

UNDERWRITING BULLETIN

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TO: All Policy Issuing Offices and Agents

FR: William C. Hart, Special Consultant and Chief Underwriter, Emeritus

RE: U.S. SUPREME COURT PIERCES VEIL OF TENANCY-BY-THE-ENTIRETY

CC: Corporate Underwriting and Claims Staff

Date: May 7, 2002

Case: United States v. Craft, U.S. Supreme Ct. No. 00-1831 (April 17, 2002); Spring 2002

ALTA Title Counsel Agenda item 23, Exhibit 47; DIRT DD 4/18/02; Landsakes Posting of 4/22/02; On appeal from the 6th Cir. Court of Appeals; Appellate opinions are cited as 140 F3d 638 (6th Cir. 1998) and 233 F3d 358 (6th Cir. 2000) [Prior Landsakes Posting of 10/11/99].

Issue: Is a federal tax lien against a husband, a lien against the wife's interest as a tenant by the entirety?

COMMENT

This memo supplements our prior Bulletin and underwriting directive of 4/22/02 issued to all policy issuing offices. The U.S. Supreme Court has just ruled on this issue in a 6-3 decision that will affect the way we view property held as tenancy by the entireties in *United States v. Craft*, supra. This Bulletin and the discussion groups set forth above discuss the case findings and its background.

THE LIEN

In that case, Don Craft and his wife owned real estate in the state of Michigan as tenants by the entirety. After he failed to file his federal income tax returns for seven years, the IRS assessed a \$482,446.00 lien against him under the federal tax lien statute. The Crafts then jointly deeded the property to Mrs. Craft for \$1.00,

and when she tried to sell the property a few years later, a title search revealed the lien. The IRS released the lien in order to facilitate the sale, but it required an agreement that one-half of the sale proceeds be held in escrow pending the determination of the government's interest in the property.

The U.S. district court awarded the escrow funds to the IRS, ruling that the tax lien survived the transfer of the property to Mrs. Craft. The 6th Circuit Court reversed, holding that the lien did not attach to entireties' property under Michigan law. After remand to the district court on another issue, the case wound up in the Supreme Court, which reversed the circuit court and held that the lien attached to the husband's interest. It held that despite "the state law fiction that a tenant by the entireties has no separate interest in entireties' property" or "right to property" for purposes of the federal tax lien statute. It then remanded the case for a determination of the value of the husband's interest but made no comment about that value.

BUNDLE OF STICKS

The decision was based on the broad sweep of the federal tax lien statute and the court's view that federal controls the question about what rights constitute property under the statute. Justice Sandra Day O'Connor's majority opinion explained the holding with a metaphor:

A common idiom describes property as a "bundle of sticks," – a collection of individual rights which, in certain combinations, constitute property State law determines only which sticks are in a person's bundle. Whether those sticks qualify as "property" for purposes of the federal tax lien statute is a question of federal law.

O'Connor analyzed different standard forms of joint property ownership and explained that a tenancy by the entirety is a type of ownership that can only exist between married persons. Traditionally, it has been viewed as a form of single ownership by the marital unity. "Neither spouse was considered to own any individual interest in the estate; rather, it belonged to the couple."

According to the court, under Michigan law, the husband had several "sticks" in the entireties property; a right to use it, a right to exclude others, a right to share any income from the property, a right of survivorship, a right to become a tenant-in-common, if he divorced, a right to sell the property with his wife's consent, and a right to block his wife from selling property unilaterally.

Because the husband had so many sticks, O'Connor concluded that the federal tax lien attached. The husband's rights were "property and rights to property, whether real or personal, belong to " him pursuant to the tax code. 26 U.S.C., Section 6321. O'Connor concluded that this interpretation is necessary to deter spouses from shielding property from federal taxation. Also, this treatment confirms the reach of IRS liens against other interests that are protected from judgment liens by state law, such as Homesteads.

O'Connor acknowledged that one of the traditional "sticks" is missing from the husband's bundle of property rights. As a tenant by the entirety, he has no right to "unilateral alienation" (the right to transfer his interest). Some commentators have pointed out that this right may be the biggest stick of all.

DISSENT

Justices Clarence Thomas, John Paul Stevens, and Anthony Scalia dissented. Thomas' dissent challenged the "bundle of sticks" analysis and wrote:

"This amorphous construct ignores the primacy of state law in defining property interests, eviscerates the statutory distinction between 'property' and 'rights to property' drawn by Section 6321, and conflicts with an unbroken line of authority from this Court, the lower courts, and the IRS. Its application is all the more unsupportable in this case because, in my view, it is highly unlikely that the limited individual 'rights to property' recognized in a tenancy by the entirety under Michigan law are themselves subject to lien."

Essentially, he did not want to change "the nature of the legal interests," that taxpayers have in property beyond those interests recognized under state law. He was concerned that the Supreme Court would be creating "an amorphous federal common law definition of property." Thomas distinguished tenancy by the entirety property from community property, one of the examples used by O'Connor.

He pointed out that a tenant in a tenancy by the entirety not only lacks a present divisible vested interest in the property, which that person cannot transfer, but also does not have the ability to leave any portion of the property to another by a will, because it is subject to the spouse's indestructible right of survivorship. In contrast, each spouse has a present one-half vested interest in community property, which may be devised by will, or otherwise, to people other than the spouse.

Thomas also chided the majority for failing “to so much as mention” the consensus of the lower courts for more than 50 years, which runs contrary to the majority’s opinion. Also, he found it “puzzling” why the court did not even mention that the IRS had acknowledged in its official manual and an IRS Chief Counsel Advisory that a federal tax lien does not attach to real property held as a tenancy by the entirety.

OPEN QUESTIONS

The Craft opinion will have wide ranging effects throughout the country. Although some of the rules revolving around these tenancies differ from state to state, Pennsylvania and other states have a similar form of tenancy by the entirety as Michigan.

The majority opinion has inspired many unanswered questions. First, the Craft case dealt with the division of proceeds by stipulation following a voluntary sale of the real estate by the married couple. The court did not deal with the rights of the IRS if title had remained with the married couple. A strict interpretation of the decision would limit the court’s conclusion to those cases where the real estate had been converted to cash. For example, in Pennsylvania, a lien against one spouse would attach to that spouse’s interest in a tenancy the entirety, but it would not be actionable until death, divorce, or voluntary division of the property makes it possible to separate the spouse’s interest. Under those circumstances, if a husband who owed the creditor died, the creditor would get nothing because the whole property would pass to the wife. It is not completely clear that under those circumstances, a tax lien would be treated any differently.

On the other hand, it is possible to interpret the Craft decision more broadly so that under those circumstances, the IRS is authorized to foreclose on the real estate. If that should occur, the Supreme Court would be running roughshod over the innocent spouse's right to control the disposition of tenancy by the entirety's property.

Will this decision increase the government's right to go against entireties' interests under other legislation? For example, the Racketeer Influence and Corrupt Organizations Act gives the federal government forfeiture rights against "property" or "interests" in property. 18 U.S.C.A. Section 1963.

One of the unanswered questions is what would happen if the lien were on the unsold real estate and the husband died just after the conveyance to his wife? (Craft apparently died in 1998.) Would the IRS lien remain against the real estate? If so, then the IRS has even greater property rights than the husband would have had, even though the IRS's rights are derivative of the husband's rights. It would have an interest in the real estate when the taxpayers' heirs would have had no rights in the property. In discussing the effect of the deed to Mrs. Craft, Thomas quotes an apt maxim:

"The tax collector not only steps into the taxpayers shoes but must go barefoot if the shoes were out."

VALUE AND OTHER CREDITORS

This raises the next questions, which the court sidestepped. It remanded the case to the 6th Circuit to determine the proper valuation of the husband's interests in the

entireties' property without any guidance. It stated, "We express no view as to the proper valuation of respondent's husband's interest in the entireties' property....."

The issue of valuation of an undivided interest with a right of survivorship can be complicated. Suppose the husband were dying in a hospital, and the lien attached to his interest the day before he died. Since the wife takes over the whole property as the survivor on the husband's death, what was the husband's interest worth the day before he died? Does that evaluation depend on whether the parties knew he was dying? What if the husband is many years older than the wife, should that be taken into account in evaluation of the value of his interest? Should the parties use standard actuarial tables in that calculation?

Suppose the husband died a day before the lien was entered against him instead of a day after. Would that then mean that since the property passed to the surviving spouse before the lien, the IRS had no interest in the property? The Craft decision leads to a focus on the relative positions of the IRS and other judgment creditors. Under state law, other creditors who have taken judgments against the husband have no lien against entireties' property.

Generally, under traditional tenancy by the entirety law, their liens would be effective only if the husband survives the wife, or upon divorce. If the wife survives, what happens to those liens that are earlier in time than the IRS lien against the husband? Are they now wiped out, or are they subordinated to the IRS? Suppose the husband survives the wife and creditors hold earlier liens than the IRS. How do you line up the various priorities? One reading of the case is that the IRS may foreclose against the husband's interest, but an earlier creditor's lien against only the husband may not. Does the earlier lien have priority to the proceeds of the sale?

What if the IRS has a lien against only the husband, but a creditor has a later judgment against both the husband and the wife. If the husband dies before the IRS is able to foreclose on the husband's interest, what are the respective lien priorities? In calculating the value of the husband's interest that would be available to the IRS, should that judgment against the husband and wife be deducted from the value of the husband's share of the property? How about an earlier judgment filed only against only the husband's interest? Should that be deducted?

Suppose the tenancy by entirety is for the couple's home instead of some other type of property. If the IRS forecloses on the husband's interest, what happens to the wife's right of possession? Will the buyer at foreclosure, or the IRS, be able to assert rights of possession along with the wife? Even if the buyer at the sheriff's sale would have partial rights of possession, how much would the rights be worth if the buyer had to share the use of a home with a presumably unhappy spouse?

In his dissenting opinion, Thomas raised the spectre that the logic of the majority opinion could lead to the conclusion that even partnership property could be attached for the tax liability of an individual partner. He stated:

'Though partnership property currently is not subject to attachment or execution except with a claim against the partnership..... under the logic of the court's opinion, partnership property could be attached for the tax liability of an individual partner.'

Like a tenant in a tenancy by the entirety, the partner has significant rights to use, enjoy, and control a partnership property in conjunction with his partners. I see no

principled way to distinguish between the propriety of attaching the federal tax lien to partnership property to satisfy the tax liability of a partner, in contravention of current practice and the propriety of attaching the federal tax lien to tenancy by the entirety property in order to satisfy the tax liability of one spouse, also in contravention of current practice.

It seems to stretch the meaning of O'Connor's opinion to apply it to partnerships. If the veil of partnerships is still intact, married couples may well want to consider the partnership as a more protective device than a tenancy by the entirety when trying to avoid the effect of a potential IRS lien against their home. For example, if the IRS takes judgment against the husband's interest in a partnership, the courts might follow the more traditional view that the IRS has only an interest in the husband's property interest and that the lien does not pierce the partnership veil and become a lien against the real estate. Under the Craft opinion, it appears that the opposite rule would apply if the couple holds the real estate by the entireties.

In joining with the dissent, Scalia felt it important to give his own take on the effect of the majority decision on married women:

"I write separately to observe that the court nullifies (insofar as federal taxes are concerned, at least) a form of property ownership that was of particular benefit to the stay-at-home spouse or mother. She is overwhelmingly likely to be the source of the individual indebtedness against which a tenancy by the entirety protects. It is regrettable that the Court has eliminated a large part of this traditional protection retained by many states."

Some have suggested that perhaps Scalia is gleefully poking fun at his good friend and colleague, Justice Ruth Ginsberg, who voted with the majority in this case.

This bulletin was originally appeared as an article for *The Legal Intelligencer*, May 6th, 2002. It was prepared by Harris Ominsky, a partner at the Philadelphia law firm of Blank Rome Comisky & McCauley. It is reprinted here for the benefit of TA Title Insurance Company with the author's permission.