

# Tax Defense Collection Strategies – What Can The Tax Practitioner Legally Advise?

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*By David L. Rice & Shafagh Ghiassi<sup>1</sup>*

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## **I. INTRODUCTION**

Practitioners are often requested by clients to advise them on what to do with their estate when they are undergoing an audit or owe a tax obligation to the IRS or other taxing agencies. In other matters, the taxpayers are in the process of obtaining a divorce with issues of unreported income asserted by one of the spouses, an audit is in process or a tax obligation is due and owing and one of the spouses now wants to assert the innocent spouse doctrine.

The tax practitioner is faced with a myriad of issues before he or she can counsel his or her client(s). First and foremost, the practitioner must deal with the professional rules of conduct and Treasury Circular 230.<sup>2</sup> Thereafter the practitioner must analyze the nature of the property (i.e., whether community or separate) and then determine whether a tax lien exists against the property. Finally, if the practitioner determines that there is no lien, the practitioner will still have to analyze whether the transmutation of the property constitutes a fraudulent conveyance.

Recent changes in California's Uniform Fraudulent Transfer Act<sup>3</sup> ("UFTA") and the Internal Revenue Service's ("IRS") disciplinary policies<sup>4</sup> may make it increasingly difficult for tax practitioners to advise clients who already owe or may owe taxes with respect to tax defenses such as post-nuptial agreements or obtaining a divorce. Not only are taxpayers subject to stringent and much more far-reaching laws, but also practitioners are exposed to severe discipline, both in the civil and criminal arena.<sup>5</sup> Because of these potential problems, tax practitioners would be well advised to stay clear of recommending any transfer of assets or similar planning that could result in a fraudulent conveyance

or an illegal plan or scheme to evade the payment of taxes.

This article will address the various issues practitioners face when advising clients contemplating property transfer between spouses either during the marriage or as a result of dissolution, in addition to transmutation of property between domestic partners in light of recent amendments to the Domestic Partnership Act.<sup>6</sup> The issues involve ethical considerations on how to advise a client and legal issues involving the interplay between federal tax lien and state property laws, and the implications of the recent amendments to the UFTA.

## **II. ETHICAL CONSIDERATIONS AND TREASURY CIRCULAR 230**

The practitioner's role becomes paramount in the manner he advises the client in order to assure that the client is aware of his or her rights under the law, as well as to try and protect the practitioner from ultimately being sued for malpractice or as a co-conspirator with respect to a fraudulent conveyance,<sup>7</sup> or even worse, disciplinary proceedings before the IRS or the State Bar of California. As a preliminary matter, the practitioner should advise the client(s) of possible conflict of interests issues in advising co-owners of property and obtain the requisite waivers and consents from the clients or, if necessary, refer one of the parties to separate counsel with appropriate waivers.<sup>8</sup>

Once the conflict issues have been addressed under the California Rules of Professional Conduct ("Rules of Professional Conduct") and Circular 230,<sup>9</sup> the practitioner still needs to take into account §10.51 of Circular 230 dealing with "Incompetence and Disreputable Conduct". Under these rules, a practitioner can be disciplined or

disbarred from practicing before the IRS<sup>10</sup> if the practitioner knowingly counsels or suggest to a client an illegal plan to evade the payment of taxes.<sup>11</sup> There are virtually no guidelines in Circular 230 as to what constitutes an illegal plan and ultimately it will be left up to the Office of Professional Responsibility ("OPR") to determine if a tax practitioner was part of such a plan or scheme. However, as further discussed below, the tax practitioner should err on the conservative side.

There have been a number of tax practitioners who have advocated to clients that they should enter into a post-nuptial agreement or consider a divorce as a result of a pending audit or tax liability in which one of the spouses may not be liable.<sup>12</sup> While an attorney has a duty to advise the client of the law, advising the clients to take these steps may very well constitute a violation of Circular 230. As an example, suppose the clients follow the advice of the attorney and get a divorce, but the divorce is fraudulent, Is that a violation of circular 230? Or, in the alternative, suppose that the parties sign a post-nuptial agreement and in doing so make a fraudulent conveyance. Is that a violation of Circular 230? While there are no cases on point, the tax practitioner needs to be extremely careful in this regard, especially considering the IRS efforts to step-up enforcement of Circular 230. In 2003, the IRS has created OPR, which investigates allegations of misconduct or negligence against tax professionals and enforces standards of practice set forth in Circular 230. Moreover, the staff of OPR is more than double that of the prior organization.<sup>13</sup> In fact, the IRS specifically stated "the Office of Professional Responsibility will thoroughly concentrate on enforcing the standards of practice for those who represent taxpayers before the IRS as detailed in Circular 230."<sup>14</sup>

In addition to Circular 230, the practitioner should have a good understanding of the Rules of Professional Conduct. The prohibition of certain conduct in these rules is not exclusive. Members of the Bar are also bound by applicable law including the State Bar Act<sup>15</sup> and opinions of California courts.<sup>16</sup> Similarly, the Rules of Professional Conduct state that member shall not advise the violation of any law, rule, or ruling of a tribunal, which is similar to the rules in Circular 230.<sup>17</sup> Specifically, a member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule or ruling is invalid.<sup>18</sup> In essence, improper advice to a client might very well not only result in a disciplinary proceeding by the IRS against the practitioner, but by the State Bar as well.

Practitioners could also be civilly liable for fraudulent transfers to creditors, in this instance the IRS, if they participated in the fraudulent conveyance.<sup>19</sup> For example, in *Durant Software v. Herman*, the California court held that an attorney who fraudulently injured a third party by acting in furtherance of a conspiracy to defraud a creditor is not relieved from liability merely because he was acting in the capacity of attorney.<sup>20</sup> To the extent that a practitioner participates in the transfer, both the practitioner and the client may be subject to criminal sanctions. California Penal Code §154 imposes a criminal misdemeanor on a debtor who fraudulently moves property out of state or transfers such property with the "intent to defraud, hinder or delay" creditors. Furthermore, §531 makes it a misdemeanor for any person who is a party to a fraudulent conveyance of any real or personal property.<sup>21</sup>

Accordingly, when counseling clients, the practitioner at best, can only advise the client as to what his or her rights are under the law. It would be imprudent at best, to advise a client to seek a divorce because of the possibility of a fraudulent divorce despite what the client represents to the tax practitioner. In addition, prior to recommending a post-nuptial agreement, the tax practitioner may be well advised to analyze whether the

transmutation of property constitutes a fraudulent conveyance.

### III. TRANSFERS BETWEEN SPOUSES AND DOMESTIC PARTNERS

Assuming the ethical issues have been dealt with, the next issue faced by practitioners is whether the property transferred is subject to an IRS lien. The threshold question is the whether the property involved is community or separate property under the laws of the State of California.

#### A. Domestic Partnerships

It should be noted that recent amendments to the California Domestic Partnership Act extend the rights and duties of marriage to persons registered as domestic partners on and after January 1, 2005. A domestic partnership exists where, in addition to meeting certain requirements, two adults have chosen to share one another's lives in an intimate and committed relationship.<sup>22</sup> As of January 1, 2005, domestic partners will have many new rights and responsibilities, including without limitation having the same community property rights as married couples.<sup>23</sup> Furthermore new California Family Law Code §299.1(e) states that to the extent the provisions of California law adopt, refer to, or rely upon, provisions of federal law in a way that otherwise would cause registered domestic partners to be treated differently than spouses in a civil marriage, registered domestic partners shall be treated by California law as if federal law recognized a domestic partnership in the same manner as California law. In other words, as of January 1, 2005, any property that would have been community property or quasi-community property if the parties had been married, will have been automatically converted to community property or quasi-community property retroactively to the date of the registration as domestic partners. The registration could have been as early as January 1, 2000. As far as the status of domestic partnerships formed before January 1, 2005 is concerned, they will be subject to these new rights and responsibilities unless terminated before January 1, 2005.

Because Federal law for spouses does not apply to registered domestic partnerships as a result of the federal defense act, domestic partners are not allowed to file a federal joint income tax return. In addition, AB205 does not permit domestic partners to file a joint state income tax return. At first blush, it might appear that one domestic partner could not be liable for the separate tax debt of the other domestic partner, but it should be recalled that community property is liable for both community and separate property debts.<sup>24</sup>

#### B. Transfers During Marriage

While the separate property of a spouse is not subject to seizure to satisfy the debts incurred by the person's spouse before or during marriage,<sup>25</sup> an attempt to transmute community property to separate property is subject to the laws governing fraudulent transfers.<sup>26</sup> In *State Bd. of Equalization v. Woo*, the California Supreme Court went so far as to scrutinize an agreement that purported to give up the right to future earnings of a spouse.<sup>27</sup> Unless the tax agency is able to show actual fraud, this decision may be somewhat limited as the court stated: "Income not yet earned, however, is not an asset under the UFTA unless it is subject to levy by a creditor."<sup>28</sup> However, the holding still stands for the proposition that any time a tax liability exists, transfer of property or even attempts to transmute property rights, may be examined under the fraudulent transfer laws. The same should now hold true with respect to domestic partners.

#### C. Transfers As Part of Dissolution

When spouses enter into marital settlement agreements dividing their property unforeseen results are possible. It is not uncommon for a spouse to be faced with a tax liability he or she did not know about or anticipate based on the other spouse's representations. Internal Revenue Code ("Code") provides relief designed to address the problem of the unwary spouse. Under Code §6015, the IRS grants innocent spouse relief when one spouse establishes that a Federal tax liability is attributable to the other spouse and the spouse requesting relief has met all of the requirements for relief.<sup>29</sup> It

should be noted though, that even if one spouse qualifies for innocent spouse relief as a result of an unknown tax liability, his or her share of the property could still be at risk because of the interplay between federal lien laws and state property laws, and fraudulent transfer issues.

**IV. FEDERAL TAX LIEN VS. STATE PROPERTY LAW**

Any time property is transferred between spouses and innocent spouse relief is applied for, the innocent spouse still has to cope with California property laws and their interplay with regard to any existing federal tax lien.

Code §6321 creates a federal lien to protect the federal government’s interest in unpaid taxes, interest, additions to tax, and any assessable penalties owed by a delinquent taxpayer.<sup>30</sup> The lien imposed by §6321 arises when the tax is assessed, a deficiency is found and the taxpayer neglects or refuses to pay a tax liability after the Service has sent a notice of assessment and a demand for payment. While the tax lien will not arise until the taxpayer refuses to pay, once the lien does arise, it will relate back to the date of assessment,<sup>31</sup> thus creating a “secret” lien of which the taxpayer may not be aware of at the time of transfer. The lien will arise automatically — the government need not file the lien or send notice of the lien in order for it to be effective. The tax lien will attach to “all property or rights to property” belonging to the taxpayer.<sup>32</sup>

Code §6323 gives the federal government access to an almost unlimited range of property that may be subject to a tax lien. “To satisfy a tax deficiency, the Government may impose a lien on any ‘property’ or ‘rights to property’ belonging to the taxpayer.”<sup>33</sup> The United States Supreme Court interpreted this language to allow the government to reach every species of right or interest protected by law and having an exchangeable value.<sup>34</sup> There are only a handful of types of property that the federal government cannot reach.<sup>35</sup> The property exemption is not an exemption from the imposition of a lien, but exempt property may not be levied upon.<sup>36</sup> This means that while the

government’s lien may attach to the property, the property cannot be seized and sold in order to use the proceeds of the sale to satisfy the liability or part thereof.

What complicates matters is that state law is used to determine whether the taxpayer has any interest or rights in property and the extent of those rights or interests. Once it is determined under state law that a delinquent taxpayer has some rights or interest in a piece of property, federal law is then used to determine whether those rights constitute property to which a federal lien may attach. Once a lien is appropriate under federal law any state law protections will be inoperative to prevent the attachment of the federal lien.<sup>37</sup>

If a delinquent taxpayer has an interest in property, as determined by California law, then that interest will be subject to a lien on behalf of the federal government. While it is clear that property solely owned by the responsible taxpayer is subject to a federal tax lien, the attachment of a lien on property that a responsible taxpayer owns with a non-responsible (innocent) spouse is more complicated. The degree to which a federal lien may attach to the property and impact the non-responsible spouse’s interest in the property will vary depending on the title in which the property is held. In California, married persons may hold property as joint tenants, as tenants in common or as community property.<sup>38</sup> In addition domestic partners may own community property subject to the same laws as community property owned by spouses.<sup>39</sup>

**A. Community Property**

In California, all property acquired during marriage is presumed to be community property unless the title of the property indicates otherwise or it is an inheritance, bequest or gift and has not been transmuted to community property. Unfortunately for the spouses, community property is available to satisfy the debts of either spouse incurred before or during marriage, regardless of whether one or both spouses are parties to the debt or to a judgment for the debt.<sup>40</sup> As a result, under California’s property laws, the federal government is allowed to attach a lien not only on the responsible spouse’s separate property but also a lien may attach to all

community property of the responsible taxpayer and his or her spouse.<sup>41</sup> California’s community property law allowing a creditor to attach a lien on all community property creates a problem for any person owning property in California who has or is planning to seek innocent spouse relief under Code §6015 as innocent spouse relief will not protect any community property from the attachment of a lien or the imposition of a levy.

Also under California law, upon division of community property, the property received by one spouse in the division is no longer liable for a debt incurred by the other spouse before or during marriage. However, if there is a lien on the property at the time of the division that property will continue to be subject to the lien and available to satisfy the liability of the other spouse even though it is now the innocent spouse’s separate property.<sup>42</sup>

Accordingly, for any tax that was assessed and a lien has attached to property prior to the division of community property, it appears that all of said community property will be liable even though the property is now the separate property of the innocent spouse. If, however, tax is assessed after the division of community property and the requesting spouse is granted innocent spouse status, then his or her share of community property might very well be protected, absent a fraudulent transfer.

**B. Joint Tenancy and Tenancy In Common**

An innocent spouse’s rights in property owned as tenants in common<sup>43</sup> or joint tenants<sup>44</sup> are generally immune, subject to the presumptions found in California law.<sup>45</sup> However, the transfer of the liable spouse’s share of such property to the nonliable spouse will not prevent the IRS from being able to reach the liable’s spouse’s share. The same rule should apply to domestic partners.

**VI. THE EXPANDED REACH OF THE FRAUDULENT TRANSFER DOCTRINE**

The UFTA<sup>46</sup> provides that a creditor may avoid a transfer made with the “actual intent to hinder, delay, or defraud any

creditor of the debtor,” (actual fraud) or a transfer made without receiving reasonably equivalent value in exchange at a time when the debtor was in a business for which the remaining assets were unreasonably small in relation to the business, the debtor intended to incur debts beyond his ability to pay as they became due, or the debtor made the transfer without receiving equivalent value and was insolvent at the time or became insolvent as a result of the transfer (constructive fraud).<sup>47</sup> In essence, there are two types of fraudulent conveyances: (1) those made with the intent to hinder, delay or defraud and (2) those made under situations that constitute constructive fraud.

Although direct evidence of fraudulent intent is rarely present, actual intent is usually established by applying the so-called badges of fraud. The primary badges of fraud would include insolvency or the absence of adequate consideration in the transfer.<sup>48</sup> In addition other badges of fraud would include:

- The transfer or obligation was to an insider.
- The debtor retained possession or control of the property transferred after the transfer.
- The transfer or obligation was disclosed or concealed.
- Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with a suit.
- The transfer was of substantially all of the debtor’s assets.
- The debtor absconded.
- The debtor removed or concealed assets.
- The debtor was insolvent shortly after the transfer was made or the obligation incurred.
- The transfer occurred shortly before or shortly after a substantial debt was incurred.

- The debtor transferred the essential assets of the business to a lienor, who transferred the assets to an insider of the debtor.<sup>49</sup>

Actual fraud can be difficult to prove in a number of situations. However, it may not be so difficult for the IRS to establish fraud where assets are transferred after the notice of an audit and the taxpayer believes or has reason to believe that there will be a substantial assessment. It could even be easier for the IRS to assert fraud where the taxpayer has received a Revenue Agent’s Report showing a substantial deficiency and then attempts to transfer assets.

If the IRS cannot prove actual fraud, then it has another shot under the theory of constructive fraud. In order for constructive fraud to apply, the transfer must be made without fair or adequate consideration. However, with respect to constructive fraud, the creditor does not have the burden of proving the transferor’s actual intent. The relevant categories of constructive fraud with respect to the IRS are:

- Transfers made when the debtor is insolvent or will be rendered insolvent as a result of the transfer — for example a spouse transferring a personal residence to the other spouse as a result of the potential imposition of a §6672 penalty on the transferring spouse.
- Transfers made when the debtor intends to incur or believes that he will incur or believes that he will incur debts beyond his ability to pay such debts.<sup>50</sup> This could result on a transfer of assets being made by a spouse who may be deemed a responsible person for payroll taxes, even though the assessment has not been made.

Until recently there was a split in the jurisdictions as to whether the fraudulent transfer doctrine could be applied in the context of a transfer between spouses. In the case of *Gagan v. Goyd*,<sup>51</sup> a California appellate court declared, “as a matter of policy, we believe that to engraft the fraudulent transfer remedies onto a valid and approved marital settlement

agreement would result in needlessly complicating the already emotionally laden dissolution process. It might result in the unraveling of a dissolution agreement painstakingly negotiated between the parties and their attorneys. We do not carry the rights of an alleged defrauded creditor that far, absent the express intent by the Legislature to do so.”

On the other side of the spectrum, in *Mejia v. Reed*, another California appellate court found a fraudulent transfer where husband and wife filed for divorce and entered into a marital settlement agreement leaving husband virtually insolvent and unable to pay child support, shortly after husband had a daughter as a result of an extra marital affair.<sup>52</sup> This split, however, was resolved when the California Supreme Court decided to review the *Mejia* case and found that the court of appeal correctly held that the provisions of the UFTA did apply to marital settlement agreements.<sup>53</sup> The court attempted to “harmonize” the UFTA with California Family Code §916, which protects property transferred to a spouse incident to divorce from the debts of the other spouse. In so doing, the court considered the overall policy of protecting creditors and the legislature’s intent to ensure that in allocating the debts to the parties, the court in the dissolution proceeding should take into account the rights of creditors so there will be available sufficient property to satisfy the debt by the person to whom the debt is assigned provided the net division is equal.

In *Mejia*, the husband and wife were married in 1970. In 1994, husband had an extramarital relationship with plaintiff. Their daughter was born in February 1995. In May 1995, wife petitioned for dissolution of her marriage to husband. They entered into a marital settlement agreement (“MSA”) under which husband conveyed all his interest in the couple’s real estate to wife and she conveyed her interest in husband’s medical practice to him. The MSA provided that husband would be solely responsible for his extramarital child support obligation and was merged into a judgment of dissolution entered in August 1995.

By June 1997, husband had abandoned his medical practice, he lived with his

mother, and he had no assets and little income. The plaintiff (ex-mistress), who had a pending paternity suit against husband, filed a *lis pendens* against the real property awarded to wife under the MSA. The trial court in the paternity action awarded plaintiff child support of \$750 per month, but it ruled that plaintiff had no standing to challenge the transfer of property under the MSA. The court later increased child support to \$953 per month plus \$200 per month for day care, or a monthly total of \$1153.

The court concluded, "a creditor may challenge a marital property division as a fraudulent transfer" under the UFTA. However, the court noted that aside from proving inadequate consideration to show constructive fraud, the creditor must also show that the debtor was insolvent at the time or became insolvent as a result of the transfer.<sup>54</sup> The court found that there was no triable issue of insolvency for two reasons. They first concluded that child support was not a "debt" for purposes of the UFTA based on two principles. First, since child support is based on income and not assets, it was not a "debt" under the UFTA. Second, and more important for tax practitioners, the court held that future income not yet earned is not an asset under the UFTA, unless it was subject to a levy. For those narrow cases in which no tax assessment has been made, providing the creditor could not prove actual fraud under the UFTA, the *Woo* case should be deemed overruled by *Mejia*.<sup>55</sup>

Additionally, as discussed above, the *Mejia* court differentiated actual fraud from constructive fraud. In order to prove constructive fraud, aside from other matters a creditor must prove, at a minimum the creditor must prove that the transfer was without adequate consideration. If the parties divide the property equally, there should be no question of adequate consideration. Nonetheless, in the marital context, the court noted that there was nothing in the Code to require parties on their own to make an equal division of community property, thus insuring adequate consideration.<sup>56</sup> Accordingly, to minimize the likelihood of the IRS proving constructive fraud, the tax and family law practitioners may very well want the trial

court to make an actual finding that there has been an equal division of property as opposed to incorporating a MSA in a court order.

Additionally, the recent amendment to the UFTA brings it in conformity with the Uniform Fraudulent Transfer Act that was approved by the National Conference on Uniform State Laws in 1984,<sup>57</sup> by emphasizing several permissive factors, which may be considered by the courts in determining fraudulent intent, known as "badges of fraud".<sup>58</sup> These "badges of fraud" are non-exclusive factors that may be considered by the courts along with other factors,<sup>59</sup> while determining whether constructive fraud exists.

The IRS is required to scrutinize any potential fraudulent conveyance under California law<sup>60</sup> and because of the decision in the *Mejia*, there is no question that the IRS can now look at property transfers in a divorce to determine whether a fraudulent conveyance occurred. As a result, with the enactment of this new amendment,<sup>61</sup> the practitioner in California, as well as the IRS will have additional tools to evaluate a potential fraudulent transfer claim.

In *Bresson v. Commissioner*, the taxpayer transferred property and refused to pay tax.<sup>62</sup> When confronted with the IRS' collection efforts, the taxpayer attempted to defeat the fraudulent transfer claim, by asserting that the government had forfeited its right to pursue him, as the claim was extinguished under California limitation periods. The court held that while the claim arose under California's UFTA, UFTA's "extinguishment" provision could not evade the rule of *United States v. Summerlin*.<sup>63</sup> The government's underlying right to collect money clearly derived from the operation of federal law (i.e., the Code). In its efforts to collect taxes, the United States unquestionably acted in its sovereign capacity, and as such the rule of *Summerlin* would not allow the "extinguishment" of a valid, fully accrued claim by the IRS brought under the UFTA. In *Summerlin*, the court held, when the United States becomes entitled to a claim, acting in its governmental capacity and asserts its claim in that right, it cannot be deemed to have abdicated its

governmental authority so as to become subject to a state statute putting a time limit upon enforcement. Hence, a state statute in this instance requiring claims to be filed within eight months could not deprive the United States of its right to enforce its claim that the United States still had its right of action, even though the state court was to be regarded as having no jurisdiction to receive a claim after the expiration of the specified period.<sup>64</sup>

While the IRS has actively pursued fraudulent conveyances in general tax matters, there have been no published cases under the recently enacted regulations under Code §6015. Under Code §6015, innocent spouse status will not be granted if there was a fraudulent scheme between the spouses in the transfer of any property. A finding for innocent spouse relief may not be equivalent to a finding that a transfer is not fraudulent. There may be some difference between a fraudulent scheme and a fraudulent transfer under state law. Fraudulent scheme under Code §6015 was not defined. Treas. Reg. §1. 6015-1(d) now provides that a "a fraudulent scheme includes a scheme to defraud the Service or another third party, including, but not limited to, creditors, ex-spouses and business partners." Whether the IRS intends to look to state law or eventually adopt its own set of rules for determining what a fraudulent scheme ultimately is remains to be seen. However, because equitable relief is being granted, the practitioner should be extremely cautious in advising his or her clients that under these regulations, the IRS may make its own determination as to a fraudulent scheme, despite the legal decisions defining a fraudulent conveyance under state law.

## VII. CONCLUSION

In divorce situations, California community property laws could result in the innocent spouse defense being nothing more than a toothless tiger with respect to property transfers, unless the person claiming innocent spouse has separate property. Because of the nature of the "secret tax lien," any division of

community property is already subject to a tax lien by the IRS and, although the IRS will not pursue collection in general against the person claiming the innocent spouse, the IRS still has the right to proceed against any property it has liened, including any portion of community property owned by or transferred to the person claiming innocent spouse. If the property was held in joint tenancy or tenants in common and transferred to the innocent spouse, the IRS would still have a right to proceed against the liable person's (the non-innocent spouse) interest in the property that was transferred.

Consequently, practitioners have to be very careful in advising their clients who are entering into a post-nuptial agreement or a divorce and transmuted community property with respect to any taxes that have already been assessed. Moreover, because of the recent changes in the Domestic Partnership Act, property held by such individuals may in fact constitute community property and, hence, such community property may be subject to recovery by the IRS (or any other taxing agency) with respect to a tax obligation of any partner. On the other hand, if the tax has not been assessed, innocent spouse may very well be a defense providing there was no fraudulent conveyance. Although there have been no tax cases discussing innocent spouse and fraudulent conveyances, practitioners need to nevertheless be mindful of the Treasury Regulations under the innocent spouse and the fraudulent conveyance laws.

The ultimate question the practitioner faces is how to reconcile the duty to properly and effectively advise the client with the myriad of rules and laws that restrict him/her in giving that advice. Assuming that a client's property is not already subject to a tax lien, one approach would be to inform the client of what the law is, especially in situations where divorce and/or a post-nuptial agreement may offer protection. By the same token, the tax practitioner must also warn the client about fraudulent divorces and the attendant consequences. If the tax practitioner actually advises the client(s) to take any of these actions, the tax

practitioner may find himself in violation of Circular 230 and hence, the various State Bar rules.

On the other hand, the tax practitioner is under a duty to advise the client(s) of the fraudulent conveyance statutes and the possibility of attack by the IRS. If the clients choose to go through a "real" divorce, then the tax practitioner should advise the clients and/or family law counsel that the court should find in its order that there has been an equal division of property, in an attempt to avoid the problems created in the *Mejia* case.

**ENDNOTES**

1. David Lee Rice, Esq., is a Certified Specialist in Taxation Law and principal of Rice & Keely, P.C., 2780 Skypark Drive, Ste 460, Torrance, CA 90505, Tel: (310) 517-8600, Fax: (310) 517-8606 where his practice emphasizes tax planning, structuring and controversy as well as estate planning and elder law. David is Chairman of the California State Bar Association's Income Tax Committee and is also Chairman of the Los Angeles County Bar's Tax Committee on Procedure and Litigation. Shafagh Ghiassi, Esq. is a senior associate with RSM Mcgladrey, 18401 Von Karman Ave, Irvine, CA, Tel: (714) 520-9561.

2. Title 31 CFR, Subtitle A, Part 10, revised as of January 26, 2002.

3. California's Uniform Fraudulent Transfer Act (CAL. CIVIL CODE §§3439-3439.12)

4. Title 31 CFR, Subtitle A, Part 10, revised as of January 26, 2002, Treasury Circular 230, §10.51

5. See generally, Peter Spero, *Asset Protection: Legal Planning, Strategies and Forms*, Chap. 3 (Warren, Gorham & Lamont 2001, updated tri-annually) (herein "Spero")

6. CAL. FAM. CODE §297.5

7. See David Rice and Peter Spero, *New Developments Affect the Statute of Limitations for Fraudulent Transfer*,

Journal of Estate Planning, August 2003, Vol. 30 (Warren Gorham & Lamont).

8. Title 31 CFR, Subtitle A, Part 10, revised as of January 26, 2002, Treasury Circular 230, §10.29. California Rules of Professional Conduct, §§3-300 and 3-310.

9. *Id.*

10. The final regulations set forth an array of penalties that include, but are not limited to, assessment of preparer penalties, disciplinary sanctions under the authority of Circular 230, suspension or disbarment of practitioners who are covered by Circular 230, suspension of filing privileges, deprivation of the privilege to represent taxpayers before the service, injunctions initiated by the Department of Justice against promoters or other advocates of illegal tax avoidance schemes, and criminal prosecution by the Department of Justice.

11. Title 31 CFR, Subtitle A, Part 10, revised as of January 26, 2002, Treasury Circular 230, §10.51(f).

12. Perhaps innocent spouse applies to one spouse or there has been a \$6672 assessment against one of the spouses.

13. IR-2003-3, Jan. 8, 2003.

14. *Id.*

15. CAL. BUS. & PROF. CODE §6000 et seq.

16. California Rules of Professional Conduct, Rule 1-100. Rules of Professional Conduct, in General

17. California Rules of Professional Conduct, Rule 3-210. Advising the Violation of Law.

18. The commentary to Rule 3-210 indicates that the provision applies not only relative to the prospective conduct of the client but also to the interaction between the member and client and to the specific legal service sought by the client.

19. See generally, Spero, *supra*, note 3,

¶2.04.

20. *Durant Software v. Herman*, (1989) 257 Cal. Rptr. 200, 208; appeal dismissed, (1990) 272 Cal. Rptr. 612.

21. CAL. PENAL CODE §531. Every person who is a party to a fraudulent conveyance of any lands, tenements, or hereditaments, goods, or chattels, or any rights or interest issuing out of the same, or to any bond, suit, judgment, or execution, contract or conveyance, had, made or contrived with intent to deceive and default others, or to defeat, hinder or delay creditors or others or their just debts, damages, or demands; or who, being a party as aforesaid, at any time wittingly and willingly puts in, uses, avows, maintains, justifies, or defend the same, or any of them, as true, and done, had, or made in good faith, or upon good consideration, or aliens, assigns or sells any of the lands, tenements, hereditaments, goods, chattels, or other things before mentioned, to him or them conveyed as aforesaid, or any part thereof, is guilty of a misdemeanor.

22. CAL. FAM. CODE §297. (a) Domestic partners are two adults who have chosen to share one another's lives in an intimate and committed relationship of mutual caring; (b) A domestic partnership shall be established in California when all of the following requirements are met: (1) Both persons have a common residence; (3) The two persons are not related by blood in a way that would prevent them from being married to each other in this state; (4) Both persons are at least 18 years of age; (5) Either of the following: (A) Both persons are members of the same sex; (B) One or both of the persons meet the eligibility criteria under Title II of the Social Security Act as defined in 42 U.S.C. §402(a) for old-age insurance benefits or Title XVI of the Social Security Act as defined in 42 U.S.C. §1381 for aged individuals. Notwithstanding any other provision of this section, persons of opposite sexes may not constitute a domestic partnership unless one or both of the persons are over the age of 62. (6) Both persons are capable of consenting to the domestic partnership. (7) Both persons file a Declaration of Domestic

Partnership with the Secretary of State pursuant to this division. (c) "Have a common residence" means that both domestic partners share the same residence. It is not necessary that the legal right to possess the common residence be in both of their names. Two people have a common residence even if one or both have additional residences. Domestic partners do not cease to have a common residence if one leaves the common residence but intends to return.

23. The legislative history of the bill amending §297.5(a) of the California Family Code states: "Registered domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law, whether they derive from statutes, administrative regulations, court rules, government policies, common law, or any other provisions or sources of law, as are granted to and imposed upon spouses." (§297.5(a) of the Family Code as amended by Chapter 421, Stats. 2003.)

24. CAL. FAM. CODE §910. See endnotes 36 and 37, *infra*.

25. CAL. FAM. CODE §913(b).

26. CAL. FAM. CODE §851.

27. In the case of *State Bd. of Equalization v. Woo* (2000) 82 CA 4<sup>th</sup> 481, 98 CR 206, the court found a marital agreement that spouse's earnings were separate property was fraudulent, finding debtor spouse to have an existing interest in spouse's future earnings and the spouses entered into the agreement to prevent creditors from attaching future earnings.

28. See *Mejia*, notes 49 & 50 *infra*.

29. Under §6015, a taxpayer can obtain innocent spouse relief under three different avenues. The first is the traditional approach, §6015 (b) that has been revised to make it easier for a taxpayer to qualify as an innocent spouse. The second, referred to as the Separate Liability Election under §6015(c), is primarily for those spouses either no

longer married, legally separated, or having lived apart for at least twelve months. Finally, a taxpayer may even obtain innocent spouse relief on equitable grounds, §6015(f), if the taxpayer is ineligible for relief under the other two sections. Relief under each of the three avenues of relief may result in relief from different liabilities in differing degrees.

30. IRC §6323 provides in pertinent part that: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount...shall be a lien in favor of the United States upon all property and right to property, whether real or personal belonging to such person."

31. *In re Fidelity Tube Corp.*, 278 F.2d 779 (3<sup>rd</sup> Cir. 1960) cert. denied sub nom.

32. IRC §6321.

33. IRC §6323.

34. See *Drye v United States*, 528 U.S. 49 (1999), see e.g., *Jewett v. Comm'r*, 455 U.S. 305, 309 (1982).

35. See IRC §6334(a)(1)-(13) (Exempt property include, among other things, the principal residence, in the absence of certain approval or jeopardy.) See §6334(e) (The principal residence is subject to a levy when (1) a district director or assistant district director of the IRS personally approves (in writing) the levy of such property, or (2) the Secretary finds that the collection of tax is in jeopardy.)

36. See IRC §6334, property exempt from levy.

37. See *Drye v. United States*, 528 U.S. 49 (1999), see also, *United States v. Estes*, 450 F.2d 62, 68 (5<sup>th</sup> Cir 1971). See IRC §6334(c).

38. CAL. FAM. CODE §750.

39. CAL. FAM. CODE §297 & 297.5

40. See CAL. FAM. CODE §910, see also, *Napa Valley Bank v. Morgan*, 94-2 USTC P 50510, 74 AFTR 2d 94-643 (Cal. ED 1994).

41. California offers less protection to a nonliable spouse than other community property states. For example, in Washington and Arizona, the nonliable spouse has a right to one-half of the community property, so a lien may only attach to half of the community property. When the community property is sold to satisfy the separate debt of one spouse the creditor may only collect one-half of the proceeds and the nonliable spouse is entitled to the other half of the proceeds of the sale. See *Melne v. United States*, 2000-1 U.S. Tax Cas. (CCH) P50, 291; 85 AFTR 2d (RIA) 1506. (Washington community property law gives each spouse an undivided one-half interest in the community. A creditor may not exceed the liable taxpayer's interest) See also *In re Ackerman*, 424 F.2d 1148 (Arizona case following *Melne v. United States*)

In other community property states, generally the creditor may only collect on one-half of the community property, unless it is determined that the debt benefited the community and as such is a "community debt" which may be satisfied out of all of the community property. *Hegg v Comm'r*, 28 P.3d 1004 (Idaho 2001). Note that both Washington and Arizona also use the concept of "community debt."

Although some California courts use the term "community debt", that concept is not in line with existing California law. See *Babb v. Schmidt*, 495 F.2d 957 (9th Cir. 1974) (California's Supreme Court explicitly rejects the community debt concept applied by other states, because it does not fit within California Community property laws, where all debts may be satisfied out of Community Property regardless of whether it is a community debt or not)

42. CAL. FAM. CODE §916(a)(2).

43. When property is held as tenants in common, each spouse has an undivided interest in the whole of the property. Each spouse's interest is distinct to the individual. In *Shaw v. United States*, 331 F.2d 439 (9th Cir. 1964) the court held real property held by husband and wife, husband's interest is such that the property is subject to the federal tax lien.

A lien attaches only to the responsible

spouse's property and extends no further, the lien does not encumber the innocent spouse's joint interest. (IRC §6321 limits the attachment of the lien to the property of the responsible person). When the property is sold the government may only collect on the responsible spouse's interest and the innocent spouse is entitled to his or her share of the proceeds. As stated above, the transfer of a tenancy in common to 100% ownership of the innocent spouse will not change the effect of a preexisting lien; a portion of the property will continue to be subject to the lien.

44. When property is held by a husband and wife as joint tenants, each spouse is a full owner of all property and each has a right of survivorship in the property. (CAL. CIVIL CODE §693) Some courts have allowed the tax lien to attach to the interest of the joint tenant in the property. However, a non-responsible spouse's one half interests may be immune from his or her spouse's creditors. See, e.g., *In re Rauer's Collection Co*, 87 Cal. App 2d 248 (1948). Generally a lien against the interest of one joint tenant does not sever the joint tenancy or affect the right of survivorship unless the property is sold prior to the death of the party who incurred the lien (the responsible spouse).

45. See *Hansford v. Lassar*, 53 Cal. App 3d 364 (1975). See also CAL. FAM. CODE §2580 (a rebuttable presumption that property jointly held by spouse's is community property, thus if the spouse's did not intend to hold property as anything but community property, then the property will be considered community property).

46. CAL. CIVIL CODE §3439

47. See generally, Rice and Spero, *New Developments Affect the Statute of Limitations for Fraudulent Transfer, supra*.

48. *Id.*

49. UFTA §4(b) and Comment (1), 7A ULA 639, 653 (1984); UFTA §4. Comment (5), 7A ULA 693, 654 (1984). See also Note 50.

50. See Rice and Spero, *New Developments Affect the Statute of Limitations for Fraudulent Transfer, supra*.

51. See *Gargan v. Gouyd*, 73 Cal. App. 4th 835, 842 (assets transferred to a former wife under a marital dissolution agreement were not subject to the claims of the former husband's creditors.)

52. See *Mejia v. Reed*, 97 Cal. App 4th 277 (6th App Dist 2002).

53. *Mejia v. Reed*, 31 Cal. 4th 657, 74 P.3d 166, 3 Cal. Rptr. 3d 390.

54. CAL. CIVIL CODE §3439.05.

55. See Spero Chapter 4. See also *In re Petir*, 59 BR 68, 71 (Bankr. MD La. 1986), which held that a marital agreement is not per se invalid if it applies to future increases in the value of community property. But note *In re Hull*, 251 BR 726, 733-734 (9th Cir. BAP 2000), wherein the court held that under Washington law, the debtor has a present interest in his spouse's future earnings.

56. CAL. FAM. CODE §2550. See *Mejia, supra.*, 31 Cal. 4th 667.

57. The adoption of the UFTA makes the uniform laws more parallel to federal law in the Bankruptcy Reform Act; takes into account certain changes in the Uniform Commercial Code regarding transfers of personal property; enforces compliance with ABA's "Model Rules of Professional Conduct"; and made changes in law dealing with avoidance of foreclosures of security interests as fraudulent conveyance.

58. In the Bill Analysis based on the hearing of the Senate Judiciary Committee Hearing on April 13, 2004 for SB 1408, which proposes the amendment to the Code, it is stated that, "Cases construing [Civil Code Section] 3439.04 have given short shrift to the "badges of fraud" because the badges are contained in the comments, rather than in the statute (unlike the uniform version). We do not think this is what the rafters of the

California statute intended . . . The divergence between the Uniform version and the California version ironically creates the misimpression that the “badges” are less important in California than they are elsewhere. Putting the badges back into the statute, as SB 1408 proposes to do, will ensure that the courts will give [them] proper consideration.”

59. 1) Whether the transfer or obligation was to an insider; 2) Whether the debtor retained possession or control of the property transferred after the transfer; 3) Whether the transfer or obligation was disclosed or concealed; 4) Whether before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; 5) Whether the transfer was of substantially all the debtor’s assets; 6) Whether the debtor absconded; 7) Whether the debtor removed or concealed assets; 8) Whether

the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; 9) Whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; 10) Whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and 11) Whether the debtor transferred the essential assets of the business to a lien holder who transferred the assets to an insider of the debtor

60. *Bresson v. Comm’r*, 213 F. 3d 1173 (9<sup>th</sup> Cir. 2000) (court concluded, the IRS had to rely on California’s Uniform Fraudulent Transfer Act to establish Bresson’s transferee liability).

61. Effective January 1, 2005, CAL. CIVIL CODE §3439.04 will be amended to provide courts with factors that judges may

consider in determining whether a debtor’s transfer of property is made with fraudulent intent to defraud a creditor. Existing law defines a fraudulent transfer as a transfer by a debtor with actual intent to hinder, delay, or defraud a creditor, where the debtor does not receive reasonably equivalent value in exchange for the transfer.

62. *Bresson, supra*.

63. In *United States vs. Summerlin*, 310 U.S. 414, 416 (1940), the Court held the federal government is not bound by state statute of limitations, even if it is required to apply state law on substantive issues.

64. *Id.*