

6-2006

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Recommended Citation

Steve R. Johnson, *Using State Fraudulent Conveyance Law to Collect Federal Taxes*, 14 *NEV. LAW* 14 (2006),
Available at: <http://ir.law.fsu.edu/articles/266>

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Using State Fraudulent Conveyance Law to Collect Federal Taxes

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The I.R.S. has an imposing armamentarium of means by which to collect unpaid taxes. They include the general tax lien, various special tax liens, administrative levy and sale, and judicial sale.¹ There are many administrative and judicial protections for taxpayers and third parties against the overly zealous application of these and other devices.² Nonetheless, the I.R.S.'s collection options are of imposing breadth and power, considerably exceeding collection options available to private creditors.³

Confronted by these collection devices, those who owe taxes and are determined not to pay them sometimes resort to transferring their assets to others, typically family members, close associates, or controlled corporations or other entities. Part I of this article describes the three principal means by which the I.R.S. protects itself against or defeats such transfers. It also notes examples of the devices in Nevada and the interaction of state law and federal law as to them. Part II details an illustrative recent case applying law essential identical to Nevada law.

I. I.R.S. Tools Against Transfers To Defeat Collection

Fraudulent conveyance: Like other creditors, the government may allege that a conveyance of assets was fraudulent. The Department of Justice would bring such an action on behalf of the I.R.S. in federal district court.⁴ A successful fraudulent conveyance action will return the property to the transferor, allowing the I.R.S. to proceed against it. In some cases, a successful action also may allow the government to recover a money judgment from the transferee.

Until fairly recently, the federal government had no general fraudulent conveyance statute of its own. Thus, the government would rely on the applicable state fraudulent conveyance statute. Nevada has substantially adopted the Uniform Fraudulent Transfer Act.⁵ A federal fraudulent conveyance statute was enacted in 1990.⁶ The government may rely on whichever law is more favorable to it.

Transferee liability: Alternatively, the I.R.S. may pursue a transferee liability remedy. IRC § 6901 sets out the required procedures, including issuance of a statutory notice of liability by the I.R.S. followed by the opportunity for review in the Tax Court. Since § 6901 is purely procedural, the I.R.S. must establish an external basis of substantive liability, which usually is a state fraudulent conveyance statute.⁷

If the I.R.S.'s determination is upheld, the I.R.S. will assess the liability (up to the lesser of the transferor's unpaid taxes or the value of the assets transferred, plus interest) directly against the transferee. After that assessment, the I.R.S. may then pursue its full range of collection options against the transferee.⁸

Alter ego and nominee liens: The transfer may be affected in name only. For instance, the taxpayer may transfer legal title but retain the beneficial use and enjoyment of the property. In tax, as in law generally, substance usually controls over form. Therefore, such sham transfers are nullities. The I.R.S. often uses alter ego and nominee liens and levies in such situations. The underlying legal basis is the assessment against the transferor; no separate assessment against the transferee is required.⁹

II. The *Verduchi* Case

In *Verduchi*,¹⁰ the taxpayers owed almost \$400,000 to the I.R.S. Under IRC § 6321, a federal tax lien attached to "all [their] property and rights to property." Nonetheless, they transferred their house to their son, Dennis, for no consideration. The tax lien remained on the house despite the transfer to Dennis.¹¹ The taxpayers successfully went through bankruptcy proceedings, but that did not alter the tax liens against them, the house, or the taxpayers' other property.

The government brought suit against the taxpayers under IRC §§ 7401 and 7403, seeking to reduce the unpaid liabilities to judgment, to set aside conveyance of the house as fraudulent, and to foreclose the tax lien against the property. During discovery, the government learned that Dennis had borrowed against the house, giving to a finance company a \$196,000 mortgage on the house. The government conceded that the mortgage had priority over the tax liens. Accordingly, the government amended its complaint to seek additional relief: a money judgment against Dennis for \$196,000 plus interest.

The issue turned on the Uniform Fraudulent Transfer Act as in force in Rhode Island. Significantly, Nevada law is essentially the same as Rhode Island law in the critical respects.¹² Thus, the result in *Verduchi* could be reached in Nevada as well.

Under both Rhode Island and Nevada law, money damages against a transferee generally are capped at the value of the property as of the transfer date. Dennis argued that requiring him to pay \$196,000 plus interest would essentially award the government the higher, current value of the property.

The district and circuit courts¹³ rejected this argument. Fraudulent conveyance is an equitable remedy, and both Rhode Island and Nevada law allow courts to adjust the amount of damages in order to make the creditor whole. Equity did not permit Dennis to pull \$196,000 out of the property by borrowing against it, eroding collectability of the government's prior claims against the property.

III. Summary

An ordinary creditor who wishes to go against particular property has recourse to state fraudulent conveyance law. The I.R.S. has that option too, plus, in some cases, its nominee and/or alter ego liens. An ordinary creditor who wishes to obtain a money judgment sometimes may do so under state fraudulent conveyance law. The I.R.S. has that option too plus its transferee liability remedy. In addition, the I.R.S. may use either state or federal conveyance statutes.

The government's ability to choose under which body of law to proceed, and which remedies to seek under such law, gives it considerable flexibility. In particular cases, the government chooses among its options based on which source of law will produce the best results for it in terms of amount recoverable (interest as well as damages), statute of limitations, ease of proof, and procedural convenience.

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¹ E.g., IRC §§ 6321, 6331 & 7403.

² See generally David Richardson, Jerome Borison & Steve Johnson, *Civil Tax Procedure* ch. 13 (2005).

³ See Steve R. Johnson, *The I.R.S. as Super Creditor*, 92 *Tax Notes* 655 (2001).

⁴ Fraudulent transfer cases involving Nevada taxpayers or arising out of Nevada business include *Mungle v. United States*, 1995 WL 783598 (D. Ariz. 1995).

⁵ NRS §§ 112.140 to .250.

⁶ Federal Debt Collection Procedures Act, included as Title XXXVI of the Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789, 4933 (codified as amended in scattered sections of 28 U.S.C.).

⁷ *Commissioner v. Stern*, 357 U.S. 39 (1958); see generally Steve R. Johnson, *Unfinished Business on the Taxpayer Rights Agenda: Achieving Fairness in Transferee Liability Cases*, 19 *Va. Tax Rev.* 403, 407-11 (2000).

⁸ Transferee liability cases involving Nevada taxpayers or arising out of Nevada business include *Adelman v. United States*, 304 F. Supp. 599 (C.D. Cal. 1969), *aff'd per curiam*, 440 F.2d 991 (9th Cir. 1971); *James O. Tomberlin Trust v. Comm'r*, 87 T.C. 876 (1986); *Paramount Warrior, Inc. v. Comm'r*, T.C. Memo. 1976-400, *aff'd without opinion*, 608 F.2d 522 (5th Cir. 1979).

⁹ Nominee/alter ego cases involving Nevada taxpayers or arising out of Nevada business include *Al-Kim, Inc. v. United States*, 650 F.2d 944 (9th Cir. 1981).

¹⁰ *United States v. Verduchi*, 434 F.3d 17 (1st Cir. 2006), *aff'd* 2005 WL 1027017 (D.R.I. 2005).

¹¹ See *United States v. Bess*, 357 U.S. 51, 57 (1958).

¹² Compare NRS §§ 112.210 & .220 to R.I. Gen. Laws §§ 6-16-7 & -8.

¹³ "Equitable determinations such as these are clearly committed to the trial court's discretion and are reviewed only for abuse of discretion." *Verduchi*, *supra*, 434 F.3d at 25.

This is so even if the trial court does not make detailed findings of fact. *Id.* at 23.