# PROTECTING TRUST ASSETS FROM THE FEDERAL TAX LIEN

*by Bryan T. Camp*[*]



## I. INTRODUCTION

One common issue facing those who create trusts is how to protect beneficiaries from creditors. One of the biggest, baddest creditors out there is the Internal Revenue Service (IRS or Service), wielding two weapons of mass

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collection: the federal tax lien and the federal tax levy. These weapons regularly pierce boilerplate spendthrift provisions. Discretionary trusts do not fare much better. Court decisions over the past ten years make it increasingly likely that even pure discretionary trusts contain clauses that traitorously turn over the treasure house keys to the federal tax lien. Once the lien attaches, the IRS can enforce it through either administrative or judicial attachments, blowing through state law barriers that keep out other creditors.

This Article offers some ideas on how to keep the federal tax lien locked out from trust assets using property law concepts of springing and shifting executory interests. This Article posits that a properly drafted tax lien lockout provision can deflect the federal tax lien. Moreover, tax lien lockout provisions can do this in the context of a support trust, thus allowing settlors to give enforceable directions to their trustees and to avoid the potential downsides of pure discretionary trusts. In short, tax lien lockout provisions can protect trust assets from the long and mighty arm of the IRS while preserving a client's wish to hold trustees to clear standards of behavior towards beneficiaries.

This Article proceeds in three parts. Part II illustrates the limited role that state law plays in controlling the scope of tax liens and in protecting non-delinquent third parties from the effect of the lien. It explains the basics of the federal tax lien, focusing on the relationship between state and federal law and the two key methods by which the IRS enforces the lien: the administrative levy and the lien foreclosure suit. Part III introduces a basic hypothetical involving a fictitious elderly widower who wants to create a trust for his kids and grandkids. Part III then uses this hypothetical to illustrate why spendthrift provisions offer no protection from federal tax liens and why it is likely that neither discretionary nor protective trusts do much better. Finally, Part IV looks at how Texas law regarding shifting executory interests might provide an opportunity for the well-advised settlor to craft trust provisions that can lock out the federal tax lien when a beneficiary encounters either expected or unexpected tax difficulties.

## II. BASICS OF FEDERAL TAX LIENS AND LEVIES

Collecting tax is most usefully viewed as a process, not an event. That is why § 6502 of the Internal Revenue Code (IRC) gives the IRS ten years from the date of the assessment to collect properly assessed but unpaid tax liabilities.[1] The IRS needs that time to resolve unpaid liabilities, either by chasing down assets to collect the full amount from those taxpayers who can pay or by developing collection alternatives for taxpayers unable to immediately pay in full.[2]

1. Unless otherwise specified, all statutes referred to in this article are to the Internal Revenue Code of 1986, which is codified as Title 26 of the United States Code.

2. *See generally* Bryan T. Camp, *The Failure of Adversarial Process in the Administrative State*, 84 IND. L.J. 57, 58-77 (2009).

During the entire multi-year collection process, one of the main collection tools the IRS uses to snag taxpayer assets is the mighty tax lien. Although the IRS has other tools—notably the setoff power—it is the tax lien that tends to cause the most trouble for taxpayers.[3] Part III will explain (i) how the tax lien arises; (ii) the scope of its effect; and (iii) the two methods that the IRS uses to make it work.

### *A. How the Tax Lien Arises*

Section 6321 provides that:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

Section 6322 provides that the tax lien continues as a charge on all of a taxpayer's "property or rights to property" until the liability, including all accruing penalties and interest, is fully paid or until the lien becomes unenforceable "by reason of lapse of time." The phrase "lapse of time" refers to the ten year period allowed for the collection of an assessed tax by § 6502, unless the government takes affirmative steps sooner to release or discharge the lien under § 6325. Ten years, however, is merely the shortest period in which the Service can collect an assessed tax.[4]

Three aspects of the federal tax lien merit emphasizing: (1) it arises automatically; (2) there is only one tax lien securing a given tax liability; and (3) the tax lien is retroactive.[5] As to the first, the tax lien arises by operation of law once the three following events have occurred: (i) the IRS must properly assess a liability; (ii) the IRS must send the taxpayer timely notice and demand for payment; and (iii) the taxpayer must fail to fully pay the liability.[6] While § 6321 does not itself require an assessment (only that the taxpayer be "liable to pay"), courts have inferred the assessment requirement from the language in § 6322.[7] Similarly, while § 6321 does not say when the "demand" must be

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3. The authority to offset comes from both § 6402 and from common law. United States v. Munsey Trust, 332 U.S. 234, 239 (1947). A good description of the offset system and its limitations is found in I.R.S. Chief Couns. Adv. 200217005, 2001 IRS CCA LEXIS 275 (Dec. 21, 2001), *available at* http://www.unclefed.com/ForTaxProfs/irs-wd/2002/0217005.pdf.

4. The ten year period generally ends up being much longer for any number of reasons. A long series of events, listed in § 6503, suspends the running of the collection period, and if the unpaid liability is large enough, then the government will file suit to reduce the assessment to judgment under the authority of § 7401. The resulting judgment not only creates a judgment lien but also extends the life of the tax lien. United States v. Overman, 424 F.2d 1142, 1147 (9th Cir. 1970).

5. *See* I.R.C. §§ 6303, 6321, 6322, 6326(a) (2006).

6. *See* §§ 6303, 6321, 6322.

7. United States v. Nat'l Bank of Commerce, 472 U.S. 713, 719-20 (1985).

made, courts have inferred the timeliness requirement from § 6303, which requires the IRS to send a demand "within 60 days, after the making of an assessment . . . ."[8] Finally, a failure to pay the entire amount of tax due after demand constitutes a neglect or refusal.[9]

The second aspect of federal tax liens that many practitioners overlook is that there is only *one* tax lien per assessed tax, which exists in either a secret state or a public state.[10] When it first arises, the tax lien is "secret" in that there is no public record of its existence. In order to protect certain creditors, Congress long ago decided that, although the tax lien may exist and be perfected on all property of the taxpayer as of the assessment date, it cannot be enforced against four types of competing creditors—known as the "four horsemen"—until such time as the IRS makes it visible by properly filing a Notice of Federal Tax Lien (NFTL).[11]

For example, if a taxpayer borrows money under a home equity loan and the bank properly files its security interest, then the tax lien is not enforceable against the bank's lien because the bank is one of the four types of special creditors listed in § 6323(a), specifically a "holder of a security interest." Only once the IRS files the public notice of the lien, the NFTL, may it enforce the tax lien against the four horsemen. Once revealed by the NFTL, the tax lien is good against almost all comers within the jurisdiction in which it is filed.[12]

Attorneys are often confused about the relation between the tax lien and the NFTL. *There is only one tax lien*, although there may be multiple NFTLs, depending on how much property the taxpayer has and where the property is located. However, it is the one and only tax lien that attaches automatically to

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8. *See, e.g.*, Blackston v. United States, 778 F. Supp. 244, 246 (D. Md. 1991); Behren v. United States, 764 F. Supp. 180, 183 (S.D. Fla. 1991) (holding that there was no valid tax lien when demand was sent after the sixty day period). However, methods of making notice and demand other than sending the § 6303 notice may suffice to meet the § 6321 "notice and demand" requirement and trigger the lien. For example, courts have counted proofs of claim in bankruptcy or probate as a demand. *See In re* Fidelity Tube Corp., 278 F.2d 776, 779-80 (3d Cir. 1960), *cert. denied*, 364 U.S. 828 (1960) (bankruptcy); United States v. Ettelson, 159 F.2d 193, 196 (7th Cir. 1947) (probate).

9. United States v. Wintner, 200 F. Supp. 157, 159-60 (N.D. Ohio 1961), *aff'd*, 312 F.2d 749 (6th Cir. 1963), *rev'd on other issues*, 375 U.S. 393 (1964); *see* United States v. Bess, 357 U.S. 51, 55 (1958). Once again, § 6321 does not itself specify a time after which a taxpayer has "failed to pay" the tax for purposes of triggering the tax lien. However, § 6331 gives the taxpayer ten days to pay before "it shall be lawful for the Secretary to collect such tax . . . by levy." The § 6651 penalty imposed for a failure to pay is triggered only after twenty-one days from the notice and demand (ten days when the tax liability demanded equals or exceeds $100,000). However, the exact time period is of little practical consequence for two reasons: first, the tax lien is retroactive to the date of assessment, and second, the IRS rarely seeks to enforce a lien sooner than twenty-one days. I.R.C. § 6322.

10. I.R.C. § 6323(a). The classic cases are United States v. New Britain, 347 U.S. 81 (1954) and United States v. Security Trust & Savings Bank, 340 U.S. 47 (1950). *See generally* Camp, *supra* note 2, at 66.

11. The four horsemen are purchasers for value, mechanics lienors, holders of security interests, and judgment lien creditors. I.R.C. § 6323(a). As to them, the tax lien is unenforceable in its secret state. *See* Camp, *supra* note 2, at 66.

12. The few exceptions are listed in § 6323(b). Note that the NFTL makes the lien visible against *all* personalty once the IRS files it in the state of the taxpayer's principal residence or place of business, whereas to make it visible for realty, the NFTL must be filed in the county where the realty is located. I.R.C. § 6323(f).

the taxpayer's assets.[13] The NFTL does not attach to anything. The NFTL just makes the lien visible and, hence, good against the four horsemen. In short, the NFTL brings the tax lien to light, not to life. This is especially important to keep in mind when it is just the taxpayer—perhaps one who is a trust beneficiary—who is trying to ward off the tax lien.

The third notable aspect of the federal tax lien is its retroactive effect. Once the tax lien arises, § 6322 provides that it relates back to the date of assessment. The retroactive nature of the lien is critically important to understand because it means that, once a taxpayer has actually received the notice of assessed tax and the demand for payment, the taxpayer is just too darn late to avoid the tax lien by transferring assets. All that happens is the transferred assets take the tax lien with them, for "it is of the very nature and essence of a lien, that no matter into whose hands the property goes, it passes cum onere . . . ."[14] So, for example, in *United States v. Kroblin* where the IRS assessed taxes on February 19, 1990, and the taxpayer quickly transferred his interests in the marital home to his wife on February 27, 1990, the court held that the transfer was subject to the tax lien because the lien arose as of the assessment date, even though the three prerequisites may not have occurred until after the transfer date.[15]

### *B. The Scope of the Tax Lien*

Section 6321 says that the tax lien attaches to all "property and rights to property." The trickiest part about understanding the scope of the tax lien is understanding how courts decide what constitutes "property and rights to property" to which the federal tax lien attaches. The federal statute itself "[c]reates no property rights but merely attaches consequences, federally defined, to rights created under state law . . . ."[16]

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13. *See* Camp, *supra* note 2; *see, e.g.*, Middlesex Sav. Bank v. Johnson, 777 F. Supp. 1024, 1027-30 (D. Mass. 1991) (applying these lien rules to a variety of competing creditors).

14. Burton v. Smith, 38 U.S. 464, 483 (1839).

15. *See* United States v. Kroblin, 2004 WL 1747467, at *2 (N.D. Okla. 2004). *See also* Sumpter v. United States, 314 F. Supp. 2d 684, 686 (E.D. Mich. 2004) (holding that taxpayer's transfer of six parcels of land before NFTL was filed was ineffective to prevent the tax lien from attaching because the transfers occurred after the assessment date); *Essex Ins. Co. v. McManus*, 299 F. Supp. 2d 939, 943 (E.D. Mo. 2003), *appeal denied*, 110 F. App'x 741 (8th Cir. 2004) (holding that the tax lien took priority over an adjuster's claim to the taxpayer's insurance proceeds). In *Essex Ins. Co.*, the IRS assessed federal income taxes against a taxpayer on February 12, 1996. *Essex Ins. Co.*, 299 F. Supp. 2d at 940. The taxpayer's business premises burned down in early November, and the taxpayer entered into a contract to pay an adjuster from the insurance proceeds. *Id*. at 941. On these facts, the court held that the tax lien took priority over the adjuster's claim to the insurance proceeds, even though there was no NFTL filed when the adjuster had contracted with the taxpayer because the tax lien arose as of the date of the assessment, which was before the taxpayer attempted to transfer an interest in the insurance proceeds. *Id*. at 943.

16. United States v. Bess, 357 U.S. 51, 55 (1958).

Courts use a two-step process to decide the scope of the federal tax lien. The first step looks to state law to see what legal interests it creates for the taxpayer.[17] The Supreme Court explained:

> The threshold question . . . is whether and to what extent the taxpayer had "property" or "rights to property" to which the tax lien could attach. In answering that question, both federal and state courts must look to state law, for it has long been the rule that "in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property . . . sought to be reached by the statute."[18]

The second step then looks to federal law to decide whether those interests constitute "property or rights to property" that the federal tax lien can latch onto.[19]

It might seem, from this abstract formulation, that state property law has a great deal to say about the scope of the federal tax lien. After all, if the tax lien can attach to only the legal interests of the taxpayer created by state law, then "the Government's lien under § 6321 cannot extend beyond the property interests held by the delinquent taxpayer."[20] Courts routinely remind us that the tax lien allows the IRS to only "step into the shoes" of the taxpayer and, equally routinely, quote Professor Bittker's apt adage that "the tax collector not only steps into the taxpayer's shoes but must go barefoot if the shoes wear out."[21] However, it is sometimes difficult to discern the size of the taxpayer's shoes.

The classic example is that of a life insurance policy that has a cash-surrender value. In *United States v. Bess*, a delinquent taxpayer died owning a whole life policy in a state that did not give him any rights to the death benefits.[22] The Supreme Court held that the tax lien did not attach to the death benefits paid to his widow.[23] However, the taxpayer's ability under state law to demand payment of his cash surrender value was indeed property—a chose in action—to which the tax lien attached.[24] Accordingly, the widow had to hand over to the IRS those proceeds paid to her that represented payment of the cash

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17. Comm'r v. Estate of Bosch, 387 U.S. 456, 463-66 (1967). Only a determination of a property interest by the highest court of a state is binding upon the federal government. *Id*. Absent a pronouncement by the state court of last resort, the federal court is as able as any state intermediate court to determine state law. *Id*.

18. Aquilino v. United States, 363 U.S. 509, 512-13 (1960).

19. *Id*.

20. United States v. Rodgers, 461 U.S. 677, 690-91 (1983).

21. Gardner v. United States, 34 F.3d 985, 988 (10th Cir. 1994) (quoting 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 111.5.4, at 111-02 (1981)).

22. *Bess*, 357 U.S. 51, 52-53 (1958).

23. *Id*. at 55-56.

24. *Id*. at 56 (The taxpayer "'possessed just prior to his death, a chose in action in the amount stated (i.e., the cash surrender value) which he could have collected from the insurance companies in accordance with the terms of the policies.'").

surrender value. This was true even though state law generally prohibited creditors from reaching the cash surrender value.

Although an evaluation of state law is the first step, state law is not the primary determinant of the federal tax lien's scope. This is because federal courts do not simply accept state law's characterization of a right; instead, federal courts look to see whether any restrictions on a taxpayer's rights are an inherent part of what state law has created or whether those restrictions are simply disguised preferences, either preferring certain creditors over the property owner or preferring the property owner over certain creditors.[25] "Were federal law not determinative of the classifier of the state-created interest, states could defeat the federal tax lien by declaring an interest not to be property, even though the beneficial incidents of property belie its classification."[26] In other words, federal law looks past state law labels to determine whether that state law is truly defining the scope of property rights or instead creating a preference regime.

State liquor license cases provide an excellent illustration of this tension and the problematic role of state law in determining the scope of the federal tax lien. States issue liquor licenses and generally allow the holders some rights in them, such as the right to use them and the right to transfer them.[27] Often, however, the very statutes that create the license property also build into the grant certain preferences for creditors, often in the form of restricting transfer of the license until the preferred creditors are paid off. Sometimes federal courts have treated these built-in preferences as part and parcel of the state property interest. More often, however, federal courts have treated these built-in preferences as creditor priority provisions that are ineffective against the supremacy of the federal statutes.

In *United States v. California*, the court decided that state-created restrictions on transferability limited the scope of the federal tax lien because the restrictions were part of the granted property right.[28] Specifically, California had reserved to itself payment of state taxes as a statutory condition for the transfer of a state-created liquor license.[29] Even though the effect of the state scheme was to allow the state's claim for taxes to take priority over the federal government's claim for federal taxes, the court reasoned that the issue was not the supremacy of the federal tax lien but was the nature of the property to which the lien attached:

> [T]he license existed because the state had issued it. If the licensee acquired something of value, it was because the state had bestowed it upon him. Whatever value the license, as property, may have had to a purchaser

25. *See* Aquilino v. United States, 363 U.S. 509, 512-14 (1960).
26. *In re* Kimura, 969 F.2d 806, 810 (9th Cir. 1992).
27. *See In re* Terwillinger's Catering Plus, Inc., 911 F.2d 1168, 1171-72 (6th Cir. 1990).
28. United States v. California, 281 F.2d 726, 728 (9th Cir. 1960).
29. *Id.*

> depended upon its transferability. If it was transferable, it was because the state had made it so. If the state had seen fit to impose conditions upon issuance or upon transfer of property it has wholly created, that is the state's prerogative so long as its demands are not arbitrary or discriminatory. The federal government has no power to command the state in this area. It has no power to direct that property be created by the state for purposes of federal seizure.[30]

Accordingly, the scope of the federal tax lien was restricted to the value of the liquor license *after* state taxes were accounted for.

In *In re Kimura*, however, the Ninth Circuit came to a different conclusion with respect to a similar statutory scheme.[31] In that case, the relevant Alaska statutes provided that licenses could only be transferred after payment to certain third-party trade creditors. The Ninth Circuit decided that, while California's reservation to itself of the right to be paid before a license could be transferred controlled the scope of property to which the tax lien could attach, a similar reservation in favor of third parties was merely a preference regime: "while a state, as the creator of a liquor license, may validly impose conditions on its transferability for the state's own benefit, it may not, consistently with paramount federal law, impose conditions which discriminate in favor of particular classes of creditors."[32]

Finally, nothing better demonstrates the stark contrast between a state's ability to regulate non-federal creditors and its inability to regulate the scope of the federal tax lien than *21 West Lancaster Corp. v. Main Line Restaurant, Inc*.[33] There, the holder of a liquor license sold the license, along with the restaurant, to a buyer. The IRS levied on the sale proceeds, and a lender also demanded payment. The buyer filed an interpleader and asked the court to determine who was entitled to the money. The IRS claimed that its lien attached to all the proceeds. The lender claimed priority for two reasons. First, the license was not property because the governing statute provided that "[t]he license shall continue as a personal privilege granted by the board and nothing herein shall constitute the license as property."[34] Second, even if the license was property, its lien still took priority over the tax lien because the lender had filed its financing statements before the IRS had filed its NFTL.

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30. *Id*. In arriving at this conclusion, the Ninth Circuit relied on prior Supreme Court cases defining the nature of a taxpayer's seat on a Stock Exchange. *See* Bd. of Trade v. Johnson, 264 U.S. 1, 10-11 (1924); Hyde v. Woods, 94 U.S. 523, 523-25 (1876) (holding that because stock exchanges created property interest in seats on exchanges, they could reserve unto themselves the right to be paid first any debts owed them from proceeds received upon sale of seats).

31. *In re Kimura*, 969 F.2d at 811-12.

32. *Id*.

33. 21 West Lancaster Corp. v. Main Line Rest., Inc., 790 F.2d 354 (3d Cir. 1986).

34. 47 PA. STAT. ANN. 4-468(b.1) (West 1997 & Supp. 2008), as quoted in 1412 Spruce, Inc. v. Pa. Liquor Control Bd., 474 A.2d 280, 281 (1984) (holding that a state liquor license was not property subject to execution by a judgment holder).

The Third Circuit rejected both propositions. As to the first, the court looked beyond the label used by state law to see whether the taxpayer had a pecuniary interest in the license that could be sold:

> [A] liquor license continues to have pecuniary value for its holder, in the form of potentially increased business revenues. Moreover, it may still be transferred and sold . . . . Consequently, we conclude that a Pennsylvania liquor license constitutes property or rights to property within the meaning of § 6321, and is therefore subject to a federal tax lien.[35]

Worse for the lender, however, was the circuit court's decision that, although the state statute was inoperative to restrict the scope of the federal tax lien, it was still controlling as to non-federal creditors. Thus, those state law cases holding that a lender could not perfect a security interest in the liquor license were effective against the lender.[36] Accordingly, the court reached what it conceded was the "anomalous conclusion that although a liquor license is not property for purposes of a security interest under Pennsylvania state law, it is property for purposes of a federal tax lien."[37]

Since 1999, state law has become even less important in determining the scope of the federal tax lien. Until 1999, the lower courts, as seen above in the liquor license cases, thought that a state-granted interest was property within the scope of the federal tax lien only when it had pecuniary value and was transferable.[38] In 1999, however, the Supreme Court concluded, in *Drye v. United States*, that a federal tax lien attached to a taxpayer's right of inheritance, regardless of whether the state-granted right had pecuniary value or was transferable.[39]

*Drye* was the last of several inheritance disclaimer cases that arose in the federal circuits within a short span of time. The fact pattern common to all of these cases was the following: (1) a taxpayer had federal tax liabilities; (2) someone died leaving some mix of realty or personalty to the taxpayer by operation of the intestate statutes; (3) the taxpayer disclaimed the inheritance; and (4) upon execution of a timely disclaimer in the proper form, state law treated the taxpayer as never having owned the property. The common

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35. *21 West Lancaster Corp.*, 790 F.2d at 358.

36. *Id*. (citing *In re* Revocation of Liquor License No. R-2193, 456 A.2d 709, 711 (Pa. Commw. Ct. 1983) (holding that a Pennsylvania liquor license was not property that could be subject to a security interest under the Uniform Commercial Code) and 1412 Spruce, Inc. v. Pa. Liquor Control Bd., 474 A.2d 280, 283 (Pa. 1984) (holding that a liquor license is not property that could be subject to execution by a judgment holder)).

37. *21 West Lancaster Corp.*, 790 F.2d at 359.

38. *See, e.g.*, *In re* Kimura, 969 F.2d 806, 811 (9th Cir. 1992). ("[A] liquor license will constitute property, within the meaning of federal law, if the license has beneficial value for its holder, and it is sufficiently transferable."); *see also* Drye Family 1995 Trust v. United States, 152 F.3d 892, 895 (8th Cir. 1998), *aff'd* 528 U.S. 49 (1999) ("In enforcing § 6321, appellate courts have interpreted 'property' or 'rights to property' to mean state-law rights or interests that have pecuniary value and are transferable."); Note, *Property Subject to the Federal Tax Lien*, 77 HARV. L. REV. 1485, 1486-87 (1964).

39. Drye v. United States, 528 U.S. 49, 59-61 (1999).

question in all of these cases was whether the federal tax lien attached to the inheritance or whether the disclaimer was effective to prevent the lien from attaching.[40]

In one thoughtful opinion, *Leggett v. United States*, the Fifth Circuit persuasively harmonized the seemingly disparate cases by relating them to how state law treated the right to disclaim.[41] The court noted that some states used a "transfer theory" under which state law viewed the heir as owning the inheritance on the date the decedent passed, subject to a later right to disclaim the inheritance. Other states used an "acceptance/rejection" theory under which state law treated the heir as *not* owning the inheritance until such time as the heir either exercised control over the property in the inheritance or failed to disclaim within the statutory period, which is generally nine months. The probate statute at issue in *Leggett* was typical of state disclaimer statutes:

> Any person . . . who may be entitled to receive any property as a beneficiary and who intends to effect disclaimer irrevocably . . . shall evidence same as herein provided. A disclaimer evidenced as provided herein shall be effective as of the death of decedent and shall relate back for all purposes to the death of the decedent and is not subject to the claims of any creditor of the disclaimant. Unless the decedent's will provides otherwise, the property subject to the disclaimer shall pass as if the person disclaiming . . . had predeceased the decedent . . . .[42]

Looking to Texas court cases interpreting this and related statutes, the Fifth Circuit concluded that Texas law did not vest property rights in heirs as of the date of death. Instead, Texas law followed the "acceptance/rejection" theory and treated heirs as acquiring ownership only once they "accepted" the inheritance by action or inaction:

> Under Texas law, [the taxpayer] had the right to accept [the decedent's] intended gift by taking possession of it, by exercising control and dominion over it, or by taking no action within the set time. She also had the right to reject [the] intended gift by filing a valid disclaimer within nine months. This right of decision was not, itself, a property right under Texas law. Because [the taxpayer] rejected the intended gift, she never had a property right. Therefore, the federal lien had nothing to which to attach.[43]

*Drye* was a typical inheritance case. Mr. Drye owed some $325,000 in federal income taxes. When his mother died intestate, Mr. Drye was the only

40. Drye Family 1995 Trust v. United States, 152 F.3d 892, 898 (8th Cir. 1998), *aff'd*, 528 U.S. 49 (1999) (disclaimer did not defeat lien); Leggett v. United States, 120 F.3d 592, 594-95 (5th Cir. 1997) (disclaimer defeated lien); United States v. Comparato, 22 F.3d 455, 457-58 (2d Cir. 1994) (disclaimer did not defeat lien); Mapes v. United States, 15 F.3d 138, 141 (9th Cir. 1994) (disclaimer defeated lien).

41. *Leggett*, 120 F.3d at 594-95.

42. *Id.* at 594 (quoting TEX. PROB. CODE ANN. § 37A).

43. *Id.* at 596.

heir under the Arkansas probate statutes, and he stood to receive some $236,000 in mixed personalty and realty. His daughter stood next in line under the intestate laws, and, when Mr. Drye properly and timely disclaimed his inheritance, she became the heir and put the property into a trust. The IRS seized the assets of the trust, and the trust filed a wrongful levy action as allowed under § 7426(a).

When *Drye* came up to the Eighth Circuit, the court followed the traditional two-step process, and first looked to see whether the legal interest that the state law gave the taxpayer had pecuniary value and was transferable.[44] In holding for the Service, the Eighth Circuit held that—unlike Texas—the governing state law of Arkansas granted Mr. Drye property rights in the inheritance as of the date of death, and the retroactive effect of a disclaimer was a legal fiction that the federal law would ignore.[45] Accordingly, the tax lien attached to the inherited personalty and realty at the date of the decedent's death.[46]

Although the Supreme Court affirmed the Eighth Circuit's decision, it did so using a very different analytical approach, one that significantly weakened the ability of state law to define the scope of the federal tax lien.[47] The Supreme Court did not focus on whether state law gave Mr. Drye a transferable, pecuniary interest as of the day his mother died; instead, it focused on his right to disclaim. It was the legal right to disclaim that constituted the "property or rights to property" to which the lien attached, because that gave Mr. Drye control over the property that constituted the inheritance. The Court used the following key analysis:

> Arkansas law primarily gave Drye a right of considerable value—the right either to inherit or to channel the inheritance to a close family member (the next lineal descendant). That right simply cannot be written off as a mere "personal right . . . to accept or reject [a] gift." . . . This power to channel the estate's assets warrants the conclusion that Drye held "property" or a "righ[t] to property" subject to the Government's liens.[48]

What is manifestly unsatisfying about the Supreme Court's analysis is that it does not explain how the federal tax lien's attachment to the *power* to disclaim morphs into a lien on the *underlying property* affected by the power. If state law extinguishes the right to disclaim after a certain time period, then it

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44. *Drye Family 1995 Trust*, 152 F.3d at 895.

45. *Id*. ("Under Arkansas law the right to inherit has pecuniary value, . . . and is transferable . . . The Arkansas Probate Code provides that an heir may disclaim, in whole or in part, an intestate interest in or right to a heritable estate within nine months of the decedent's death . . . The Arkansas Probate Code further provides that a disclaimer effected under these provisions creates the legal fiction that the disclaimant predeceased the decedent and 'relates back *for all purposes* to the date of death of the decedent.'").

46. *Id*. at 896.

47. *See* Drye v. United States, 528 U.S. 49, 49 (1999).

48. *Id*. at 60-61.

is not clear how the IRS can raise that power from the dead, as it were, years later to seize the assets. The shoes have worn out. The Supreme Court analogized the right to disclaim to a joint account holder's right to withdraw funds.[49] However, it is well settled that a bank need only pay over that which the taxpayer would have the power to withdraw at the time the levy is served.[50] Further, no one suggested that, once disclaimed, Mr. Drye had any power to reclaim the property. Regardless of the criticism, the Supreme Court has spoken and we had best take heed.

The most important aspect of *Drye to understand* is how the Court's new analysis reduced the ability of state law to circumscribe the scope of the federal tax lien.[51] The Court made no attempt to analyze how state law viewed the relationship between the taxpayer and the property. Unlike the Eighth Circuit, and the Fifth Circuit in *Leggett*, the Supreme Court made no attempt to decide what part of the relationship between an heir and an inheritance was a legal fiction. Instead, it sifted through state law simply to find some feature that could be, in some imaginable circumstance, part of that bundle of rights that make up property. In other words, the teaching of *Drye* is that once state law gives a taxpayer *any* right, no matter how slim, that right becomes property to which the tax lien attaches. *Drye* changes the task from understanding state property law *in context* to finding an excuse for the tax lien to attach. In *Drye* itself, the excuse was the control Mr. Drye had over the property:

> In sum, in determining whether a federal taxpayer's state-law rights constitute "property" or "rights to property," "[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property . . . Drye had the unqualified right to receive the entire value of his mother's estate (less administrative expenses), . . . or to channel that value to his daughter. 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.[52]

After the Supreme Court issued its opinion in *Drye*, perceptive commentators noted that its approach increased the scope of the federal tax lien to include historically protected state property interests such as tenancies-by-the-entireties ("T by E") property.[53] It had long been the rule that the

49. *Id*. at 58 (citing United States v. Nat'l Bank of Commerce, 472 U.S. 713, 727 (1985)).

50. Rev. Rul. 73-310, 1973-2 CB 408, as amplified 1979-1 CB 356 (finding that a bank is required to pay over only funds actually on hand at the time the levy is served rather than the amount indicated in its acknowledgement of service; therefore, if a bank acknowledged that $100 was in the account but on the same day that the levy was served the taxpayer had withdrawn $90 from the account, then the bank is required to pay over only the $10 that it held at the time of the service of the levy).

51. *Drye*, 528 U.S. at 61.

52. *Id*.

53. *See* Steve R. Johnson, *After Drye: The Likely Attachment of the Federal Tax Lien to Tenancy-by-the- Entireties Interests*, 75 IND. L.J. 1163, 1163 (2000).

federal tax lien would not attach to T by E property.[54] This was because state laws provided that T by E property was held by "the marriage" with each marriage partner's interest merged. It was that non-severable unity of ownership which led the Supreme Court to note in prior cases that "as a result of the peculiar legal fiction governing tenancies by the entirety in some States, no tax lien could attach in the first place because neither spouse possessed an independent interest in the property."[55]

And, indeed, it took only three years after *Drye* before the Supreme Court decided, in *United States v. Craft*, that the federal tax lien attached to T by E property, and state law was ineffective to prevent the attachment.[56] In *Craft*, Don Craft owed taxes. His wife, Sandra Craft, did not. Together they owned a house in Grand Rapids as T by E property. After learning of the tax lien, they transferred the house to Sandra for one dollar so that she held sole title. When she later went to sell the property, however, the buyer balked because of the NFTL. Sandra got the property discharged from the lien by agreeing to put half of the sale proceeds into escrow, and then filed a quiet title action.[57]

The district court decided that the tax lien attached at the moment the couple transferred the home to Mrs. Craft:

> "[E]ven though each spouse has an indivisible interest in the entireties property and owns it as a whole, each also holds an individual interest. . . . This individual interest is not realized and remains inchoate until the entireties estate is terminated by the death of one spouse, divorce or joint conveyance. . . . As long as the entireties estate is intact, the property is not subject to levy and execution by the creditors of one spouse. Yet, each spouse's survivorship interest is distinct, cognizable, and sufficient to support attachment of a creditor's lien."[58]

On appeal, the Sixth Circuit rejected that theory, holding that:

> In Michigan, it is well established that one spouse does not possess a separate interest in an entireties property. . . . Although the entireties estate was terminated upon conveyance of the Berwyck Property to Sandra, Don's interest in the property terminated at the same time. We are unaware of any precedent indicating that an entireties estate is automatically transformed into a tenancy in common as an intermediary step in the conveyance of the property. To the contrary, it is clear that at the time the entireties estate terminated, Sandra was vested with "full and complete title." Thus, Don

54. United States v. Waltman, 98-1 USTC ¶ 50,487 (S.D. Ind. 1998) (collecting cases).
55. United States v. Rodgers, 461 U.S. 677, 703 n.31 (1983).
56. United States v. Craft, 535 U.S. 274, 288-89 (2002).
57. 28 U.S.C. § 2410 (2006) waives the federal government's sovereign immunity to state law quiet title actions.
58. Craft v. United States *ex rel.* IRS, 94-2 U.S.T.C. ¶ 50,493 (W.D. Mich. 1994) (quoting Fischre v. United States, 852 F. Supp. 628, 630 (W.D. Mich. 1994)).

> never held an interest in the Berwyck Property to which the United States' lien could attach.[59]

The Sixth Circuit also rejected the government's alternative argument that the tax lien attached to some inchoate interest held by Mr. Craft. The Sixth Circuit recognized that the federal tax lien could attach to a future or contingent interest in property, but it read Michigan state law, as construed by the Michigan Supreme Court, as denying that Mr. Craft held any severable future interest in the T by E property.[60] Accordingly, "the federal tax lien could not attach to a future interest that did not exist under Michigan law."[61]

As in *Drye,* the Supreme Court reversed the Circuit court without adopting the district court's theory.[62] The Court instead used the analytical method it had used in *Drye* where it simply looked for any sliver of interest that state law gave Mr. Craft in the T by E property. It found plenty:

> [I]n Michigan, each tenant by the entirety possesses the right of survivorship. Each spouse—the wife as well as the husband—may also use the property, exclude third parties from it, and receive an equal share of the income produced by it. Neither spouse may unilaterally alienate or encumber the property, although this may be accomplished with mutual consent.[63]

These interests were more than enough to constitute property or rights to property "belonging to the taxpayer" to which the federal tax lien could attach.[64] The Supreme Court thought that whether Mr. Craft's interests were severable or nonseverable future interests under state property law was irrelevant. It was enough that "[t]hese rights . . . gave him a substantial degree of control over the entireties property, and, as we noted in *Drye*, 'in determining whether a federal taxpayer's state-law rights constitute "property" or "rights to property," [t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property.'"[65]

The role of state law is thus very slim in determining the scope of the federal tax lien. Whenever state law gives a taxpayer *any* right, enforceable under state law, to control or affect the use or disposition of any one of those rights that are commonly thought of as comprising the "bundle of sticks" that make up property, the federal tax lien attaches, regardless of whether state law labels those enforceable rights as property interests or not. Even contingent

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59. Craft v. United States *ex rel.* Comm'r, 140 F.3d 638, 643-44 (6th Cir. 1998) (internal citations omitted).

60. *Id*. (citing Sanford v. Bertrau, 169 N.W. 880, 881 (Mich. 1918)). "We think the better doctrine is that the right of survivorship is merely an incident of an estate by entirety, and does not constitute a remainder, either vested or contingent." *Sanford*, 169 N.W. at 881.

61. *Craft*, 140 F.3d at 644.

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

63. *Id*. at 282 (internal citations omitted).

64. *Id*. at 294.

65. *Id*. at 283.

future interests are subject to the tax lien.[66] As the liquor license cases show, it is irrelevant that the state legislature passes a statute that provides such rights are not property but are merely a privilege. As *Drye* and *Craft* show, it is irrelevant that the highest court of a state holds that those enforceable rights are not property for state law purposes. The federal tax lien will nonetheless stick to those legal interests, with consequences determined by federal law and with federal law controlling how the IRS may enforce the lien.

### *C. Enforcing the Federal Tax Lien*

Once the NFTL is filed, the IRS need do nothing more to enforce the federal tax lien. As in *Drye*, the IRS can choose to wait passively for the taxpayer to sell property encumbered by the lien, at which time the lien will be paid off from the sale proceeds in priority with other creditors' claims on that property. However, the IRS can also choose to actively seize and sell the property itself. It may seize property unilaterally through its administrative power of levy or judicially by seeking to foreclose the lien as to specified property. This part will discuss each method in turn.

#### *1. Administrative Levy*

Administrative levy is a "summary, non-judicial process, a method of self-help authorized by statute which provides the Commissioner with a prompt and convenient method for satisfying delinquent tax claims."[67] Specifically, § 6331 gives the IRS the power to levy, which § 6331(b) defines as "the power of distraint and seizure by any means."[68] Section 6332(a) requires that "any person in possession of (or obligated with respect to) property or rights to property subject to levy" must "surrender such property or rights" when properly served a notice of levy. A person subject to a federal levy has two, and only two, defenses to the levy: (i) that the person does not have possession of (or obligation with respect to) property or rights to property subject to levy;

66. Bigheart Pipeline Corp. v. United States, 600 F. Supp. 50, 53 (N.D. Okla. 1984), *aff'd*, 835 F.2d 766 (10th Cir. 1987) (holding that the federal tax lien attached to the right to receive proceeds from the oil and gas lease where, under Oklahoma law, the taxpayer—an oil and gas lessee—had only an incorporeal interest that did not vest the title to the oil and gas in the land but was simply a grant of a right to prospect for oil and gas).

67. United States v. Sullivan, 333 F.2d 100, 116 (3d Cir. 1964).

68. In its internal guidance, the IRS distinguishes between a "levy" and a "seizure," although the statutes make no such distinction. In Service jargon, a "seizure" is what is done to something that can be sold, usually tangible realty or personalty, while a "levy" is done to something that cannot be sold, generally intangible property such as payments due the taxpayer from a third party or money. *See generally* Internal Revenue Manual ("IRM") Part 5 (Collecting Process) at Chs. 5.10 (Seizure and Sale) and 5.11 (Notice of Levy), especially 5.11.1.1.2 ("Notice of Levy vs. Seizure"), *available at* http://www.irs.gov/irm/part5/ch10s01.html.

or (ii) that another court has already placed the subject property under its control.[69]

Three features of the administrative levy are important to understand for purposes of this article. First, it has extraordinary reach. Second, it is theoretically a provisional remedy. Third, it only attaches to property existing at the time it is served. Let's take a closer look at each feature.

The scope of the administrative levy is as broad as that of the tax lien, and courts use the same analysis to determine what constitutes "property or rights to property" of the taxpayer subject to levy.[70] Like the tax lien, the levy can reach "every interest in property that a taxpayer might have."[71] It allows the Service to step into the shoes of the taxpayer and exercise rights that state law would not allow any other creditor to exercise.[72]

Most importantly for this Article's purpose, the Service can exercise access rights to property, even property that may not belong to the taxpayer. The common example is a levy of a taxpayer's bank account held jointly with other depositors. Taxpayers have no rights to any specific dollars in bank accounts or similar arrangements but, instead, they have a right to withdraw.[73] It is this right to withdraw to which the tax lien attaches.

The leading case regarding the ability of the IRS to exercise *access* rights to an account is *United States v. National Bank of Commerce*, where the Service levied on two bank accounts at the National Bank of Commerce.[74] Each of the accounts had three account holders, only one of which was the delinquent taxpayer. The IRS had no idea what monies in the accounts belonged to which account holder but, nonetheless, demanded that the bank pay over the monies. Because Arkansas law gave the taxpayer an unqualified right to withdraw the proceeds of the joint account, the Supreme Court said that the right of withdrawal was the "property or rights to property" that both the federal tax lien attached to and the federal levy could seize. The IRS levy could thus require the payment of all monies in the account, regardless to whom those monies belonged.[75] Courts have used similar reasoning in authorizing the IRS

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69. United States v. Nat'l Bank of Commerce, 472 U.S. 713, 721-22 (1985) (reviewing cases).

70. *See, e.g.*, *id.* at 719. In addition, § 6331 authorizes the Service to levy any property "on which there is a lien provided in this chapter . . . ." I.R.C. § 6331. Thus, even if property ceases to belong to the taxpayer, if the federal lien attached to it at any time, then the lien stays attached and provides the basis for administrative seizure. *Id*.

71. *Nat'l Bank of Commerce*, 472 U.S. at 719.

72. *Id.* at 727.

73. *See generally In re* Bakersfield Westar Ambulance, Inc., 123 F.3d 1243, 1246 (9th Cir. 1997) ("By depositing money into a bank account, the depositor enters a debtor-creditor relationship with the bank. Title to the funds passes to the bank, and the depositor receives a contract claim against the bank for an amount equal to the account balance.") (citations omitted).

74. *See Nat'l Bank of Commerce*, 472 U.S. at 721-22.

75. The Court said that the remedy of filing suit against the United States for a wrongful levy was enough to protect the interests of the non-delinquent joint account holders. *Id.* at 728.

to levy all manner of annuity and retirement funds when the beneficiary has the contractual right immediately to withdraw the money sought.[76]

*National Bank of Commerce* also reveals a key limitation on the Service's administrative levy powers. Because the IRS steps into the shoes of the taxpayer, if state law places restrictions on the taxpayer's access rights to the funds, then those same restrictions bind the IRS.[77] For example, the Service will not use an administrative levy to cash out a retirement plan when the relevant non-tax law requires that lump sum payments may be made only with a non-delinquent spouse's consent.[78]

A key reason that the Supreme Court in *National Bank of Commerce* was so complacent about allowing the IRS to seize all the monies in the jointly held accounts was because of the second important feature of the administrative levy: it is a provisional remedy. It allows the Service to seize first and ask questions later. Third parties who have an interest in the property seized must come forward to assert their interest by filing suit in federal court under § 7426(a).[79] For example, where the IRS levied on a bank account held solely in the taxpayer's name and the bank turned over the proceeds from the account, it was up to the taxpayer to prove, which he did, that the monies in the account belonged entirely to the estate of his late father, for which he was the executor.[80] The fact that he was also the beneficiary of the estate did not give him a superior interest in the account over the estate, so the levy was wrongful.

The third important feature to understand about administrative levy concerns timing. Unlike the tax lien, the levy does not attach to after-acquired property but only to property rights and obligations that exist at the time of the levy.[81] An obligation exists when the liability of the person levied to the taxpayer is fixed and determinable, even if the right to receive payments is deferred until a later date.[82] So long as a present obligation exists, it does not

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76. For example, the court in Kane v. Capital Guardian Trust Co., 145 F.3d 1218, 1223 (10th Cir. 1998) held that:

> [The taxpayer's] right to liquidate his IRA and withdraw the funds therefrom (even if subject to some interest penalty) undoubtedly constituted a "right to property" subject to the IRS' administrative levy power under § 6331(a). Upon [the plan's] receipt of the notice of levy, the IRS stepped into [the taxpayer's] shoes and acquired *all* his rights in the IRA, including his right to liquidate the mutual fund shares in his IRA and withdraw the cash proceeds.

*Id.*; *see also* United States v. Metro. Life Ins., 874 F.2d 1497, 1500 (11th Cir. 1989) (holding that the IRS had immediate right to levy the full value of an annuity when the taxpayer "had the right to withdraw the full value of the annuity").

77. *Nat'l Bank of Commerce*, 472 U.S. at 722-23.

78. *See* I.R.S. Priv. Ltr. Rul. 200426027 (June 25, 2004).

79. The Supreme Court has recently held that a wrongful levy suit under § 7426(a) is the exclusive means for third parties to vindicate their interest in seized property. EC Term of Years Trust v. United States, 550 U.S. 429, 429 (2007).

80. *See* Craig v. United States, 89 F. Supp. 2d 858, 866 (S.D. Tex. 1999).

81. Treas. Reg. § 301.6331-1(a) (as amended in 1994). Section 6331(h) allows levies on a very limited set of recurring payments—notably wages—to have a continuous effect so that the service of a single levy will seize all future payments as well.

82. United States v. Hemmen, 51 F.3d 883, 890 (9th Cir. 1995) (determining that the levy seized a bankruptcy trustee's obligation to pay one of the creditors even when the levy was served before the

matter that the precise sum of the obligation cannot be measured until some point in the future. For example, a levy on a party-defendant being sued by the delinquent taxpayer captures any funds that party eventually becomes obligated to pay the taxpayer as a result of the suit.[83] In this way, an administrative levy can seize a *present* right to *future* payments.[84]

This timing rule sometimes limits the usefulness of administrative levies. For example, if the IRS serves an administrative levy on a bank at 1:00 p.m. in the afternoon, then the levy will seize only the monies on deposit with the bank at that moment. If the taxpayer has previously closed out her accounts moments before, then the levy will fail to seize the monies.[85] Likewise, additional funds put into the account after the levy hits are not captured by the levy.[86]

### *2. Lien Foreclosure Suit*

Section 7403 authorizes the government to institute a lien foreclosure suit and seek a judicial order authorizing the sale of property to which the federal tax lien is attached. The statute provides for a plenary proceeding that adjudicates all interests with respect to the property, somewhat similar to a quiet title action. All persons who claim any interest in the property must be given notice of the suit and joined as parties. Further, § 7403(c) provides that the court must "adjudicate all matters involved" and "finally determine the merits of all claims to and liens upon the property." Most importantly, however, the court may decree the sale of the property and order the distribution of the sale proceeds "according to the findings of the court in respect to the interests of the parties and of the United States."[87]

The chief advantage of this procedure over an administrative levy is that it allows the IRS to seize and sell property in which a taxpayer holds joint ownership and with respect to which the taxpayer does not have an unqualified right to withdraw or use as against the co-owners. Recall that the

bankruptcy estate was liquidated or the order of creditor payouts was determined by the bankruptcy court); *see also* United States v. Rockland Trust Co., 860 F. Supp. 895, 905 (D. Mass. 1994) (ruling that the levy served on a foreclosing mortgagor after the sale but before funds transferred was sufficient to reach the surplus funds generated by the sale).

83. United States v. Morey, 821 F. Supp. 1438, 1442 (W.D. Okla. 1993) (ruling that the levy served during pendency of the suit was sufficient to seize funds created by the eventual settlement of the suit).

84. *See* Rev. Rul. 55-210, 1955-1 C.B. 544, 545 ("[W]here a taxpayer has an unqualified fixed right, under a trust or a contract, or through a chose in action, to receive periodic payments or distributions of property, a Federal lien for unpaid tax attaches to the taxpayer's entire right, and a notice of levy based on such lien is effective to reach, in addition to payments or distributions then due, any subsequent payments or distributions that will become due thereunder, at the time such payments or distributions become due.").

85. *See, e.g.*, Resolution Trust Corp. v. Gill, 960 F.2d 336, 338 (3d Cir. 1992) (remanding to district court for factual findings on whether the taxpayer had closed out her retirements accounts before the 1:00 p.m. levy).

86. Treas. Reg. § 301.6331-1(a)(1) ("[A] levy has no effect upon any subsequent deposit made in the bank by the taxpayer. Subsequent deposits may be reached only by a subsequent levy on the bank.").

87. § 7403(c).

administrative levy allows the Service to seize a taxpayer's right of access to property. While this is useful for bank accounts, it is less useful for joint interests in realty. For example, if a delinquent taxpayer owned a half-interest in an apartment building, then the IRS could use the administrative levy to seize and sell only that half-interest. It would much rather seize and sell the entire building. Using § 7403, it can.

The leading case on § 7403 foreclosure actions is *United States v. Rodgers*.[88] There, the IRS had filed suit to foreclose the tax lien attached to a deceased taxpayer's home in Texas. The deceased taxpayer's wife, Mrs. Rodgers, did not owe taxes but, under Texas law, she did have homestead rights in the property, where she still lived. Article 16 of the Texas Constitution creates for spouses a species of property rights called homestead rights with respect to a declared homestead.[89] Similar to T by E property, one spouse may not alienate homestead property without the consent of the other spouse, regardless of how it is titled.[90] More importantly, even when one spouse dies, article 16, section 52 prohibits the partition, sale, or distribution of the property "during the lifetime of the surviving husband or wife, or so long as the survivor may elect to use or occupy the same as a homestead . . . ."

In *Rodgers*, the Fifth Circuit refused to allow the IRS to foreclose its lien:

> [W]hen a delinquent taxpayer shares his ownership interest in property jointly with other persons rather than being the sole owner, his "property" and "rights to property" to which the federal tax lien attaches under § 6321, and on which federal levy may be had under § 7403(a), involve only his *interest* in the property, and not the entire property.[91]

This decision gave the IRS an unpleasant choice: it could either wait until Mrs. Rodgers abandoned the property as homestead property or it could sell the deceased taxpayer's fractional interest in the property. But the Fifth Circuit thought the very definition of homestead property under state law prevented the IRS from seizing and selling the home as a whole.[92]

The Supreme Court reversed.[93] It recognized that a "Texas homestead right is not a mere statutory entitlement, but a vested property right."[94] State law, however, could not defeat federal law because "the power granted § 7403 is not the act of an ordinary creditor, but the exercise of a sovereign prerogative,

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88. United States v. Rodgers, 461 U.S. 677 (1983).

89. TEX. CONST. art. XVI, § 50.

90. *Id*. ("An owner or claimant of the property claimed as homestead may not sell or abandon the homestead without the consent of each owner and the spouse of each owner, given in such manner as may be prescribed by law."); *see also* Paddock v. Siemoneit, 218 S. W. 2d 428, 436 (1949) (holding that a spouse "has a vested estate in the land of which she cannot be divested during her life except by abandonment or a voluntary conveyance in the manner prescribed by law.").

91. United States v. Rodgers, 649 F.2d 1117, 1125 (5th Cir. 1981).

92. *See* TEX. CONST. art. XVI, § 50.

93. *Rodgers*, 461 U.S. at 677.

94. *Id*. at 686.

incident to the power to enforce the obligations of the delinquent taxpayer himself, and ultimately grounded in the constitutional mandate to lay and collect taxes."[95] The plain language in § 7403 allowed the IRS 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."[96] Thus, "[t]his clause in and of itself defeats the reading proposed by the Court of Appeals."[97] Accordingly, over the thoughtful dissent of four justices, the Court decided that § 7403 allowed the IRS to acquire rights *greater* than the delinquent taxpayer had under state law. Instead of simply stepping into the shoes of the taxpayer, federal law gave the IRS "the power to sell jointly owned property [even] if an unindebted co-owner enjoys an *indestructible* right [under state law] to bar a sale and to continue in possession."[98]

The Court was comfortable in reading the IRS statutory right so broadly, in contrast to the more limited power of administrative levy, because the IRS had to act through application to an Article III court and had to give notice to all others who also had rights to the subject property. Analogizing to a quiet title action, the Court noted that the statute allowed a "district court hearing a § 7403 proceeding to exercise a degree of equitable discretion and refuse to authorize a forced sale in a particular case."[99]

The tax lien and the powers to levy or file a foreclosure suit are enormously powerful collection tools that the IRS can use at its discretion. While state law has something to say about the scope of federal power, the undeniable trend in the case law has been to relegate state law from a leading role to a bit part and has resulted in the growth of a federal common law of property. Even so, there remain property law concepts that may help taxpayers make trusts impervious to the federal tax collector if and when a beneficiary becomes a delinquent taxpayer.

## III. THE INEFFECTIVENESS OF SPENDTHRIFT AND DISCRETIONARY TRUSTS

### *A. Red Rader Hypothetical*

A hypothetical will help put the law in context and allow the reader to see how various trust provisions might or might not be effective against the federal tax collector. Imagine an elderly, red-headed client, Eric "the Red" Rader, who has retired from a long and successful career as a salesman for Viking Range Corporation. In addition to considerable assets in stocks and bonds, he owns two vacation homes, one in Vail and one in Key West.

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95. *Id*. at 697 (internal quotation marks omitted).
96. I.R.C. § 7403(a) (2006) (emphasis added).
97. *Rodgers*, 461 U.S. at 692.
98. *Id*. at 713 (Blackmon, J., dissenting) (emphasis in original).
99. *Id*. at 705.

Red is a widower with one son, Darth, who is now forty years old. Darth Rader is a study in contrasts. His love for adventure has led to careers in emergency rescue operations and as an oil well control specialist. He has travelled the world saving people and putting out fires. While working in Saudi Arabia, Darth met and married his wife Padma, and they have twin children, Leia and Luke, who are now ten years old. But Darth's love of adventure has sometimes moved him to the darker side of life—gambling and associating with known drug runners. Last Christmas Darth gave Red a book entitled "Hide Your Assets and Disappear: A Step-by-Step Guide to Vanishing Without a Trace" by Edmund Pankau. Red thinks that Darth is getting mixed up in tax avoidance schemes involving Caribbean tax haven countries. Red is worried about Darth and about what his possible delinquencies might mean for Padma and his two grandkids, all of whom he loves dearly.

Red wants to create a trust in his Last Will and Testament for the benefit of Darth, Padma, Leia, and Luke. On his death, Red wants most of his estate liquidated, except for the two vacation homes. After making some charitable donations, he will put the residuary of the estate into a trust. He wants Darth and Padma to be life beneficiaries with the trust paying each of them the trust's yearly income and with the trustee having the power to invade the trust corpus if needed for their health. The grandchildren are to be the remaindermen, to take whatever is left in the trust upon the death of the survivor of Darth or Padma. Red is not sure whether he wants to give Darth or Padma power of appointment. As to the vacation homes, Red insists they be held in the trust and not sold. The trustee will be directed to use the trust's income for the upkeep of both vacation homes so that Darth and his family can enjoy them. Red wants the trustee to have broad discretion in renting out the vacation homes in order to help pay for their upkeep. To protect Darth's family, Red does not want Darth to be able to pledge any of the trust's assets to creditors and does not want creditors to be able to break into the trust and seize Darth's share. Red is particularly worried about the IRS. He should be.

### *B. Problems with Spendthrift Trusts*

One option Red has is to insert a spendthrift provision into the trust. Such provisions operate to restrain the voluntary or involuntary alienation of a beneficiary's interest in trust distributions or corpus, thus flummoxing creditor attempts to reach trust assets.[100] A typical provision that Red might use would read as follows:

> No trust assets or income shall be liable for the debts of any beneficiary, nor subject to seizure under any judicial writ or proceeding. No beneficiary shall have the power to give, grant, sell, assign, transfer, mortgage, pledge,

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100. *See generally* 4 KENNETH MCLAUGHLIN, JR., TEXAS PROBATE, ESTATE AND TRUST ADMINISTRATION, § 80.05[5] (Matthew Bender and Co., Inc. 2008) (collecting cases).

> encumber, or in any manner to anticipate or dispose of the interest in the trust estate or its income or to dispose of the interest in the trust estate or its income or to dispose of any trust property until it has been actually delivered to him in accordance with the terms hereof . . . .[101]

In Texas, spendthrift provisions are recognized by statute and enforced by courts. Section 112.035 of the Texas Property Code provides that a settlor "may provide in the terms of the trust that the interest of a beneficiary in the income or in the principal or in both may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee." Case law also recognizes that spendthrift provisions will "protect the beneficiary's interest in the trust corpus and income from claims of a beneficiary's creditors while the corpus and income remain in the trust and are held by the trustee."[102]

However, spendthrift provisions are totally ineffective against the federal tax lien. Recall that the tax lien attaches to any property or rights to property, and the levy can either seize the taxpayer's property or rights to property or enforce a valid lien attached to any property. Once state law recognizes a right, it is federal law that determines whether the tax lien attaches. Texas has long recognized a beneficiary's "equitable, even though untouchable" interest in trust assets (for example, the right to receive income from the trust on a yearly or other routine basis).[103] Accordingly, the tax lien can attach to that interest, and settlors cannot immunize any interest in a trust from the federal tax lien once that interest is created.[104]

It gets worse. Even though a trust beneficiary may not receive any actual income from a trust, the tax lien attaches to the *present* right to receive future distributions. Accordingly, once that lien attaches, the beneficiary cannot shake it off even by diving into the refreshing waters of bankruptcy. For example, in *In re Orr*, the taxpayer was the income beneficiary of a trust created by his grandfather's will.[105] The trust provided that Orr, after reaching a certain age, was to receive "all of the net income of the trust . . . distributed

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101. *See In re* Orr, 180 F.3d 656, 658 (5th Cir. 1999) (example taken from the trust at issue).

102. Burns v. Miller, Hiersche, Martens & Hayward, P.C., 948 S.W.2d 317, 321 (Tex. App.—Dallas 1997, pet. denied) (holding that the assets held in a valid spendthrift trust created for a judgment debtor by his deceased parents were exempt from the turnover provisions in section 31.002(a)(2) of the Texas Civil Practice and Remedies Code); s*ee also* First Bank & Trust v. Goss, 533 S.W.2d 93, 94-96 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ) (holding that a spendthrift trust's assets were exempt from garnishment).

103. United States v. Dallas Nat'l Bank, 152 F.2d 582, 586 (5th Cir. 1945) (holding that the tax lien attached to the beneficiary's interest in trust distributions despite the spendthrift clause).

104. Spendthrift trusts have been found to be ineffective against the federal tax lien in all states where the issue has been litigated. *See, e.g.*, First Nw. Trust Co. v. Internal Revenue Serv., 622 F.2d 387, 390 (8th Cir. 1980); United States v. Rye, 550 F.2d 682, 685 (1st Cir. 1977); Leuschner v. First W. Bank & Trust, 261 F.2d 705, 708 (9th Cir. 1958).

105. *In re Orr*, 180 F.3d at 656.

. . . annually or at more frequent intervals."[106] The trust also contained a standard spendthrift provision.

In 1992, the IRS assessed over $630,000 in income tax liabilities for multiple years against Orr and properly filed NFTLs for those liabilities in 1993. Orr filed his bankruptcy petition on November 1, 1995, and received a discharge of personal liability for the tax liabilities on May 21, 1996. However, although discharged from personal liability, the federal tax lien remained attached to any property or rights to property that belonged to Orr as of the bankruptcy petition date and passed through bankruptcy.[107] Therefore, the question in *Orr* was "whether a federal tax lien in this situation attaches to a spendthrift trust beneficiary's equitable interest in the trust itself or to each individual distribution as it is paid to the beneficiary."[108] If the property to which the lien attached was only each individual distribution, then the bankruptcy discharge would effectively cut off the IRS from taking part in any post-bankruptcy distributions from the trust. However, if the property to which the lien attached was Mr. Orr's *right* to all future distributions, then the IRS could enforce the lien as to *all future* distributions. That is, "the only way the IRS can collect from Orr's trust distributions is if the tax lien on future distributions attached before Orr's personal liability was discharged through bankruptcy."[109]

The Fifth Circuit used the standard two-step analysis described above to decide the scope of the federal tax lien: first, it determined what legal interest Texas law gave Orr in the trust; second, it determined the federal tax consequence of that legal interest.[110] After explaining Texas law, the court concluded:

> [A]t the time the liens were filed, Orr possessed equitable and legal rights to future income distributions from the Trust [notwithstanding the spendthrift clause]. With reference to federal law, we conclude that those rights constituted "property" or "rights to property" subject to attachment pursuant to § 6321. Because the federal tax lien attached to Orr's rights to future payments at the time of the filing of the lien, Orr's subsequent bankruptcy does not affect the validity of the lien against Orr's equitable ownership of the Trust and legal right to receive income distributions from

106. *Id.* at 657.

107. *See In re* Isom, 901 F.2d 744, 745-46 (9th Cir. 1990) (holding that the tax liens remained attached to the taxpayer's property despite the Chapter 7 discharge). This is a specific application of the settled general principle that a discharge in bankruptcy does not remove liens that attached and were perfected as to property of the debtor before the petition date. *See id*. Rather, such liens remain on the property and the property remains liable "in rem" for the debts secured by the liens. *See id.*; *see, e.g., In re* Thompson, 182 B.R. 140, 154 (Bankr. E.D. Va. 1995) (holding that after a bankruptcy discharge, a creditor can proceed in rem against property securing their claim). As the Supreme Court puts it, "liens pass through bankruptcy." Dewsnup v. Timm, 502 U.S. 410, 417(1992); Johnson v. Home State Bank, 501 U.S. 78, 84-86 (1991).

108. *In re Orr*, 180 F.3d at 661.

109. *Id.* at 662.

110. *Id.* at 659-64.

> the Trust. The tax lien is therefore valid against future income distributions.[111]

The practical effect of *Orr* is that a beneficiary's interest in a spendthrift trust is vulnerable to the federal tax lien. Worse, once the lien attaches, the IRS can either seize individual payments by repeated administrative levies, or it can foreclose on the entire interest by filing suit under § 7403. If it chooses the latter course of action, then the IRS can obtain a court order that the trustee distribute all future payments to the IRS, up to the amount secured by the lien.[112]

### *C. Problems with Discretionary Trusts*

The second approach Red could take toward protecting the trust's assets from Darth's potential tax troubles is to create some form of discretionary trust. Discretionary trusts come in many flavors, but they all have the common feature of removing the obligation of the trustee to pay income or corpus to a beneficiary and replacing that obligation with discretion, such that no beneficiary has the right to demand a distribution from the trust.[113] At the extreme, Red could give absolute discretion to the trustee, as follows:

> The Trustee may distribute any amount, including zero, of the income or principal from the Trust to Darth and Padma during their lives, as the Trustee, in his uncontrolled discretion, sees fit to give them, and neither Darth nor Padma shall have any right to compel the Trustee to pay any amount from the Trust to or for their benefit.

A more moderate discretionary trust would tie the discretion to some sort of ascertainable standard as in this example:

> The Trustee shall pay to or for the benefit of Darth and Padma so much of the Trust income or principal as the Trustee, in his absolute and uncontrolled discretion, decides is necessary to maintain their health, education, or current standard of living.

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111. *Id.* at 664.

112. United States v. Riggs Nat'l Bank, 636 F. Supp. 172, 177 (D.D.C. 1986) (holding that the protective trust with a forfeiture clause was inoperative against the federal tax lien, therefore ordering the trustee "to turn over to the United States at regular intervals, and no less than semi-annually, all income earned by said Trust from the date of this Order until the tax liabilities described above have been fully satisfied, or until the death of [the taxpayer], whichever first occurs.").

113. *See, e.g.*, Estate of Vak v. Comm'r, 973 F.2d 1409, 1410 (8th Cir. 1992) ("The trustees could elect to distribute or accumulate current income, in whole or in part, in their discretion. The trustees also had an unrestricted sprinkling power among the holders of the beneficial certificates for both corpus and income."). When a trustee is given discretion as between a group of beneficiaries, the discretion is sometimes called a sprinkling power. *See id*. A sub-type of discretionary trust is the protective trust, which grants beneficiaries defined rights until the happening of an event at which time it becomes a discretionary trust. The trust at issue in *Riggs Nat'l Bank*, 636 F.Supp. at 175-76 is an example of a protective trust.

Replacing a trustee's obligation to distribute trust assets with discretion has the same effect as a spendthrift provision because creditors cannot reach the funds until the trustee's discretion has been exercised and a distribution has actually been made.[114] However, provisions such as these differ from spendthrift trusts, at least in theory, in one crucial respect: whereas spendthrift provisions simply seek to regulate a beneficiary's recognized legal or equitable interest in trust assets, discretionary provisions avoid giving a beneficiary a recognized legal or equitable interest in the first place.[115] In theory, by vesting discretion in the trustee, a discretionary trust divests the beneficiary of any interest to which the federal tax lien can attach.[116]

Some states regulate the creation and operation of discretionary trusts by statute. For example, North Carolina defines a "discretionary trust interest" by statute.[117] Texas, however, recognizes discretionary trusts in case law, not by statute, and the extent of that recognition is unclear. While numerous federal courts in Texas have declared that Texas recognizes discretionary trusts, they all appear to rely on dicta in *Hughes v. Jackson*, an opinion authored by an intermediate Texas appellate court that was then adopted by the Texas Supreme Court in 1935.[118] The Texas Supreme Court has never, so far, cited *Hughes* for the proposition that Texas recognizes absolute discretionary trusts. In *Hughes* itself, the trust in question was for a limited purpose—the education of a beneficiary—with the trustee being given the discretion on when and how to accomplish that goal. The Texas intermediate court adopted a rule excerpted from a contemporary treatise on trusts.[119] A close reading of that excerpt and the surrounding passage indicates that it was discussing how beneficiaries of trusts that were created for a particular purpose could not alienate their interests because the settlor had limited their interests to the particular purpose stated. Neither the treatise nor the courts in *Hughes* were discussing the validity of a

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114. *See* RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. e (2001) ("A transferee or creditor of a trust beneficiary cannot compel the trustee to make discretionary distributions if the beneficiary personally could not do so.").

115. *See In re* Wilson, 140 B.R. 400, 404 (Bankr. N.D. Tex. 1992).

116. *See id*.

117. N.C. GEN. STAT. § 36C-5-504(a)(2) (2006) ("'Discretionary trust interest' means an interest in a trust that is subject to the trustee's discretion, whether or not the discretion is expressed in the form of a standard of distribution.").

118. Hughes v. Jackson, 125 Tex. 130, 81 S.W.2d 656 (1935). The federal courts relying on the *Hughes* case start with *In re Wilson*, 140 B.R. at 404, and include: *Bass v. Denney (In re Bass)*, 171 F.3d 1016, 1029 (5th Cir. 1999); *Tex. Commerce Bank Nat'l Ass'n v. United States*, 908 F. Supp. 453, 457 (S.D. Tex. 1995); *In re Young*, 297 B.R. 492, 496 (Bankr. E.D. Tex. 2003).

119. *Hughes*, 125 Tex at 136, 81 S.W. at 659. The court stated:

> This [purpose of education] was clearly the intention of the parties to the creation of the trust fund as shown by the testimony of Hughes and Cain and the other facts and circumstances of the record. Perry on Trust, Vol. 1, sec. 386a; Talley v. Ferguson, 64 W. Va., 328, 63 S. E. 456, 17 L. R. A. (N. S.) 1215. The opinion in Talley v. Ferguson, supra, quotes from Perry on Trust, supra. We think the law as there announced rules this case. We, therefore, also quote from Perry on Trust . . . .

*Id.*

trust that vested absolute discretion in a trustee—discretion both as to the operation of the trust and also as to its purposes. Nonetheless, at least one intermediate Texas appellate court has recognized the validity of a discretionary trust. [120] Thus, while the issue is not settled, it would be reasonable to predict that the Texas Supreme Court would at least recognize the idea of a discretionary trust and possibly would recognize even the extreme form of a discretionary trust rather than the limited discretionary trust at issue in *Hughes*.

That a discretionary trust can defeat the federal tax lien gains initial support from the fact that the IRS lost two of three recorded attempts in Texas to enforce its tax lien against discretionary trusts. In 1987. Judge Fitzwater of the Northern District of Texas permitted the IRS to levy on assets in a trust that contained a moderate type of discretionary clause, one that tied the trustee's discretion to an ascertainable standard.[121] In 1992, however, Judge Akard of the Bankruptcy Court in the Northern District of Texas rejected an IRS attempt to seize assets of a trust in *In re Wilson*. [122] He found that the trustee's discretionary powers were so absolute that the lien could not attach.[123]

In 1995, the IRS also lost *Texas Commerce Bank v. United States*, where Judge Harmon for the Southern District of Texas rejected the IRS's attempt to hold a bank liable for failing to honor a levy that sought to reach assets held in a trust.[124] The trust at issue provided that "the income of the trust was to be accumulated and retained by the trustee who was permitted to distribute . . . such amounts of the trust as, in the sole discretion of the trustee, may be in the best interests" of the taxpayer.[125] The trust provided that the taxpayer would have rights to the income and principal in 2002. Until then, however, it was the trustee's "sole discretion" to make payments.[126] The IRS tried to levy in 1993, but the bank ignored the levy and continued to make distributions to the taxpayer. In its defense against the suit for failure to honor the levy, the bank argued that, because it had "sole discretion" over when and whether to make any distribution to the taxpayer, it had no "property or rights to property" belonging to the taxpayer at the time of the levy.[127]

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120. Van Hoose v. Moore, 441 S.W.2d 597, 612 (Tex. Civ. App.—Amarillo 1969, writ ref'd n.r.e.) (construing a testamentary trust to be a discretionary trust).

121. *Wright v. United States*, No. 88-2655, slip op. at 6 (N.D. Tex. Aug. 11, 1989). The provision read that: "the Trustee *may* pay to [the taxpayer] or for his benefit so much or all of the income and principal of the trust . . . at such time or times as the Trustee, in the Trustee's *sole discretion*, believes desirable for the comfortable maintenance, health, education . . . best interest and welfare of [the taxpayer]." *Id.* The trust did not contain a spendthrift clause. *Id.*

122. *In re* Wilson, 140 B.R. 400 (Bankr. N.D. Tex. 1992)

123. *Id.* at 404.("[n]o standard or guide is attached to the [t]rustee's power.")

124. Texas Commerce Bank Nat'l Ass'n v. United States, 908 F. Supp. 453, 459 (S.D. Tex. 1995).

125. *Id.* at 455 (summarizing the trust provisions at issue and finding that this trust also had a standard spendthrift clause).

126. *Id.*

127. *Id.* at 455-56.

The court agreed with the bank that the taxpayer had no "property or rights to property" to which the levy could attach in 1995.[128] The court first considered whether the taxpayer had sufficient rights to current distributions. It concluded that the absolute nature of the trustee's discretion meant the taxpayer had no interest.[129] Second, the court considered whether the taxpayer had a present right to future income in 2002 when she would become entitled to mandatory yearly distributions. It concluded that there was no assurance that there would be any trust assets in 2002 because the trustee also had discretionary powers to distribute trust assets to other beneficiaries[130]

While these three cases some hope that discretionary trust language can fend off the federal tax lien, a careful practitioner would be foolish to rely on them, or to think that discretionary provisions will protect trust assets from the reach of the federal tax lien and levy powers, without further analysis. This is particularly true because both of the favorable cases were written before the Supreme Court's game-changing decisions in *Drye* and *Craft* discussed in Part II.B. above. Thus, the lower court case law may no longer provide much support, much less the proper analysis.

Properly analyzed, discretionary trusts have four potential holes that the careful practitioner must try to close so that the federal tax lien cannot pierce the trust and attach to trust assets: (1) the tension between discretion and ascertainable standards contained in the trust instrument; (2) trust provisions that may be inconsistent with absolute discretion; (3) beneficiaries who have different types of interests in different types of trust property; and (4) the inherent equitable interests of all beneficiaries to certain standards of conduct by a trustee, no matter how much discretion the trust instrument purports to give. As discussed below, it may not be possible to satisfactorily address all of these problems so as to block the IRS tax lien from attaching to trust assets.

### *1. Ascertainable Standards*

The hole is created by the inherent tension between language giving the trustee discretion and language giving the trustee guidance as to the purpose of the trust. I submit that the more the settlor attempts to guide the trustee as to the administration of the trust—by using support trust terms such as "education," "needs," or "maintenance"—then the more likely the settlor will have given beneficiaries a legal interest in the trust assets to which a federal tax lien can attach.

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128. *Id*. at 456.

129. *Id*. at 458-59 ("to the extent that [the taxpayer] was entitled to wholly discretionary distributions from the trust in June 1993, there was no interest to which the IRS's levy could attach.").

130. *Id*. at 459 ("[s]ince [the taxpayer's] right to receive income payments after November 3, 2002 is clearly a contingent, non-vested, and non-determinable right, the IRS's levy in June 1993 could not reach it.").

For example, the inclusion of support language was fatal in the *Wright* case in which the IRS was able to enforce the tax lien against a beneficiary.[131] Likewise, in *United States v. Taylor*, the trust instrument contained the following language that was inconsistent with the notion of an absolute discretionary trust: "The [T]rustees shall pay to or apply for the benefit of my son, LEE JONES, JR., so much of the net income of said trust, up to the whole thereof, as the Trustees may from time to time deem necessary or advisable for his proper care, maintenance and support."[132] The *Taylor* court held that the language establishing a standard for the trustee meant that the trust was a support trust, and the "taxpayer has a lifetime, enforceable, equitable right to support from the income of the trust."[133] Accordingly, the tax liens attached, and the trustee was directed to pay over to the government all amounts that could be paid to the beneficiary.[134]

Practitioners should not ignore *Taylor* just because it came out of California! Courts in other jurisdictions have come to similar conclusions when discretionary trust language bumps up against language creating an ascertainable standard. For example, in *United States v. Delano*, the federal district court in Colorado held that the following trust language did not prevent the tax lien from attaching:

> During my son's lifetime, my trustee shall pay to or apply for the benefit of my son so much of the income or principal, or both, as my trustee in its sole and absolute discretion shall deem necessary or advisable for his maintenance, health, education, comfort and welfare. My trustee may, but need not, consider all funds known to my trustee to be available to him. Any undistributed income may be added to principal from time to time in the discretion of my trustee.[135]

The court rejected the argument that the "sole and absolute discretion" language permitted the trustee to make no payments:

> [T]he word 'shall' directly precedes the word 'pay' while the 'sole and absolute discretion' follows 'so much of the income or principal, or both.' Accordingly, the court concludes that the . . . trustees' discretion relate[s] only to the amount of the payment and whether it came from trust income, principal, or both.[136]

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131. *See supra* note 121.

132. United States v. Taylor, 254 F. Supp. 752, 754 n.1 (N.D. Cal. 1966).

133. *Id*. at 755.

134. *Id*. at 756 ("The trust being one fundamentally for support, the taxpayer has a basic beneficial right to receive payments from income to the extent needed for his support. It follows that the government liens have attached to and subsist against that right.").

135. United States v. Delano, 182 F. Supp. 2d 1020, 1022 (D. Col. 2001).

136. *Id.*; *see also* Magavern v. United States, 550 F.2d 797, 801 (2nd Cir. 1977) (stating that the language "Trustee shall pay over or use, apply and expend whatever part or all of the net income or principal" created a property right to which the lien could attach, notwithstanding the discretionary language, because

Practitioners should further be aware that, in non-tax contexts, the Texas Supreme Court has itself resolved conflicting language in favor of creating enforceable support trusts as opposed to unenforceable discretionary trusts. Thus, in *State v. Rubion*, the state was seeking contribution from a testamentary trust for the costs of supporting the disabled beneficiary in a state institution.[137] The trustee claimed that provisions in the will giving the trustee broad discretion as to the operation of the testamentary trust allowed the trustee to refuse to pay for the costs that the state incurred in keeping the beneficiary. The Texas Court of Appeals had agreed that the ambiguities in the will, coupled with extrinsic evidence, meant that the trustee had absolute discretion to refuse to make any payments for the beneficiary while she was in the state institution.

The Supreme Court of Texas reversed. It first recognized that the question was "whether [the beneficiary] can enforce a demand for the delivery of all or a part of the trust property for her present support." [138] The court thought that question "must depend upon the intention of the testatrix, for the testatrix had a legal right to devise her property as she saw fit and to prescribe the terms upon which her bounty should be enjoyed."[139] Construing the trust as a whole, it held that the support-type language in the will did not create an ambiguity but instead trumped the discretionary language:

> It is undoubtedly true that the will gives the respondent broad powers of management of the trust estate to provide "a means for the support" of the beneficiary and invests him with wide discretion in the use of the income or corpus, or both, when "the exigencies of the situation" require. On the other hand, the central and controlling language of the will is that the trust property shall be used for the "support and maintenance" of the beneficiary "both in sickness and health." That language, it seems to us, expresses the true intention of the testatrix.[140]

One commentator suggested in 1983 that courts are wrong in their attempt to read trusts as being either support trusts or discretionary trusts.[141] She argued that courts should recognize a hybrid type of trust which she calls the "discretionary support trust."[142] Similarly, the Restatement (Third) of Trusts

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the trustee did not have the discretion to deny a particular beneficiary anything at all); La Salle Nat'l Bank v. United States, 636 F. Supp. 874, 876 (N.D. Ill. 1986) (finding that the word "shall" indicated the settlor's intent that the trustee was obligated to pay and that the discretionary language just went to amount); State *ex rel.* Sec'y of Soc. Rehab. & Servs. v. Jackson, 822 P.2d 1033, 1038-39 (Kan. 1991) (finding that the discretionary language did not create a discretionary trust because the trust also contained mandatory language that controlled the distribution and that the discretionary language controlled only the amount and timing of the payments).

137. State v. Rubion, 308 S.W.2d 4, 5-6 (1957).

138. *Id*. at 8.

139. *Id*.

140. *Id*.

141. Evelyn Ginsberg Abravanel, *Discretionary Support Trusts*, 68 IOWA L. REV. 273, 277 (1983).

142. *Id*.

does not draw a bright line between discretionary and support trusts but basically views all trusts as having some combination of discretionary features and support standards.[143] And a few jurisdictions have abandoned an either/or position between support trusts and discretionary trusts.[144] However, most courts continue to "use the designation 'support trust' and 'discretionary trust' to label, respectively, those trusts from which distribution can be compelled as opposed to those in which the trustee's broad discretion is controlled only by the duty of loyalty and obligation of good faith."[145] And Texas courts appear to favor finding that trusts with competing provisions are support trusts.[146]

For tax lien purposes, the concept of a discretionary support trust is not analytically useful. Nor does it matter how ascertainable standards are blended with discretion for the trustee. The relevant analysis remains: to what extent does a beneficiary have enforceable rights in trust assets? To the extent that courts in Texas, and elsewhere, read support provisions as providing enforceable rights regardless of discretionary provisions, then that creates "property or rights to property" for federal tax lien purposes.

To summarize this first potential hole, if the trust instrument contains any kind of objective standard for uses of the trust income or principal, then that expression of the settlor's intent will likely be read as trumping any discretionary language and will create a legal interest under Texas law that is then subject to the federal tax lien, even if it may not be subject to the claims of ordinary creditors.

### *2. Provisions Inconsistent with Discretion*

The second potential hole in discretionary trusts is trickier to find Even if the careful practitioner plugs the first hole by convincing the client to rigorously eliminate any mention of purpose in the trust instrument and by carefully avoiding language that contradicts the trustee's absolute and unfettered discretion, other typical trust provisions can still make the trust assets vulnerable to the federal tax lien. For example, in our hypothetical, Red may want to give Darth and/or Padma powers of appointment over the residuary of the trust so that they can deal with unforeseen events. A power of appointment

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143. The Reporter's Notes in the Third Restatement of Trusts states the following:

> The fact of the matter is that there is a continuum of discretionary trusts, with the terms of distributive powers ranging from the most objective (or "ascertainable," IRC § 2041) of standards (pure "support") to the most open ended (e.g., "happiness") or vague ("benefit") of standards, or even with no standards manifested at all (for which a court will probably apply "a general standard of reasonableness."

RESTATEMENT (THIRD) OF TRUSTS § 60, reporter's note to cmt. a (2003).

144. *See* Strojek by Mills v. Hardin County Bd. of Supervisors, 602 N.W.2d 566, 571 (Iowa Ct. App. 1999); Smith v. Smith, 517 N.W.2d 394, 398 (Neb. 1994).

145. Lang v. Commonwealth, 528 A.2d 1335, 1344 (Pa. 1987) (collecting cases).

146. *See, e.g.*, Keisling v. Landrum, 218 S.W.3d 737, 744 (Tex. App.—Fort Worth 2007, pet. denied) (using State v. Rubion, 308 S.W.2d 4 (1957), to analyze discretionary provisions with support provisions and concluding that "like the testatrix in *Rubion*, [the settlor] created a support trust").

is exactly the kind of "rein of control" that the United States Supreme Court held could be subject to the federal tax lien, as discussed above regarding the *Drye* case.[147] There the Supreme Court held that the right to disclaim under state law was property under federal law and concluded that "despite the State's characterization, the heir possessed a 'right to property' in the estate—the right to accept the inheritance or pass it along to another—to which the federal lien could attach."[148] Remember, too, that once the federal tax lien attaches, the IRS has a variety of ways to enforce the lien, including the nuclear bomb of a lien foreclosure suit under § 7403.[149]

Spendthrift clauses may also inadvertently create an interest in trust assets to which the tax lien can attach. In the two Texas federal court cases discussed above—*In re Wilson* and *Texas Bank of Commerce*,— where the IRS was not allowed to enforce its tax lien against the assets of a discretionary trust, each trust contained a typical spendthrift clause. Both federal courts apparently missed the true significance of that clause in their analyses. However, Texas state courts have not overlooked the significance. In *Burns v. Miller, Hiersche, Martens & Hayward, P.C.*, a law firm attempted to collect a judgment from the assets of a trust by using the powerful Texas turnover statute.[150] The turnover statute allows creditors to reach all assets of a judgment debtor except those specifically exempted from its reach.[151] The law firm argued that the spendthrift trust assets could not be considered exempt because they were not the judgment debtor's property at all. In other words, the law firm argued that the spendthrift provisions deprived the judgment debtor of any interest in the trust assets; therefore, the assets could not be exempt because the trustees of the trusts owned the assets. This, of course, reads the effect of spendthrift provisions exactly *backwards*, as the Fifth District Court of Appeals noted:

> While this is a novel argument, it has no merit. The trustee of a trust holds bare legal title and the right to possession of trust assets, while the beneficiary is considered the real owner of the property, holding equitable or beneficial

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147. *See supra* notes 46-49 and accompanying text.

148. United States v. Craft, 535 U.S. 274, 278 (2002) (citing Drye v. United States, 528 U.S. 49, 59-61 (1999)).

149. Before the *Craft* case, the IRS would likely have taken the position that it could not leverage the lien on the appointment power to seize all trust assets because he cannot use that specific power to gain unrestricted access to the entire trust principal. This would be analogous to the life insurance issue in *United States v. Bess*, where the Supreme Court noted that the "right to change the beneficiary, even to designate his estate to receive the proceeds, gives him no right to receive the proceeds while he lives." United States v. Bess, 357 U.S. 51, 55 (1958); *see* I.R.S. Chief Couns. Adv. 200036045 (May 16, 2000), *available at* http://www.unclefed.com/ForTaxProfs/irs-wd/2000/0036045.pdf. However, since *Craft*, the IRS might believe that the power to divert the entire trust corpus can be seized and used to divert the assets to the IRS.

150. *Burns v. Miller, Hiersche, Martens & Hayward, P.C.*, 948 S.W.2d 317,320 (Tex. App.—Dallas 1997, pet. denied).

151. TEX. CIV. PRAC. & REM. CODE ANN. § 31.002 (Vernon 2008). The turnover statute allows creditors to overcome normal procedural barriers in reaching the assets of debtors. *Id*. For example, the turnover statute authorizes a court to compel a debtor to execute documents that will aid in collecting a judgment debt. *Burns*, 948 S.W.2d at 328.

> title. **Furthermore, unless trust beneficiaries had an ownership interest in trust assets, spendthrift provisions disabling them from alienating that interest would be superfluous.** We conclude that [the beneficiary] has an ownership interest in the spendthrift trust assets at issue and that those assets are exempt property in terms of the turnover statute.[152]

Accordingly, if an otherwise discretionary trust also contains a spendthrift provision, then the IRS will argue—and most likely win—that the beneficiary must have some legal interest in the trust that the spendthrift provision operates on.

### *3. Different Types of Trust Property*

The third hole that could allow the tax lien to invade discretionary trusts has less to do with particular language in a trust instrument than it does the type of property held by the trust. In our example, the trust will contain both personalty and realty—the two vacation homes. Although the vacation homes will be titled in the name of the trustee, the beneficial use of the homes is meant for Darth and Padma. Looking closely at the analysis from *Drye* and *Craft*, the federal tax lien can attach to *any* one of the sticks that make up the bundle of sticks in a property, so long as that stick is recognized and protected by state law.

Any trust that contains realty and gives the beneficiaries some right regarding that realty, other than the right to the income that the realty might produce, is vulnerable to the federal tax lien. Take, for example, the right to use the property. The Supreme Court recognized a use interest as one of the more important "sticks" in the bundle that federal law recognizes as property rights.[153] If the trust instrument gives Darth and Padma a right to use the vacation homes and if Texas law will allow them to enforce the right, then the federal tax lien will attach.[154]

Once the tax lien attaches to any interest in realty, the lien can then be enforced through a § 7403 lien foreclosure suit, and the IRS can force the sale of the entire realty. Remember "the government has the right in a section 7403 proceeding to seek a forced sale of the entire property in which a delinquent taxpayer has an interest even where innocent others also have an interest in the property. This special privilege arises from the express terms of section 7403 . . . ."[155]

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152. *Burns*, 948 S.W.2d at 322 (citation omitted) (emphasis added).

153. *Craft*, 535 U.S. at 283 (citing Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419, 435 (1982)).

154. *See* United States v. Rodgers, 461 U.S. 677, 693 (1983).

155. Markham v. Fay, 74 F.3d 1347, 1354, n.5 (1st Cir. 1996).

### *4. Inherent Beneficiary Rights*

It gets worse. Even if the cautious practitioner does everything right and carefully drafts the trust instrument to close up the three holes described above—even if the client agrees to create a trust vesting *absolute* discretion to all future trustees, agrees to keep realty out of the trust, and agrees that beneficiaries shall not have power of appointment—there still remains one last problem that could cause assets in the trust to become impressed with the federal tax lien if a beneficiary becomes a delinquent taxpayer.

As I discussed above, until the Supreme Court declared otherwise in *Drye*, it was the general rule that the federal tax lien would attach only to a state property right that was transferable and that had pecuniary value.[156] As long as the key issue was the extent to which a state-granted interest in property was transferable, or alienable, then discretionary trusts were a reasonable method to insulate trust property from the federal tax lien because discretionary trusts avoided giving beneficiaries a transferable interest in trust income or corpus. And, empirically, we can find two examples of where discretionary trusts appeared to have successfully deflected the federal tax lien in Texas.[157]

That all changed in 1999, after the two supporting cases in Texas were decided. It was that year that the Supreme Court in *Drye*, rejected transferability as the analytical touchstone.[158] As it later elaborated in *Craft*, the true test was to search for *any* one of the bundle of sticks that commonly are thought of as comprising property:

> 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.[159]

Under this new analytical paradigm (some might say it has always been the true analytical paradigm), if a court determines that state law gives a taxpayer rights that will be enforced by state law, then federal law swoops in to claim those rights as property. The place to start, then, is Texas law. Texas law takes a broad view of what constitutes property for purposes of the Trust Code: "'Property' means any type of property, whether real, tangible or intangible, legal, or equitable. The term also includes choses in action, claims, and contract rights, including a contractual right to receive death benefits as

156. *See supra* notes 37, 43-49; *see, e.g.*, Drye Family 1995 Trust v. United States, 152 F.3d 892, 895 (8th Cir. 1998) ("In enforcing § 6321, appellate courts have interpreted 'property' or 'rights to property' to mean state-law rights or interests that have pecuniary value and are transferable.").

157. Tex. Commerce Bank Nat'l Ass'n v. United States, 908 F. Supp. 453, 457 (S.D. Tex. 1995); *In re* Wilson, 140 B.R. 400, 404 (Bankr. N.D. Tex. 1992).

158. Drye v. United States, 528 U.S. 49, 51 (1999).

159. *Id.* at 277 (citation omitted).

designated beneficiary under a policy of insurance, contract, employees' trust, retirement account, or other arrangement."[160] But it bears emphasizing that the state definition of property is only a starting point. Rather than accept a state law label, one must first look at the specific legal interests, then one must determine whether they are property within the meaning of § 6121—the federal tax lien statute.

Even as to the purest of pure discretionary trusts, trustees have certain state law duties which give the beneficiaries corresponding rights. Heck, it would not be a trust otherwise. Even absolute discretion is not absolute, as the Restatement of Trusts explains:

> [W]ords such as "absolute" or "sole and uncontrolled" or "unlimited" are not interpreted literally. It is contrary to sound policy, and a contradiction in terms, to permit the settlor to relieve a trustee of all accountability. Even under the broadest grant of fiduciary discretion, a trustee must act honestly and (as cases have sometimes quoted from prior Restatements) "in a state of mind contemplated by the settlor." What this means is that courts will intervene to prevent trustees from acting in bad faith, or without regard to the terms and purposes of the trust or the interests of its beneficiaries, or for some purpose or motive other than the accomplishment of the purposes of the discretionary power. Except to the extent the power is for the personal benefit of a beneficiary-trustee, the court may also be called upon to prevent the trustee from failing to act, whether capriciously, arbitrarily, or from a misunderstanding of the trustee's powers or duties.[161]

Specifically, Texas law imposes the following duties on trustees, duties that give beneficiaries corresponding rights to have judicially enforced: (1) the duty not to self-deal; (2) the duty of fidelity to the interest of the beneficiary; (3) the duty to exercise reasonable care and skill in preserving and managing trust property; (4) the duty to enforce claims of the trust; (5) the duty to deal impartially with beneficiaries; (6) the duty to keep accounts and furnish information; and (7) the duty to keep trust property separate.[162] The Texas Supreme Court summed it up this way:

> The discretion with which a trustee of a support trust is clothed in determining how much of the trust property shall be made available for the support of the beneficiary and when it shall be used is not an unbridled discretion. He may not act arbitrarily in the matter, however pure may be his motives. His discretion must be reasonably exercised to accomplish the

160. TEX. PROP. CODE ANN. § 111.004(12) (Vernon 2007).

161. RESTATEMENT (THIRD) TRUSTS § 87 (2005) (citation omitted).

162. *See generally* Kenneth McLaughlin, Jr., Texas Probate, Estate and Trust Administration, § 81.21 ("Duties of Trustee") (collecting cases); *see also* Jochec v. Clayburne, 863 S.W.2d 516, 518-19 (Tex. App.—Austin 1993, writ denied).

purposes of the trust according to the settlor's intention and his exercise thereof is subject to judicial review and control.[163]

Beneficiaries who believe that a trustee has violated some or all of these can obtain and have obtained both judicial review and damages, both in Texas and elsewhere.[164]

State law thus gives all beneficiaries of all types of trusts equitable rights, such as equitable rights in the proper maintenance and investment of the trust property, equitable rights to fair treatment as to even discretionary distributions, and equitable rights to fair dealing as between them and other beneficiaries, either income or remaindermen. Now the inquiry becomes whether those interests amount to "property or rights to property" within the meaning of § 6121. It is difficult to see why not.

The Supreme Court has repeatedly insisted that "Congress meant to reach every interest in property that a taxpayer might have."[165] Equitable rights are unquestionably "rights to property" to which the tax lien can attach.[166] There is still a question of how may the IRS enforce its lien against those rights. Also, there is the question of what dollar amounts those rights have. However, uncertainty as to value does not change the nature of the interests that can count as property or rights to property. In enforcing the tax lien against a discretionary trust, one court noted that the "taxpayer's property right in the trust at bar differs from any other property right only in that it has no permanently fixed dollar value."[167] In this situation, there is some utility to discretionary provisions. They can prevent the IRS from vindicating the tax lien through administrative levy and, instead, force the IRS to unleash its mightiest weapon, which is the lien foreclosure suit under § 7403.[168]

163. State v. Rubion, 308 S.W.2d 4, 9 (Tex. 1957) (citations omitted).

164. *See, e.g.*, *Jochec*, 863 S.W.2d at 516. A jury awarded a substantial judgment because of a trustee's conflict of interest, but the case was reversed by the appellate court for failure of the trial court to instruct the jury on waiver. *Id.* at 521-22; *see also In re* Scheidmantel Trust, 868 A.2d 464, 481 (Pa. Super. 2005) (punishing the trustee for an unreasonable exercise of the "absolute discretion" conferred by the trust instrument and finding that "even when there is no evidence of bad faith or improper motive, the exercise of discretion by trustees is subject to the limitation that they must not act outside 'the bounds of reasonable judgment.'"); Wiggins v. PNC Bank, 988 S.W.2d 498, 501-02 (Ky. App. 1998) (awarding the beneficiaries damages from a trustee's abuse of discretion and violation of its duty of impartiality by favoring one set of beneficiaries over another by invading trust principal); Jones v. Jones, 30 N.Y.S. 177, 183-84 (1894) (removing a trustee for abusing discretion by favoring one beneficiary over others).

165. United States v. Nat'l Bank of Commerce, 472 U.S. 713, 719 (1985).

166. IRS v. Orr, 180 F.3d 656, 664 (5th Cir. 1999) (holding that the tax lien attached not only to trust distributions already made but also to the beneficiary's equitable interest in future trust distributions).

167. United States v. Taylor, 254 F. Supp. 752, 756 (N.D. Cal. 1966).

168. *Compare* Magavern v. United States, 550 F.2d 797, 801 (2d Cir.1977) (interpreting a trust's discretionary language as giving the trustee the duty to not deny payment to each beneficiary and ordering the trustee to honor an administrative levy by making the same payments to the IRS where the trustee had made regular payments to the taxpayer prior to the administrative levy) *with* First of Am. Trust Co. v. United States, 93-2 USTC ¶ 50,507 (C.D. Ill. 1993) (interpreting a trust's discretionary language concerning the invasion of principal as controlling over mandatory language thus refusing to allow the IRS to enforce the administrative levy).

In sum, a discretionary trust will be vulnerable to the federal tax lien if the trust language inadvertently gives the beneficiary any type of property interest. Even if the settlor intends to create an unfettered zone of trustee discretion, the inclusion of contrary language creating some ascertainable standard, the inclusion of inconsistent provisions such as spendthrift or power of appointment provisions, and the inclusion of different types of property in which the beneficiary might have different sticks of enforceable interests, all work to destroy the trust's ability to withstand the attachment of the federal tax lien. It is even likely that under the analytical method adopted by the Supreme Court in *Drye* and *Craft*, the equitable interests created by state law for any beneficiary of any trust will be "property or rights to property" for purposes of the federal tax lien statute. Moreover, once that federal tax lien attaches, it's all over except for the litigation on just how the IRS can vindicate the lien.[169]

## IV. TAX LIEN LOCKOUT PROVISIONS

Although a prudent practitioner would not advise Red Rader to rely on a discretionary trust to prevent the IRS from reaching trust assets to satisfy Darth's potential tax liabilities, a practitioner can still help Red achieve his goals. In fact, Red can make the trust a true support trust for Darth and Padma, can give Darth powers that will constitute property under federal law—such as a power of appointment—and can even include realty in the trust to which Darth has use rights. Red can do all this with every confidence that none of the property will be subject to the IRS tax lien should Darth screw up his federal taxes. He can do this using the concept of shifting executory interests, as illustrated in the following sample trust provision:

> The Trustee shall pay at regular intervals so much of the income from the Trust as the Trustee judges to be appropriate for Darth or Padma's support. The Trustee may pay, in the Trustee's sole discretion, so much of the Trust principal as is necessary for Darth or Padma's medical or emergency needs. The Trustee shall manage my two vacation homes and allow Darth or Padma reasonable access to use them from time to time for vacations. However, on the earliest day on which any triggering event occurs, Darth shall cease to be a beneficiary of this Trust and his rights and interests in this Trust shall shift to the remaindermen (his children), share and share alike, until such time as all revesting conditions have occurred, at which time the rights and interest he lost shall shift back to Darth and he shall once again be a beneficiary of this Trust as before. The triggering events are: (1) Darth's failure to timely file a required tax return, or to fully and timely pay a federal tax liability reported on his filed return; (2) the IRS's sending Darth either (i) a Notice of Deficiency or (ii) a notice of a proposed assessment of an assessable penalty or (iii) a notice that his return has been selected for

169. *See, e.g.*, Markham v. Fay, 74 F.3d 1347, 1347 (1st Cir. 1996) (discussing various ways that the IRS can enforce a lien on beneficiary rights in a trust).

> examination; (3) the commencement of federal bankruptcy or state receivership proceedings regarding Darth; or (4) a determination by an authorized IRS employee that at least one of the conditions described in sections 1.6851-1 or 1.6861-1 of the Treasury Regulations exist with respect to Darth, if such determination results in a termination or jeopardy assessment. The revesting conditions are (1) Darth has fully satisfied all outstanding federal tax liabilities; (2) there are no outstanding, enforceable, federal tax liens against Darth; (3) all Notices of Deficiency or notices of proposed assessments of an assessable penalty have been resolved, either by (i) the IRS agreeing or being required to make no assessment of any further taxes or penalties against Darth or (ii) Darth fully paying any taxes or penalties proposed by the notices that the IRS becomes authorized to assess either by Darth's action or court order; and (4) any claims for taxes made by the IRS in federal bankruptcy or state receivership proceedings have been resolved. The word "tax" has the meaning given to it by the Internal Revenue Code.

Texas property law recognizes that a grantor can condition a grant on the occurrence of an event that, if and when it occurs, will automatically divest the grantee of the property rights given and pass those property rights to another person.[170] The grantee's interest is called a determinable interest subject to an executory limitation, and the term "executory limitation denotes an event which, if and when it occurs, will automatically divest the grantee of the property."[171] The person who automatically gets the property interest upon the occurrence of the event has what is called a shifting executory interest.[172] In the example above, Darth has a determinable property interest subject to an executory limitation, and Darth's children have shifting executory interests.[173]

Properly used, shifting executory interests will effectively protect trust assets from the federal tax lien. In order for the federal tax lien to attach, there must be "property or rights to property" within the meaning of § 6121, and, as discussed above, courts start with state law to determine what interests state law gives the taxpayer in the property at issue at the time the tax lien arises. A

170. *See* Deviney v. Nationsbank, 993 S.W.2d 443, 448 (Tex. App.—Waco 1999, pet. denied) (collecting cases).

171. *See id*.

172. Now it might be that upon the occurrence of the event, the grant merely ceases, in which case the event works a forfeiture. If the interest revests in the grantor, it is called a springing executory interest. *See, e.g.*, Peveto v. Starkey, 645 S.W.2d 770, 771 (Tex. 1982). There, the grantor made out two deeds—the first to Mr. Peveto and the second to Mr. Starkey—each conveying the same interests in oil and gas royalties. *Id*. To prevent overlap, the second deed expressly provided that it would become effective only on the expiration of first deed. *Id*. The grant to Mr. Peveto was an interest subject to an executory limitation. *Id*. at 772. If the condition occurred, then the interest would spring back to the grantor, who then had re-granted the interest to Mr. Starkey. *Id*. So the interest was called a springing executory interest. *Id*. If the deed to Mr. Peveto had provided that the royalty interests would shift to Mr. Starkey upon the occurrence of the event, then Mr. Starkey would have had a shifting executory interest. *See id*.

173. *See e.g.*, Gutierrez v. Rodriguez, 30 S.W.3d 558, 560-62 (Tex. App.—Texarkana 2000, no pet.) (finding the holders of shifting executory interests estopped from claiming interests once having signed quitclaim deeds before the events triggering the shift occurred).

properly written trust instrument will have divested Darth of any enforceable interests in the trust assets before the time the tax lien arises and will have shifted them to his children. Once the shift occurs, he will have ceased to be a beneficiary of the trust, and his children will succeed to his life estate in the trust.

If and when Darth's interest shifts, then his children will take that life estate subject to an executory limitation—that Darth cleans up his act and gets rid of all outstanding tax liabilities. It is true that the condition subsequent also gives Darth a shifting executory interest. But the federal tax lien cannot attach to a shifting executory interest because a *present* right does not exist; rather, the right depends on unknowable future events.[174] A lien cannot attach to future property rights that depend on future events. The long-settled example of this is wages: the federal tax lien cannot attach to future wages until the employer's obligation to pay them to the employee arises, at which time the lien attaches and may be enforced by levy.[175] Even the federal government admits that.[176]

The curious practitioner may have several questions about the idea of using shifting executory interests to block the federal tax lien from attaching to trust assets. First, why not simply use a forfeiture provision? Second, what should be the proper trigger for the shift? Third, what is the interplay of shifting interests and community property rules in Texas? I shall address each of these in turn.

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174. *See* Texas Commerce Bank Nat'l Ass'n v. United States, 908 F. Supp. 453, 459 (S.D. Tex. 1995). The district court got it right in *Texas Commerce Bank Nat'l Ass'n*, where the taxpayer (Elly) was the beneficiary of a trust which was a "pure" discretionary trust until 2002 when she would become vested and entitled to mandatory distributions. *Id*. The court properly rejected the IRS's argument that it could levy on her future rights, noting:

> The IRS levied on the trust over nine years before Elly would receive any of the mandatory income distributions. By November 3, 2002, the trust estate may no longer be in existence. There may not be any income. The trustee may decide to exercise its discretion after November 3, 2002 to disburse the entire trust estate after November 3, 2002 to Elly, her husband, her issue, or the spouses of such issue. Since Elly's right to receive income payments after November 3, 2002 is clearly a contingent, non-vested, and non-determinable right, the IRS's levy in June 1993 could not reach it.

*Id.*

175. *See, e.g.*, Wagner v. United States, 573 F.2d 447, 454 (7th Cir. 1978) ("[F]uture wages and commissions of the taxpayer were contingent on his continued employment and thus did not represent an existing property right to which a lien could attach. [He] had no present right to the wages and commissions."); United States v. Long Island Drug Co., 115 F.2d 983, 986 (2d Cir. 1940) ("Though we shall assume that a salary or wages which have been earned may be made subject to a lien for unpaid taxes and also subject to distraint and levy, the situation in respect to future earnings is quite different. They are contingent upon performance of a contract of service and represent no existing rights of property.").

176. Treas. Reg. § 301.6331-1(a)(1) (1967); *see, e.g.,* I.R.S Chief Couns. Adv. Mem. 200124020 (May 10, 2001), *available at* http://www.unclefed.com/ForTaxProfs/irs-wd/2001/0124020.pdf. ("A levy does not reach property acquired after the levy has been made . . . and does not reach payments promised a taxpayer but contingent upon the performance of some future service.").

### *A. Better than Forfeiture Provisions and Protective Trusts*

One wrinkle on the shifting executory interest idea is to simply make it a forfeiture provision so that upon the occurrence of a triggering event, Darth's theretofore enforceable interest in the trust ceases. Many practitioners are familiar with what are called "protective trusts" where the triggering event does not truly eliminate a beneficiary's interest in the trust; instead, the triggering event replaces that interest with a purely discretionary interest.[177]

This is a bad idea. First, it is not clear that Texas law recognizes protective trusts.[178] Second, a forfeiture provision which simply morphs the trust into a discretionary trust raises all of the problems with discretionary trusts as discussed above in Part II.C. Third, as an empirical matter, courts have proved hostile to the use of forfeiture provisions against a federal tax lien.[179]

Courts have found forfeiture provisions ineffective against the federal tax lien because they believe it is against public policy for a beneficiary to have access to funds when owing taxes. For example, in *United States v. Riggs National Bank*, the court held that a forfeiture clause was inoperative against a federal tax lien on public policy grounds.[180] The court first noted that, unlike private creditors, the federal government is an involuntary creditor; thus forfeiture provisions would be construed strictly against the settlor.[181] The court then held that the forfeiture clause was inoperative as against public policy because enforcing it would allow the beneficiary to continue to receive benefits from the trust, all the while owing taxes that would remain unpaid. The court found it both "offensive and disruptive to federal tax law for a beneficiary to receive an income stream for years" under those conditions.[182]

In contrast, where trusts have contained a shifting provision rather than a straight forfeiture, courts have been willing to give force to the provision as against similar public policy concerns. For example, the State of Kentucky has

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177. *See* RESTATEMENT (THIRD) OF TRUSTS § 57 cmt. c (2003):

> The terms of a trust can validly provide that the interest of a beneficiary other than the settlor shall cease upon voluntary or involuntary alienation of the interest and that, instead, the trustee shall thereafter have discretionary authority with respect to any further payments to the beneficiary. These are often called "protective" provisions, and often authorize discretionary distributions also to the original income beneficiary's family or other relatives.

*Id*.

178. Texas courts appear to equate the term "protective trust" with the term "spendthrift trust." *See, e.g.*, Glass v. Carpenter, 330 S.W.2d 530, 533 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.). If courts equate the two, then the well-settled rule that tax liens pierce spendthrift trusts would seem to apply. *In re* Orr, 180 F.3d 656, 658 (5th Cir. 1999).

179. *See, e.g.*, Bank One Ohio Trust Co. v. United States, 80 F.3d 173, 177 (6th Cir. 1996) (holding that the forfeiture provision was ineffective against the federal tax lien).

180. United States v. Riggs Nat'l Bank, 636 F. Supp. 172, 176 (D.D.C. 1986).

181. *Id*. ("While it is clear that [the settlor] sought to restrict her son from squandering his future income stream, this court sees a distinction between language designed to prevent general creditor foreclosure and language that would stop government assessments.").

182. *Id*. at 177; *see also* United States v. Taylor, 254 F. Supp. 752, 756-58 (N.D. Cal. 1966).

long disapproved spendthrift provisions as against public policy.[183] At the same time, however, the highest court in Kentucky repeatedly upheld shifting executory interest provisions as valid, stating that "where the income from certain property is devised to one for life, with the provision that if any court should ever hold it subject to the devisee's debts his interest therein should cease and the title should vest at once in the remaindermen, such provision is valid."[184]

A forfeiture provision might still be possible if it were a true forfeiture provision, where the beneficiary's interest is totally destroyed, never to be regained. The problem there, of course, is that many settlors would like to still help the beneficiary or at least give the beneficiary a second chance rather than cut them out for all time. The possible advantage here of a shifting provision is that it can shift back when the delinquent beneficiary straightens up and flies right. However, once a true forfeiture provision is triggered it is not clear how the settlor might "undo" the forfeiture. If that issue could be figured out, then it should work as well as a shifting interest and for the same reasons.

### *B. Finding the Proper Triggers*

The key to writing a successful shifting provision is finding the proper events to trigger the shift. Practitioners who are not conversant with federal tax procedure will almost always pull the trigger too late to prevent the federal tax lien from attaching. The perfect example of what trigger not to use comes in *Bank One Ohio Trust Co. v. United States*.[185] At first glance, the elaborate trigger language used in that case appears quite comprehensive:

> If by reason of any act of any such beneficiary, or by operation of law, or by the happening of any event, or for any other reason except an act of the Trustee authorized hereunder, any of such income or principal shall, or except for this provision would, cease to be enjoyed by such beneficiary, or if, by reason of an attempt of any such beneficiary to alienate, charge or encumber the same, or by reason of the bankruptcy or insolvency of such beneficiary, or because of any attachment, garnishment or other proceeding, or any order, finding or judgment of court either in law or in equity, the same, except for this provision, would vest in or be enjoyed by some other person,

183. *See* Montgomery v. Offutt, 123 S.W. 676, 677 (Ky. 1909) (holding that a trust provision attempting to shield a beneficiary's interest from creditors was void because it was against public policy); Bull v. Ky. Nat'l Bank, 14 S.W. 425, 427 (Ky. 1890) ("A testator cannot vest the title in a trustee for the use of another, and permit its enjoyment by the *cestui que trust*, without subjecting it to the debts of the latter. This is the rule in this state . . . .").

184. Todd's Executors v. Todd, 86 S.W.2d 168, 169-70 (Ky. 1935) (collecting cases); *see also* RESTATEMENT (THIRD) OF TRUSTS, § 60 cmt. e and e(1) (2003) where the Reporter's analysis of that case concluded that "[p]ossibly most important, however . . . was a provision directing that the trust 'cease' and that principal shall go 'to the remaindermen if the Court should adjudge that any part should be subjected to the claims of any creditor.'").

185. Bank One Ohio Trust Co. v. United States, 80 F.3d 173 (6th Cir. 1996).

> firm or corporation otherwise than as provided herein, then the trust herein expressed concerning such income and/or principal shall cease and determine as to such beneficiary.[186]

The flaw in the above language, however, was that none of the events listed occurred before the assessment of federal income tax. The case arose from an IRS levy on the trustee to seize money in the trust bank account. The trustee honored the levy but then brought a wrongful levy action, arguing that the service of the levy triggered the forfeiture clause. That was a loser argument, because, as Part I.A. describes in detail, the federal tax lien arises *as of the date of assessment*, even though the prerequisites to its creation do not occur until *after* the date of assessment. It is the tax lien that practitioners should be concerned with, not the levy, and waiting until a levy hits is much too late.

To write an effective shifting provision, the practitioner must select a triggering event that occurs *before* the date of assessment. That advice requires a brief explanation of how federal taxes are assessed. But first, here are the triggering events that Darth should use:

> (1) Darth's failure to timely file a required tax return, or to fully and timely pay a federal tax liability reported on his filed return; (2) the IRS's sending Darth either (i) a Notice of Deficiency, (ii) a notice of a proposed assessment of an assessable penalty, or (iii) a notice that his return has been selected for examination; (3) the commencement of federal bankruptcy or state receivership proceedings regarding Darth; or (4) a determination by an authorized IRS employee that at least one of the conditions described in sections 1.6851-1 or 1.6861-1 of the Treasury Regulations exist with respect to Darth, if such determination results in a termination or jeopardy assessment.

Assessments are foundational to tax practice and procedure. They are the culmination of the liability determination process.[187] Section 6203 provides that an assessment is simply a bookkeeping entry "recording the liability of the taxpayer." The regulations say the act of assessment is accomplished when the assessment officer schedules the liability and signs the "summary record of assessment."[188] The summary record simply reflects the total amount of tax liabilities that are assessed that day. The regulations also require the Service to keep backup documentation to verify that any particular taxpayer's liability is

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186. *Id.* at 174.

187. *See* Bryan T. Camp, *The Failure of Adversarial Process in the Administrative State*, 84 IND. L.J. 57, 58-65 (2009) (providing a fuller description).

188. Treas. Reg. § 301.6203-1 (2007). Typically, the summary record is Form 23C. Sometimes it is computer-generated on the Revenue Accounting Control System (RACS) Report 006 ("Summary of Assessments"). *See also* EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE "NEW" IRS: A PRACTICAL MANUAL FOR THE TAX PRACTITIONER WITH SAMPLE CORRESPONDENCE AND FORMS (Jerome Borison ed., 3d ed. 2004) (providing examples).

included in the summary.[189] The date of assessment is the date an assessment officer signs the summary record.[190]

While all assessments occur by recording the liability of the taxpayer on the Service's books of accounts, there are basically three pre-assessment processes that the IRS must use before actually making the assessment. These processes involve different degrees of notice to taxpayers about the impending assessment and are "rooted in the concept of voluntary compliance which does not permit the government to arbitrarily assess tax without a proper list or report."[191] I label them as follows: (1) the summary process; (2) the deficiency process; and (3) the emergency process. The possibility that Darth could be subject to each of these three processes requires at least three potential triggers, as reflected both in the above sample language and in the following analysis.

### *1. Regular or Summary Process (§ 6203)*

The first trigger ties to the summary assessment process. Making an assessment under the summary process involves no notice to the taxpayer and is the general rule created by § 6203. All other processes are statutory or judicial exceptions to the regular summary process of simply recording the liability on the books.[192]

The most common assessments using the summary process are those made on the basis of the returns that taxpayers file. Section 6011(a) requires all taxpayers who are liable for any type of tax to report their financial transactions to the IRS each year on "a return or statement according to the forms and regulations prescribed" by the IRS. Section 6201(a) permits the IRS to use a filed return, whether individual or joint, as the basis for an immediate assessment of tax.

Accordingly, the first trigger is Darth's failure to either file a required return or to fully pay all the taxes shown on a filed return. The filing date will, by definition, come before the assessment date. Thus, the sample language above is "(1) Darth's failure to timely file a required tax return, or to fully and timely pay a federal tax liability reported on his filed return."

The Service also uses the summary assessment process to assess some of the assessable penalties described in Chapter 63, Subchapter B of the Tax Code. However, because most of these assessable penalties are tied to the proper filing of returns and reporting of taxes on those returns, the general trigger language should cover most such cases. The Service also uses the

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189. *See* Treas. Reg. § 301.6203-1. The backup documentation is generally in the form of data recorded into one of the computer systems that feed into the mater file account systems, rather than data recorded onto paper. Likewise, rather than being kept in paper form, the data is stored electronically and printed out in various forms (discussed below). The Form 23C itself is now computer-generated but is printed out and signed, usually on Mondays.

190. *Id.*

191. Millsap v. Comm'r, 91 T.C. 926, 931 n.10 (1988), *acq.*, 1991-2 C.B. 1.

192. *See, e.g.*, § 6211, et seq. (requiring the deficiency process).

summary assessment process to record the results of certain audits, mainly audits of employment taxes imposed on employers by § 3111, which is essentially an excise tax imposed for the privilege of employing workers. The audit selection language in the second trigger covers that possibility.

### *2. Deficiency Process (§ 6212)*

Prior to 1924, the IRS could assess all tax liabilities using the summary process.[193] In 1924, however, Congress added what is now § 6211 et seq. to the Tax Code.[194] These statutes require that the Service use a special process whenever it concludes that any taxpayer has a "deficiency in respect of" any income, estate or gift tax, or certain excise taxes.[195] In such situations, the Service may not summarily assess that deficiency. Instead, the Service must send the taxpayer a "Notice of Deficiency" indicating the Service's intent to assess the deficiency at the end of ninety days.[196] The taxpayer then has ninety days ( or 150 days if the notice is sent to an address outside the United States) to file a Tax Court petition for a redetermination of tax and during this time, the Service is barred from assessing the deficiency.[197] This Notice of Deficiency is also called the "90-day letter" and is often thought of as the "ticket to the Tax Court" because one of its main functions is to allow the taxpayer access to a pre-payment forum to resolve any disputes relating to the merits of the proposed deficiency.[198] Without this procedure, the taxpayer would not be able to contest the Service's determination until after paying the deficiency in full, an impossibility for some taxpayers.[199]

The deficiency process is also used for non-filers. That is, although § 6011 requires taxpayers to file returns, not all do so. Taxpayers who fail to file required returns are called "non-filers."[200] The IRS typically deals with non-filers by using powers granted under § 6020 to prepare returns for them.[201] But the IRS may not simply assess the tax on the "return" it has prepared for the taxpayer. It must first send the taxpayer a Notice of Deficiency and follow the deficiency procedures.[202] That is because such a return—prepared by the

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193. Bryan T. Camp, *The Never-Ending Battle*, 111 TAX NOTES 373, 376 (April 17, 2006).

194. Revenue Act of 1924, 43 Stat. 253.

195. § 6212(a).

196. *Id*.

197. § 6213.

198. *See generally* Leandra Lederman, "*Civil" izing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency*, 30 U.C. DAVIS L. REV. 183 (1996).

199. Flora v. United States, 362 U.S. 145, 158-59 (1960).

200. Taxpayers whose income is below the filing threshold are called "poor."

201. *See* Bryan T. Camp, *The Function of Forms in the Substitute-for-Return Process,*111 TAX NOTES 1511 (June 26, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1369272 (explaining the § 6020 process, exploring its implications for the legal definition of return and critiquing IRS positions); *see also* Bryan T. Camp, *The Never-Ending Battle*, 111 TAX NOTES 373, 376 (Apr. 17, 2006), (exploring the legislative history of § 6020 back to 1862).

202. Taylor v. Comm'r, 36 B.T.A. 427, 428 (1937).

Service often on the basis of third-party information, which may or may not be accurate—is not a return within the meaning of § 6201(a)(1), which allows the IRS to use the regular assessment process to assess a tax shown on a return.[203] So the IRS must follow the deficiency procedures before assessing the tax shown on a § 6020(b) return and must send the taxpayer a Notice of Deficiency.

Finally, the IRS must use a process similar to the deficiency process before it may assess the Trust Fund Recover Penalty of § 6672 against a taxpayer. This is a penalty that the IRS uses to collect what are called "trust fund taxes," which are taxes that certain third parties, notably employers, are required to collect from those responsible for the tax. For example, employers must withhold their employees' income taxes from wages and pay that amount to the IRS at least quarterly.[204] Section 6672 allows the Service to impose a penalty on any "person"—which can include individual employees as well as the employer—who, under a duty to collect a trust fund tax, "willfully fails to collect such tax, or truthfully account for and pay over such tax."[205] However, § 6672(b) requires that before the Service may assess the penalty, it must send the taxpayer a notice that it intends to assess the penalty and give the taxpayer sixty days to respond. While the taxpayer has no right to go to court, the IRS still may not make the assessment using the summary process. The IRS calls this a "notice of proposed assessment."[206]

The second trigger addresses these deficiency procedures by keying the shift to "(2) the IRS's sending Darth either (i) a Notice of Deficiency, (ii) a notice of a proposed assessment of an assessable penalty, or (iii) a notice that his return has been selected for examination." Two features of this trigger bear mention. First, the trigger is keyed to the IRS action in sending out a notice, not in Darth actually receiving a notice. That language parallels the Service's duty in the deficiency process, which is simply to "send notice" to the taxpayer.[207] The applicable regulations emphasize that the Service's duty is to

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203. *Id.* at 429.

204. *See* Bryan T. Camp, *Avoiding the Ex Post Facto Slippery Slope of Deer Park*, 3 AM. BANKR. INST. L. REV. 328, 330-32 (1995) (providing a full description). Briefly, two of the most important trust fund taxes are the income and social security withholding taxes. The Code makes every employer responsible for collecting their employees' income and social security taxes and paying these collected taxes to the government on a quarterly basis. I.R.C. §§ 3102(a)-(b), 3402(a) (social security taxes and income taxes). If the employer fails to properly pay over these withheld amounts to the government, then the Treasury suffers a loss because the employees are given credit for taxes withheld regardless of whether the money actually reaches the government's coffers. I.R.C. § 31(a); Slodov v. United States, 436 U.S. 238, 243 (1978). This trust fund tax is in addition to the taxes imposed directly on employers by § 3401 for the privilege of employing workers. Initially, the idea of withholding was a byproduct of the creation of the social security system created by the Social Security Act of 1935. Social Security Act of 1935, Pub. L. 74-271, ch. 531, 49 Stat. 620 (1935). In 1943, Congress expanded the withholding scheme to require employers to withhold employees' income taxes and social security taxes. Act of June 9, 1943, 57 Stat. 126.

205. I.R.C. § 6672.

206. *See* Rev. Proc. 2005-34, 2005-1 C.B. 1233, 2005-24 I.R.B. 1233.

207. I.R.C. § 6212.

simply send notice to the taxpayer's "last known address."[208] Therefore, the taxpayer may never actually receive any notice of what the IRS proposes to do. Second, the "notice of a proposed assessment of an assessable penalty" language above covers the Trust Fund Recovery situation. Finally, the "selected for examination" segment is partly redundant but is necessary to cover employment tax audits. The term "selected for examination" is IRS parlance for what is commonly called an audit. Although every Notice of Deficiency results from an audit, not every audit results in a Notice of Deficiency. As discussed above, the examination of some types of returns, notably employment tax returns, may result in an assessment being made without going through the deficiency process.

### *3. Emergency Processes (§§ 6851, 6861, 6871)*

If the IRS determines that the collection of a tax is in jeopardy because a taxpayer is about to skip out with his or her assets or "do an act which would tend to prejudice" tax collection, then it may use an emergency assessment process without notice to the taxpayer.[209] Issuing a deficiency notice would just give the taxpayer ninety days to hide assets or avoid collection. Therefore, §§ 6851 and 6861 allow the IRS to immediately make a jeopardy assessment, meaning it could record the liability without the notice protections that would otherwise be required by the deficiency process.[210]

Additionally, when a taxpayer goes into either a state receivership proceeding or a federal bankruptcy proceeding, § 6871 authorizes the Service to immediately assess deficiencies without having to follow the deficiency procedure. Even if the taxpayer has already received the 90-day letter and has filed a petition in tax court, § 6871(c) authorizes claims for tax liabilities to be presented to the bankruptcy court or the court having jurisdiction over the receivership. According to § 6871(c)(2), once a receiver is appointed for the taxpayer, the taxpayer may not file a tax court petition but must instead proceed through the receivership proceeding.

Before the Service can make any of these emergency assessments, the Chief Counsel, or a properly authorized delegate, must personally approve the proposed assessment.[211] However, the taxpayer does not get notice of the

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208. Treas. Reg. 301.6212-2(a) (2001) ("A taxpayer's last known address is the address that appears on the taxpayer's most recently filed and properly processed federal tax return, unless the . . . Service . . . [receives] clear and concise notification of a different address.").

209. Sections 6851 and 6861 cover slightly different situations, but they require the same findings. Treas. Reg. 1.6861-1(a).

210. *See, e.g.*, I.R.C. §§ 6861, 6862, 7429 (the titles all refer to "Jeopardy Assessment"). The emergency process authorized by § 6851 is called the different name of "termination assessment" because it occurs when the IRS makes the assessment in the middle of the taxpayer's tax year, thus terminating that tax year in order to assess tax.

211. § 7429(a).

jeopardy determination until after the assessment is made.[212] Accordingly, by the time the taxpayer learns of a jeopardy assessment, the tax lien will have already attached.

The third and fourth triggers outlined above cover these emergency processes: "(3) the commencement of federal bankruptcy or state receivership proceedings regarding Darth; or (4) a determination by an authorized IRS employee that at least one of the conditions described in sections 1.6851-1 or 1.6861-1 of the Treasury Regulations exist with respect to Darth, if such determination results in a termination or jeopardy assessment."[213] Note that the language regarding bankruptcy and receivership is not dependent on whether Darth's bankruptcy or receivership is voluntary or involuntary.

### *C. Selection of Revesting Conditions*

Generally, the revesting conditions match the triggering events. The revesting conditions that Darth should include are as follows:

> (1) Darth has fully satisfied all outstanding federal tax liabilities; (2) there are no outstanding, enforceable, federal tax liens against Darth; (3) all Notices of Deficiency or notices of proposed assessments of an assessable penalty have been resolved, either by (i) the IRS agreeing or being required to make no assessment of any further taxes or penalties against Darth or (ii) Darth fully paying any taxes or penalties proposed by the notices that the IRS becomes authorized to assess either by Darth's action or court order; and (4) any claims for taxes made by the IRS in federal bankruptcy or state receivership proceedings have been resolved. The word "tax" has the meaning given to it by the Internal Revenue Code.

The important point to remember about the revesting conditions is that *all* the conditions must be met. This is to ensure that when his interest revests he is truly square with the IRS and that none of the other triggering events have occurred during the period of which his interest has shifted. The reason for the sentence about the definition of tax is because the Tax Code treats the term tax as including all associated interest and penalties.[214]

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212. The notice entitles the taxpayer to limited court review. § 7429(b). In court, the government bears the burden to show the facts upon which its jeopardy determination was based, but otherwise the burden is on the taxpayer as usual. *See* Comm'r v. Shapiro, 424 U.S. 614, 627-29 (1976).

213. *See supra* Part IV.

214. I.R.C. § 6665(a)(2) ("[A]ny reference in this title to 'tax' shall be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter.").

### *D. Selecting the Shifting Executory Interest Recipient*

The final issue that a practitioner in a community property state, such as Texas, will want to address is who should receive Darth's interest in the trust, should a triggering event occur. As with most trust issues, this will depend largely on the specific circumstances and personalities involved; however, a simple caution is that the person who has the shifting executory interest should not be the beneficiary's spouse, here Padma.

Texas is a community property state where the property possessed by either spouse during a marriage is presumed to be community property unless the spouse claiming separate property shows by clear and convincing evidence that it is separate property.[215] Each spouse owns an equal interest in community property.[216] While that is generally a welcome rule, the dark side of that arrangement is that community property is subject to the liabilities of either spouse, whereas separate property is generally not.[217] Property that is received by gift or that is inherited by one spouse during the marriage is separate property.[218] A spouse who claims to be holding separate property must trace the property and prove its separate origin by evidence showing how and when the spouse originally came into possession of the property.[219]

Recall that Red wants to give both Darth and Padma a life estate in the trust and that Darth and Padma are married. One question that might arise is whether Padma's interest could be subject to federal tax liens securing Darth's *separate* income tax liabilities by being classified as community property.[220] There is little danger of that because her interest will have been received as a gift. It is true that one student commentator believed that "Texas law is unsettled as to the marital property character of income from trusts."[221] However, after an exhaustive review, a federal court concluded otherwise:

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215. *See* TEX. FAM. CODE ANN. § 3.003 (Vernon 2006).

216. *See* Mitchell v. Schofield, 171 S.W. 1121, 1122 (Tex. 1915).

217. *See* TEX. FAM. CODE ANN. § 3.202; Gensheimer v. Kneisley, 778 S.W.2d 138, 140 (Tex. App.—Texarkana 1989, no writ).

218. TEX. FAM. CODE ANN. § 3.001; *see* Medaris v. United States, 884 F.2d 832, 833 (5th Cir. 1989) ("Texas law provides that property acquired during marriage, other than by gift, devise, descent or personal injury recovery, is community property.").

219. *See* Whorrall v. Whorrall, 691 S.W.2d 32, 35 (Tex. Civ. App.—Austin 1985, writ dism'd) (citing McKinley v. McKinley, 496 S.W.2d 540, 543 (Tex. 1973)); Ganesan v. Vallabhaneni, 96 S.W.3d 345, 354 (Tex. Civ. App.—Austin 2002, pet. denied).

220. Another issue that Red should consider here is whether to make both Padma and Darth's interests subject to executory limitation. If they file joint returns, then § 6013(d)(3) provides that both become jointly and severally liable for the tax reported on the return or determined after audit. In such case, shifting only Darth's interest would be ineffective to defeat the attachment of the federal tax lien. The assumption here, for good or bad, is that Darth and Padma will be filing separate returns each year. However, that is certainly an issue that needs to be addressed with the client, along with subsequently adjusting the trust language one way or another.

221. W. Michael Wiist, Comment, *Trust Income: Separate or Community Property?*, 51 BAYLOR L. REV. 1149, 1155 (1999).

> [D]ecisions by Texas intermediate appellate courts, when considered in connection with the decisions by the Supreme Court of Texas previously mentioned, make it plain that, under Texas law, income to a married person as the beneficiary of a trust established by someone else as a gift, either *inter vivos* or testamentary, is the separate property of the married beneficiary.[222]

For these reasons, Padma should not be the person who has the shifting executory interest in Darth's trust interests. If they were still married at the time the shift occurred, then Darth would still have an enforceable interest in the trust; therefore, the shift would be ineffective to prevent the attachment of the federal tax lien and its disruptive enforcement through administrative levy or lien foreclosure suit. Accordingly, Red needs to be sure to shift Darth's interest to a non-spouse. The logical choice is the grandchildren, who are also the remaindermen.[223]

## V. CONCLUSION

Most Trust and Estate lawyers do not fully appreciate the complexity of the federal tax assessment and collection system. This can cause problems when drafting trusts for clients who are concerned with protecting trust assets from the IRS. While spendthrift provisions can protect clients from ordinary creditors under state law, state law has become increasingly ineffectual at protecting state citizens against the might of the federal tax collector. Similarly, while discretionary provisions have proved somewhat successful in the past, they are increasingly problematic under the law as it has evolved since 1999, and indeed, they were not really that successful even before then. Certainly a well-advised practitioner should not be telling his or her client to rely on discretionary or sprinkling provisions to protect beneficiaries. In addition, the degree of discretion necessary to even have a hope of fending off the federal tax lien may not be compatible with the desires of many clients.

Shifting executory interests provide the best armor plating for trusts that seek to protect beneficiaries from the reach of the federal tax collector. The key

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222. Wilmington Trust Co. v. United States, 4 Cl. Ct. 6, 11 (1983); *see also* Cleaver v. Cleaver, 935 S.W.2d 491, 493-494 (Tex. App.—Tyler 1996, no writ) (concluding that interest was separate property because it was established before marriage and conveyed by devise); Hardin v. Hardin, 681 S.W.2d 241, 242 (Tex. App.—San Antonio 1984, no writ) (finding that interest in the trust acquired by gift was separate property); *In re* Marriage of Burns, 573 S.W.2d 555, 556-57 (Tex. Civ. App.—Texarkana 1978, writ dism'd) (noting that trusts established before marriage and testamentary trusts were separate property); Currie v. Currie, 518 S.W.2d 386, 388 (Tex. Civ. App.—San Antonio 1974, writ dism'd) (recognizing that interest was inherited and thus separate property);.

223. A final potential issue here is the possibility that the holders of the shifting executory interest may also be delinquent taxpayers at the time the beneficiary's interests shift to them. For example, if Red provides that Darth's interest will shift to Leia and Luke, then this will not protect trust assets from the federal tax lien if either Leia or Luke have outstanding federal income tax liabilities at the time Darth's interest shifts. One possibility is to have a double shift provision; however, if there are no further beneficiaries to shift the interest to, then the next best approach would be to put in forfeiture provisions and hope for the best.

to their success is the careful selection of events that trigger the shift and the equally careful selection of persons to receive the shifted interests. This article has attempted, through the use of a simple hypothetical, to give the practitioner a sense of the provisions to use to best effectuate a settlor's intent that the bad acts of one beneficiary should not impair the enjoyment of the settlor's bounty by other beneficiaries.