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FEDERAL TAX COLLECTION CONTROVERSIES
IN THE ERA OF DRYE

By Steve Johnson

By "tax collection controversies," I mean cases in which it has been established that the taxpayer owes additional taxes, those taxes remain unpaid, and the IRS is attempting to enforce collection out of the taxpayer's assets. Such cases are numerous and involve attorneys in general legal practice as well as tax specialists. For example, the taxpayer may be your client for non-tax matters, and may expect you to handle her tax collection controversy as well. Or, your client may not be the taxpayer herself, but instead someone who co-owns property with the taxpayer. Your client expects you to make sure that his interest is not impermissibly infringed if the IRS tries to effect collection out of the taxpayer's interest in the jointly owned property. Or, the taxpayer owes money to your client as well as to the IRS, such that your client and the IRS are competing for assets that, typically, are insufficient to satisfy all the claims against or debts of the taxpayer. Or, your client may be a financial institution or other party holding assets of the taxpayer, and the IRS has served a notice of levy on your client to satisfy tax liabilities out of those assets. In short, attorneys in general practice as well as tax specialists often need to understand the rules governing tax collection by the IRS.

The IRS can effect enforced collection only out of assets to which its tax lien attaches. Fairly recently, in December 1999, the Supreme Court handed down a landmark decision clarifying the reach of the federal tax lien: Drye v. United States.1 After providing background, this column describes Drye and contemporary tax lien analysis in light of its teaching.

I. Background

Under I.R.C. § 6321, the general federal tax lien2 attaches to "all property and rights to property, whether real or personal" belonging to the taxpayer. The Supreme Court has emphasized that this language "is broad and reveals on its face that Congress meant to reach every interest in property a taxpayer might have."3 The lien arises upon assessment of the tax by the IRS, followed by failure to pay the amount after the IRS makes notice and demand for payment on the taxpayer. Once it arises, the lien relates back to the date of assessment.4 It attaches to property owned by the taxpayer as of that date as well as after-acquired property.

Once the lien attaches, it remains on the property even if conveyed to another person. The tax lien generally has priority over subsequently perfected claims and judgments, although filing of a notice of tax lien may be required to achieve priority over certain classes of competing claims.5 Once the lien attaches, the IRS has a variety of options against the property, including administrative levy and sale under I.R.C. § 6331 and seeking judicial sale and apportionment of proceeds under I.R.C. § 7403.

II. Drye

A. Facts

Given the broad language of § 6321, it usually is clear that the lien attaches to property the IRS seeks to reach. However, whether a given interest of the taxpayer constitutes "property [or] rights to property" has been litigated in hundreds of cases, especially when the interest is less than full and possessory or when state law limits the ability of creditors to proceed against the interest.

Drye was such a case. Rohn F. Drye, Jr. had unpaid federal tax assessments of approximately $325,000. The IRS had filed liens against him, but it had little prospect of being paid since Mr. Drye was insolvent. Thereafter, Drye's mother died intestate, leaving an estate worth over $230,000. He was her sole heir and the administrator of her estate. Six months later, Drye disclaimed any interest in his mother's estate. In short order, she established the Drye Family 1995 Trust. She used the proceeds of the estate to fund the trust. The daughter and her parents (including Mr. Drye) were the beneficiaries of the trust. Mr. Drye's attorney was the trustee. He had discretion to make

continued on page 16
distributions to the beneficiaries for their health, maintenance, and support. The trust was a spendthrift trust, its assets shielded under state law from creditors of the beneficiaries.

The IRS filed a notice of tax lien against the trust, asserting that the trust was Drye's nominee. The IRS also served a notice of levy on accounts held in the trust's name by an investment bank. In response, the trust filed a wrongful levy suit under I.R.C. § 7426(a) in federal district court. The IRS counterclaimed against the trust, its trustees, and its beneficiaries. It sought to reduce to judgment its assessments against Drye, to confirm its right to levy on the trust assets in order to satisfy the assessments, to foreclose on its liens, and to sell the trust property.

As is the case in most states, Arkansas law provides that a disclaimer "relates back for all purpose to the date of death of the decedent," creating the legal fiction that the disclaimer predeceased the decedent. Thus, Drye contended that he never had a property interest in his mother's estate, so there was nothing to which the tax liens against him could attach.

The IRS rejoined that its liens attached to Drye's interest in the estate as of his mother's death and that Drye's later disclaimer could not remove them. The IRS based its argument on the principle that substance prevails over legal fictions in tax and the rule that, once the tax lien attaches, it remains on the property until released or satisfied by payment.

Upon cross-motions for summary judgment, the district court held for the IRS. The Eighth Circuit affirmed. The Supreme Court unanimously affirmed. As described below, the Court's opinion clarifies tax lien analysis in two principal respects: (1) the respective roles of federal law and state law and (2) the definition of "property" and "rights to property."

**B. State Versus Federal Law**

To what extent does federal tax lien analysis incorporate or depend on state law property or debtor-creditor rules? As the Court itself acknowledged in Drye, its prior decisions sometimes contained loose or imprecise language, leading to confusion as to this question in the lower courts. Drye should put such confusion to rest. The Court declared: "The Internal Revenue Code's prescriptions are most sensibly read to look to state law for delineation of the taxpayer's rights or interests, but to leave to federal law the determination whether those rights or interests constitute 'property' or 'rights to property' within the meaning of § 6321."9

In light of Drye, it is now clear that three stages of analysis exist in tax lien controversies: (1) One first must ascertain what, if any, interest the delinquent taxpayer has in the underlying property from which the IRS seeks to effect collection. Can the taxpayer possess, use, control, or benefit from the property, or prevent others from doing so? If so, how? (2) Next, one must ask a characterization question: do whatever powers the taxpayer possesses rise to the level of being "property" or "rights to property" under § 6321? If so, the tax lien attaches. In that event, (3) one must ask: what action can the IRS take against the underlying property and what safeguards or protections are available to the taxpayer and third parties against such actions?

It also is clear that only the first of these stages involves state law. Once it has been determined what powers the taxpayer has, recourse to state law ends. All further matters - whether of characterization (property right or not) or consequences (IRS options, and protections for the taxpayer and third parties) - turn on federal law only.

**C. "Property" and "Rights to Property"**

As seen, the stage two characterization question is a function of federal law. But what exactly rises to "property" or "rights to property" for § 6321 purposes? Neither the Code nor the Regulations promulgated under it define these terms.

Although Drye did not propound comprehensive definitions, it did shed light on the characterization issue. Without committing to them, the Court reprised criteria of property advanced in other cases, including: "every species of right or interest protected by law and having an exchangeable value," a right to gain possession of an item, even if possession does not amount to ownership, items "within [the taxpayer's] reach to enjoy," "any beneficial interest as opposed to bare legal title, in the asset at issue," "a valuable, transferable, legally protected right to the property at issue," "rights or interests that have pecuniary value and are transferable," and something beyond a mere expectancy.
However, these formulations are not to be applied in a wooden or mechanical fashion. Not all of the indicia may be necessary. For instance, the Court remarked: "We do not mean to suggest that transferability is essential to the existence of 'property' or 'rights to property' under § 6321."11

D. Application to the Facts

Let's see how the Court applied these two levels of teaching - the relation of federal and state law and the meaning of property and property rights - to the facts of Drye. (1) At stage one, the Court noted that the applicable state law gave Mr. Drye two strings or powers over the $230,000 constituting his mother's estate. First, he had the ability to do nothing, i.e., not to disclaim, in which case the estate would go to him. Second, he had the ability to disclaim, the effect of which would be to "channel the inheritance to a close family member (the next lineal descendant)," specifically Mr. Drye's daughter.12 These strings or powers having been ascertained, state law - including the fiction that Mr. Drye is viewed as having predeceased his mother and the spendthrift restrictions13 - ceased to be relevant and all further questions were matters of federal law.

(2) At stage two, the Court held that, taken together, the two abilities gave Mr. Drye a "control rein" over the property, a "power to channel" the $230,000,14 and that this power had "considerable value."15 This, the Court held, "warrants the conclusion that Drye held 'property' or a 'right' to property," under a federal definition of these terms.16 This conclusion is fully consistent with criteria of property, federally defined for § 6231 purposes, that we earlier saw the Drye Court distilled illustratively from prior cases. (i) Mr. Drye's "control rein" surely was a "species of right or interest protected by law," and, by virtue of the ability to disclaim, it was exchangeable or transferable, at least to one person: the next lineal descendant. (ii) Mr. Drye had a right to gain possession of the $230,000, by choosing not to disclaim. (iii) Similarly, the $230,000 was "within [Mr. Drye's] reach to enjoy." (iv) Mr. Drye's interest was beneficial, not merely legal. (v) Mr. Drye's right was "valuable, transferable [at least to one other, and] legally protected." (vi) Mr. Drye's interest was something beyond a mere expectancy.

(3) At stage three, since Mr. Drye had a § 6321 properties right, the federal tax liens against him attached to the $230,000. Since the lien travels with the property once it attaches, the liens could not be defeated by Mr. Drye's transfer, via the disclaimer, of the property into another's (the daughter's) hands nor by her subsequent transfer of the property into yet another's (the trust's) hands. The government could reduce to judgment against Drye, could levy on the trust assets to satisfy those assessments, could foreclose on its liens, and could sell the trust property, since all of those are post-lien attachment powers that federal law, specifically the Internal Revenue Code, confers on the IRS.17

III. Conclusion

Drye fundamentally clarifies the standards governing federal tax lien controversies. Dozens of lower court decisions have applied its teaching,18 and in the main have done so correctly.19 Drye will shape this area of the law for decades to come.

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ENDNOTES

1The § 6321 general lien is the principal federal tax lien. Special liens also are variously provided, such as for federal estate taxes, gift taxes, and taxes on distilled spirits. See I.R.C. §§ 5004, 6324(a) & (b), 6324A & 6324B.
3See I.R.C. § 6323.
7See I.R.C. § 6322.
8See 528 U.S. at 57.
9Id. at 52.
10See id. at 56-60 (citations and internal quotation marks omitted).
11Id. at 60 n.7.
12Id. at 60.
13State spendthrift rules do not limit the federal tax lien. See, e.g., Bank One Ohio Trust Co. v. United States, 80 F.3d 173, 176 (6th Cir. 1996).
14Drye, 528 U.S. at 61.
15Id. at 60.
16Id. at 61.
17See, e.g., I.R.C. §§ 6331, 7402(a) & 7403(a).