IRS concurs that this administrative remedy may also bring harsh results because a TBE interest can carry a marketability discount. If a foreclosure sale does occur, the non-liable spouse would be compensated by the IRS for the portion of the proceeds attributable to his/her interest in the property.¹¹ Unlike lien foreclosures, levies upon cash and cash equivalents would be more likely to be carried out by the IRS. They are considered "preferred" and less problematic because of their divisibility.

In the future, taxpayer liens may suspend the sale of a home until the outstanding deficiencies are either paid or are extinguished with the proceeds at closing. Notice 2003-60 states that if property is conveyed via either a sale or other transfer with the tax lien intact, the lien would then continue to encumber the property to the extent of one-half of the transferee's interest

Til' death (or divorce) do us part

According to 2003-60, TBE property encumbered by a federal tax lien that is distributed incident to divorce remains subject to the lien when received by the ex-spouse. However, nonfraudulent property transfers executed prior to *Craft* would convey an unencumbered interest in the property to the ex-spouse.

If the non-liable spouse passes away first, the IRS will then encumber the entire interest in the property. On the flip side, if the TBE owner who generated the liens dies first, the federal tax lien is extinguished and the non-liable spouse will obtain the creditor spouse's interest free and clear of the IRS's attachment to the property.

In his dissent of the *Craft* decision, Justice Clarence Thomas indicated that he believed the court was creating a "federal common law of property." The ultimate impact upon federal tax collection with the utilization of *Craft* and Notice 2003-60 remains to be seen. Asset Protection Advisors, however, will likely be adjusting their plans in response to these more expansive IRS tax collection powers.

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1. NYS Estates, Powers & Trust Law § 6-2.1
2. *United States v. Sandra L. Craft*, 535 U.S. 274.
3. Section 6321 of the Internal Revenue Code of 1986 as Amended
4. Notice 2003-60, I.R.B. 2003-39, 9/11/03
5. *Ibid.*
6. 34 Buff. L. Rev. 297
7. Full Bar Jurisdictions include Delaware, the District of Columbia, Florida, Hawaii, Indiana, Maryland, Michigan, Mississippi, Missouri, North Carolina, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, the Virgin Islands and Wyoming. The Partial (or Modified) Bar states are Alaska, Arkansas, Kentucky, Massachusetts, Montana, New Jersey, New York, Oregon and Tennessee. Steve R. Johnson, *Indiana Law Journal*, Vol. 75:1163
8. Notice 2003-60, I.R.B. 2003-39, 9/11/03
9. 461 U.S. 677 (1983)
10. According to Notice 2003-60, Donees of property acquire their interests subject to the tax lien, however pre-*Craft* transfers are evaluated on a case-by-case basis in establishing whether the lien should be asserted.
11. Section 7403(c) of the Internal Revenue Code of 1986 as Amended.