Newsletter of the State Bar of Michigan General Practice–Solo and Small Firm Section

Volume 36, Number 4 July/August 2012

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EDITOR'S NOTES

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This newsletter will be published six (6) times per year by the General Practice Section of the State Bar of Michigan to inform members of the section activities and other matters of particular interest to general practitioners.

Federal Tax Liens of One Spouse in Divorce

By Neal Nusholtz

Introduction

After filing for divorce, spouses often file separate tax returns. Spouses are jointly liable on joint returns, and one spouse might cause an unexpected income tax liability in an income tax audit (subject to the innocent spouse rules). Since most (there are exceptions,) audits must occur within three years after the filing of a return, it often makes sense to stop filing joint returns as soon as possible, even if it might be more expensive.

During the period of separate filing, one of the spouses might accumulate an unpaid tax liability and, perhaps, the government will file a tax lien. How does that separate tax liability affect the ownership for the wife, for example, if she gets the home in a divorce decree? According to the government, tax liens on one spouse entitle the government to one-half of all property on divorce[1]. This article discusses the rules and concepts and offers a legal position contrary to the government's for situations where your client gets in a pinch.

Timing Issues

One thing to do in divorce situations where tax liens are filed is to determine the timing of the tax lien relative to the decree of divorce. In *Hendry v. U.S.*[2] a Michigan divorcing couple had entered into a property settlement agreement on September 15, 2006. The federal government filed a tax lien against the husband on October 12. The wife received the home by quit claim deed filed on October 23, 2006. The lien came between the time of the property settlement and the receipt of the property by the wife.

In that case, the government filed a motion for summary judgment on the theory that the wife was not a purchaser under the divorce decree. The court denied the motion, holding that the divorce decree made the wife a purchaser under §6323(h)(6)[3], but whether she had knowledge of the lien[4] would have to be a factual question for trial.[5]

Valuing a Spousal Interest Against the Tax Lien

Rodgers, Craft, and Barr

If a tax lien attaches to the interest of only one spouse, one issue would be the value or percentage of the property which the non-delinquent spouse may claim ahead of the government. The value of a spouse's interest in property ahead of a federal tax lien was considered by the Supreme Court in the 1983 *Rodgers* case.[6]

In *Rodgers,* the U.S. Supreme Court ruled on whether, under an IRC §7403(c)[7] foreclosure, the government could force the sale of a home by a Texas widow when her deceased husband had owed taxes. The wife had had a half interest in the home under Texas community property law, but she also had an indestructible right to stay in the home for her lifetime. The *Rodgers* Court ruled: (a) that a tax lien on the property gave the government the right to sell the whole parcel under §7403(a)[8]; and (b) that the Fifth Amendment of the Constitution would be satisfied if the widow was paid just compensation for her interest. On valuing the wife's separate interest, the Court conjectured:

> The exact method for the distribution required by §7403 is not before us at this time. But we can get a rough idea of the practical consequences of the principles we have just set out. For example, if we assume, *only for the sake of illustration,* that a homestead estate is the exact economic equivalent of a life estate, and that the use of a standard statutory or commercial table and an 8% discount rate is appropriate in calculating the value of that estate, then three non-delinquent surviving or remaining spouses, aged 30, 50, and 70 years, each holding a homestead estate, would be entitled to approximately 97%, 89%, and 64%, respectively, of the proceeds of the sale of their homes as compensation for that estate. In addition, if we assume that each of these hypothetical non-delinquent spouses also has a protected half-interest in the underlying ownership rights to the property being sold, then their total compensation would be approximately 99%, 95%, and 82%, respectively, of the proceeds from such sale. (*Rodgers* at 698).

The next important case regarding valuation of a spousal interest was the *Craft* case,[9] which reversed a 31-year precedent that federal tax liens did not attach to entireties property in Michigan. When that case was being argued, the Supreme Court wanted to know from the assistant solicitor general how a ruling that tax liens applied to

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entireties property would impact tax foreclosures under §7403:

> QUESTION: But in your view, you always value the taxpayer's interest at 50 percent?
>
> MR. JONES: No. I think in the *Rodgers*...well, if the property's been sold, yes. If the property hasn't been sold, and we're talking about in a foreclosure context, I believe the *Rodgers* Court goes through the example of the varying life expectancies of the two tenants, and which one...and I believe what the Court in *Rodgers* said was that each of them should be treated as if they have a life estate plus a right of survivorship, and the Court explains how that could, well...I think in the facts of *Rodgers* resulted in only 10 percent of the proceeds being applied to the husband's interest and 90 percent being retained on behalf of the spouse, but.... [Mr. Jones was then interrupted with the following unanswered question: "But there must be a foreclosure to that extent?"][10]

Finally, the *Barr* case[11] addressed the value of a Michigan spousal interest in the §7403 home foreclosure context, where a husband and wife were both 68 years old at the time of the government's motion for summary judgment to foreclose on the property and take one-half of the net proceeds. Specifically, the issue in the *Barr* case was whether, in a motion for summary judgment, where no evidence was proffered as to the value of a wife's interest in a Michigan marital home, a district court could conclude that the following three rights were equal to 50 PERCENT of the net selling price as a matter of law:

- the right to the use of the entire home (with her husband during their joint lifetime);
- the right to inherit the home if she survived her husband; and
- the right to prevent its encumbrance or forced sale.

The Sixth Circuit held that the value of each spouse's rights in their home was equal to one-half right of the net selling price of the home. According to the majority opinion, the right to prevent encumbrances or forced sale by creditors was worth zero. More importantly, the court held that survivorship and lifetime rights of spouses in Michigan are equal even if they have different actuarial ages:

> Michigan law dictates the result that survivorship rights are equal between spouses. If the spouse with the greater life expectancy had a larger interest under Michigan law, then this greater interest would be reflected in the Michigan rules for dividing property upon divorce or consensual sale. However, because Michigan law provides for equal division of property upon divorce or consensual sale, differences in life expectancy do not result in different survivorship interests. (*Barr* at 374)

The Court went on to say that there was a presumption of equal spousal life expectancy under Michigan law and:

> Mrs. Barr presents no compelling reason why this court should not apply the presumption of equal spousal life expectancy implicit in Michigan law. (*Id* at 374)[12]

The *Barr* case stands for the proposition that the homestead value for one spouse is worth 50 percent of the net selling price. It was the first reported case in the country where an entireties home was forfeited for taxes, i.e., one which has not been sold or transferred to a third party after a tax lien was filed.

Superior Rights

The only true place to determine the property rights of a spouse is in a state divorce court. The presumption of equal life expectancy in *Barr* was built on the assumption that each item of property is equally split in a divorce. Implicit in that holding is a rule that state court divorce settlements control property rights between husband and wife. Property rights determined in a Michigan divorce court were superior to government forfeiture rights in *U.S. v. Certain Real Property Located at 2525 Leroy Lane, West Bloomfield, Michigan.*[13] In that case, the Sixth Circuit had remanded the case after having held that a forfeiture claim by the government did not destroy the tenancy by the entireties. The lower court then held:

> On remand, the district court found that Leah Marks was entitled to all of the proceeds of the sale of the house. The district court based its deci-

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> sion on her Michigan state court divorce decree, which divided the property in such a way that Leah received the entire estate "free and clear of any and all claims or interest of the Defendant, Mitchell Marks...." The district court found that because Michigan statutes allow a divorce court to re-determine the nature of property held in its entirety, Leah owned the entire property as a whole by virtue of the divorce decree, and she held the property free of any interest by her ex-husband. Because the property was free of her husband's interest, the court found that the property was also free of the United States' succeeding interest. The district court denied the government's motion for summary judgment and awarded the entire proceeds of the sale of the property to Leah. This second appeal followed. (*2525 Leroy Lane* at 137)

The Sixth Circuit remanded again to make sure the divorce was proper:

> To insure that the record is complete and to insure fairness to all, this case is again remanded to the district court for such evidence as is necessary to insure total disclosure to the Michigan Circuit court of all facts surrounding the entry of the divorce decree. Such evidence may include, but is not limited to, who paid the mortgage, who maintained the property in a livable fashion, are there minor children involved, as well as other matters that are normally considered by a trial court in a divorce proceeding. (*2525 Leroy Lane* at 138).

A result similar to *2525 Leroy Lane*, (i.e., relying on a *proper* divorce to determine spousal property rights), was reached in *Gardner v. U.S.*[14] There, a tax lien was filed on a husband after the Kansas divorce was started but before the divorce decree was entered. The *Gardner* court held that Kansas law treats "property interests created by the divorce decree as having vested on the date the divorce petition was filed." (*Gardner* at 988). The ruling meant that the lien was inferior to the property rights of the wife as determined by the divorce court.

The government had argued in *Gardner* that preferring divorce decrees over tax liens would cause contrived property settlements to avoid tax payment. The *Gardner* court responded that such contrived divorces could be attacked as fraudulent:

> Finally, during oral argument the government urged that the outcome we reach today might encourage spouses to conspire to engage in tax evasion. In the unlikely event that spouses may seek to avoid a tax lien through a divorce action, it could, of course, be set aside for fraud—just as any other fraudulent conveyance may be redressed. (*Gardner* at 989).

The property at issue in the *Gardner* case belonged to the husband, Billie, before the divorce.[15] The *Gardner* court ruled that the divorce vested jurisdiction of the property in the Kansas court and that meant that the court's determination of inchoate spousal property rights came ahead of the IRS lien.

But the Kansas *Gardner* case did not involve entireties property like in Michigan. In Michigan, the non-delinquent spousal rights should always come ahead of the government lien because, as long as that innocent spouse had an ownership interest at the time the tax lien attached, his or her interest precedes that of the government. Once a Michigan divorce court judge *properly* determines the property rights of a wife , those property rights should come ahead of the government lien.

Here is why that is the case. The underlying premise of the *Rodgers* decision was that the government could foreclose on the husband's lien because the lien extends to the entire parcel (not just the interest of the husband). The government can only foreclose on property that has a tax lien on it under §7403(a).[16] The only way the government can have a lien on the *entire* property is if the husband has an interest in the entire property. And if the husband has an interest in the entire property, so does the wife, and so does the government by virtue of its lien. That means that the government and the non-delinquent spouse have simultaneous competing interests in entireties property.

When two people or entities have competing interests in property, the rule is "the first in time is first in right."[17] When the government files a tax lien on a husband's interest, its lien is junior to the rights of the wife if the wife co-owned the home before the government's lien attached.[18] Therefore, whatever the wife's interest in the home is, as *properly* determined by virtue of a bona fide divorce decree, it is hers ahead of a federal tax lien.[19] ■

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Endnotes

1 See Q6 – IRS Notice 2003-60, 2003-2 CB 643

2 2011 WL 2531400 (E.D.SD Mich. 6/24/11) 107 A.F.T.R.2d 2011-2704, 2011-2 USTC P 50,487.

3 The term "purchaser" means a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice.

4 The government has said that a divorcing spouse is not a purchaser under §6323. See A! Divorce Notice 2003-60, 2003-2 CB 643.

5 Even if a lien is not recorded, an unrecorded tax lien is considered to have arisen from the moment the taxes are not paid but it only applies to bona fide purchasers without knowledge of its existence.

6 *U.S. v. Rodgers*, 461 U.S. 677 (1983).

7 §7403(c) **Adjudication and decree.**
The court shall, after the parties have been duly notified of the action, proceed to adjudicate all matters involved therein and finally determine the merits of all claims to and liens upon the property, and, in all cases where a claim or interest of the United States therein is established, may decree a sale of such property, by the proper officer of the court, and a distribution of the proceeds of such sales according to the findings of the court in respect to the interests of the parties and of the United States. If the property is sold to satisfy a first lien held by the United States, the United States may bid at the sale such sum, not exceeding the amount of such lien with expenses of sale, as the Secretary directs.

8 §7403(a) **Filing.**
In any case where there has been a refusal or neglect to pay any tax, or to discharge any liability in respect thereof, whether or not levy has been made, the Attorney General or his delegate, at the request of the Secretary, may direct a civil action to be filed in a district court of the United States to enforce the lien of the United States under this title with respect to such tax or liability or to subject any property, of whatever nature, of the delinquent, or in which he has any right, title, or interest, to the payment of such tax or liability. For purposes of the preceding sentence, any acceleration of payment under section 6166(g) shall be treated as a neglect to pay tax.

9 *United States v. Craft*, 535 U.S. 274 (2002).

10 Oral Tr. p. 15, Alderson Reporting Company. The transcript can be found at 2002 WL 73224 (Oral Argument) (U.S. January 14,2002), Oral Argument, (No. 00-1831).

11 *U.S. v. Barr*, 617 F3rD 370 (6th Cir. 2010) *Cert Denied* _U.S._ (3/21/2010).

12 The *Barr* decision was a majority opinion in *U.S. v. Barczyk* 2011 WL 3624947 (C.A.6 (Mich.)). Honorable Judge Helene White wrote a separate concurring opinion in *Barczyk* stating:

As observed by Chief Judge Batchelder in her partial dissent in *Barr*,

> "[t]he weight of federal law argues strongly against the majority opinion's conclusion that [a non-defaulting spouse] is entitled to a simple fifty percent interest because she is a tenant by the entireties." *Id.* at 379 (Batchelder, C.J., concurring in part and dissenting in part). Like Chief Judge Batchelder, I believe that an automatic fifty-percent valuation of the non-defaulting spouse's interest in the property is incorrect, and that courts should consider actuarial evidence in calculating the spouses' respective shares in the property.

13 972 F.2d 136 (6th Cir. 1992).

14 34 F2d 985 (10th Cir. 1994).

15 814 F Supp 982 (USDC KS 02/03/1993).

16 See note 8.

17 *U.S. v. McDermott, et. al.* 507 U.S. 447, 449 (1993).

18 See *O'Hagan, Ann H. v. United States*, 86 F3d 776 (8th Cir. 1996).

19 The government takes a different position, see note 1.