EXEMPTIONS FROM CREDITORS

Recent Court Decision Highlights a Limit to Asset Protection Planning

As is illustrated by the Tax Court decision in Rubenstein, taxpayers should not expect state creditor exemptions to stop a "super-creditor" like the IRS, even with respect to transferee liability.

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Estate planners who must frequently navigate through asset protection issues know that most of the essential elements of asset protection planning lie in our state laws, specifically in statutory exemptions from creditors. While bankruptcy law sometimes plays a role, in most situations clients seek to avoid bankruptcy; thus, state law exemptions/protections typically decide what assets are available to satisfy a claim and what assets are not.

Most creditors are subject to these state law exemptions; however, as highlighted in a recent Tax Court case, planners must recognize that the federal government and at least some of its agencies (specifically including the IRS) are treated as "super-creditors" who are not bound by state creditor protection statutes. [1] Even the "granddaddy of them all"—Florida's virtually boundless homestead protection—recently met its match when butting heads with the IRS.

Specifically, in the June 2010 case of *Rubenstein*, [2] the Tax Court confirmed that not only can the IRS levy against a taxpayer's Florida homestead (an issue decided long ago), but the recipient of a transfer of the homestead is subject to transferee liability (which according to the Tax Court's opinion was a novel issue). In summary, the Tax Court sustained an IRS determination that a son had transferee liability arising from his father's transfer to him of a homestead property—i.e., a Florida condominium.

As provided in the holding, the facts were reasonably straightforward, and in hindsight the outcome seems to have been reasonably obvious; however, the case offered a few

novel arguments, and it serves as a reminder of the boundaries of asset protection planning in reliance on state creditor protection statutes.

Facts of the case

The facts of *Rubenstein* may be summarized as follows:

- In 1989, Scott E. Rubenstein moved to live with his parents in Florida.
- After his mother's death in 1993, Scott remained to care for his father, Jerry Rubenstein.
- In March 2002, Jerry bought a condo in Delray Beach, Florida, for $35,000.
- In February 2003, Jerry deeded the condo to Scott. Scott did not pay for the condo, although in the trial he alleged he provided services to his father as consideration. It was stipulated that the fair market value of the condo in February 2003 was $41,000.

At the time of the transfer in February 2003, Jerry was insolvent, and Scott knew of this situation. Most significantly for the case, Jerry owed about $112,000 to the IRS for unpaid federal income taxes, penalties, and interest for tax years 1994 through 2002. The trouble arose in connection with this liability.

On 5/13/2002, Jerry submitted to the IRS an offer-in-compromise of $10,000 to settle his income tax liabilities. The IRS rejected the offer on the ground that it was less than Jerry's reasonable collection potential. One issue in the case related to the IRS's calculation of the reasonable collection potential. As stated in the decision, in calculating Jerry's reasonable collection potential, the IRS determined that his "Net Realizable Equity" in the condominium was zero. This calculation became part of Scott's argument at trial.

In September 2004, the IRS filed a notice of federal tax lien with respect to Jerry's unpaid assessments for income taxes, penalties, and interest. Subsequently in October 2005, the IRS determined that Scott had liability of $44,681 (later reduced to $41,000 by agreement of the parties—equal to the condo's stipulated value on the date of transfer), plus interest as provided by law. The IRS's position was this liability was created as Scott was a transferee of Jerry's condo, and Jerry's IRS liability for unpaid income taxes passed to Scott along with the property.

Scott Rubenstein's arguments

Scott challenged the IRS arguing three theories:

> (1) The homestead was an exempt asset under Florida law, so the transfer to him was not fraudulent and thus he should have no transferee liability.
> (2) The transfer of the condo was for valid consideration (i.e. Scott provided services to his father in exchange for the transfer of the condo). Thus, there should be no transferee liability, as he paid reasonably equivalent value.
> (3) Because the IRS determined that the property was worth zero on the calculation of the reasonable collection potential, it should be estopped from arguing the condo had value in the collection proceeding.

Court holding

As one would imagine, Scott lost on all three counts.

1. Was the gift of the homestead a fraudulent transfer giving rise to transferee liability? First, Scott argued the homestead was exempt from the claims of creditors under Florida law; thus, his father's transfer of the homestead to him could not be fraudulent. Scott cited the Uniform Fraudulent Transfer Act (UFTA) and Florida's version of it—the Florida Uniform Fraudulent Transfer Act (FUFTA)—to argue that the homestead was not an "asset" within the meaning of FUFTA and thus its transfer was not fraudulent. Apparently this approach was somewhat novel as the court stated:

> We have found no case expressly addressing this issue under the FUFTA or any other state's version of the UFTA. Petitioner's position might appear to be bolstered by cases holding, as a general proposition, that homesteads are "generally exempt under nonbankruptcy law" and are thus excluded from the definition of "asset" under the UFTA.

Thus, as a primary statement of law, the Tax Court reinforced the fact that the IRS has "super-creditor" status. To support that position, the Tax Court ruled that the condominium was "clearly" subject to collection by the IRS to enforce the rights of the U.S. government to collect income taxes. In support of this position, the Tax Court, citing to prior case law, ruled:

> Clearly the condominium was subject to judicial process by the United States to collect Jerry Rubenstein's taxes, notwithstanding any homestead exemption. The Code provides "two principal tools" to enforce the collection of unpaid taxes: lien-foreclosure suits in Federal District Court under section 7403(a) and administrative levy under section 6331(a). ... Pursuant to section 7403, as of the date of the transfer the United States could have enforced its lien on Jerry Rubenstein's condominium by filing suit in Federal District Court, which would have been empowered to order the condominium's sale, notwithstanding any homestead protections. Alternatively, the IRS could have sought authorization of the Federal District Court to levy on the condominium.

Citing to *Estes* [3] (which stated that a "homestead exemption does not erect a barrier around a taxpayer's home sturdy enough to keep out the Commissioner of Internal Revenue"), the Tax Court confirmed the Florida homestead protection does not stop the IRS from collecting federal taxes. Once the Tax Court confirmed that "super-creditor" status even as to homestead property, the Tax Court then used that status as a basis to reject Scott's first argument, which apparently had not been decided before, regarding the application of transferee liability.

Central to the case is Section 6901(a), which provides in relevant part that the liability of a transferee of a taxpayer's property may be "assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." As the Tax Court held, this Section does not create or define a substantive liability but merely provides to the IRS a procedure to assess and collect from the transferee of property an amount up to the transferor's liability. Interestingly, the Tax Court's ruling that the existence and extent of the transferee's liability are determined by the law of the state in which the transfer occurred—i.e. Florida.

As its first response, the IRS argued that under Florida law, the transfer of the condo was a fraudulent conveyance. The IRS pointed to Florida Statutes (FS) §726.106 (which

apparently is identical to section 5 of the Uniform Fraudulent Transfer Act), and which is referred to as part of the Florida Uniform Fraudulent Transfer Act (FUFTA) which provides in part:

> Transfers fraudulent as to present creditors
>
> (1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

For purposes of this statute, a transfer is defined as a disposition of an "asset." An "asset," in turn, is defined very broadly to mean "property of a debtor" but excludes "property to the extent it is generally exempt under nonbankruptcy law."[4] Therefore, the IRS argued that Scott is liable as a transferee under FS §726.106, because Jerry was insolvent at the time of the transfer.

In response, Scott argued (and apparently the IRS did not deny) that under Florida law the condominium was Jerry's exempt homestead property. Consequently, Scott argued, the condominium was "generally exempt under nonbankruptcy law," and as such it was not an "asset" for purposes FS §726.106. As to virtually any other creditors (other than the federal government and a few other exceptions under Florida law) Scott is likely right. The homestead is generally not available to the creditors and, as such, a transfer of it is generally not a disposition of an asset for fraudulent transfer purposes.

The Tax Court held, however, that because the condo was subject to judicial process for collection proceedings brought by the IRS (for Jerry's federal income tax liabilities), it is properly considered to be an "asset" for purposes of FS §726.106. Citing its conclusion that the condominium was an "asset" within the meaning of the FUFTA, the Tax Court reasoned that transferee liability was thus applicable to the gift to Scott, stating:

> We conclude that, as to the United States, the condominium was not "generally exempt under nonbankruptcy law" within the meaning of the FUFTA. Consequently, we conclude that the condominium was an "asset" within the meaning of the FUFTA.

Because the homestead was not exempt from a claim by the IRS against Jerry, and it was an "asset" within the FUFTA, the gift of it to Scott was a transfer for purposes of Florida's state laws creating transferee liability in the cases of fraudulent conveyances.

2. Did Jerry receive reasonably equivalent value for the transfer? As to Scott's second issue, he argued that his providing services to his father was reasonably equivalent value for the transfer of the house, and thus the transfer was not fraudulent under FUFTA. To be a fraudulent transfer under FUFTA (FS §726.106(1), in particular), a transfer must satisfy these requirements:

> (1) The creditor's claim arose before the transfer was made.
> (2) The debtor did not receive a "reasonably equivalent value" in exchange for the transfer.
> (3) The debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer.

It was stipulated that the IRS claim arose before the transfer and Jerry was insolvent at the time of the transfer. Thus, Scott's defense focused on the second prong: Did Jerry receive a "reasonably equivalent value" in consideration?

Scott argued that his caring for his father was fair consideration and met the "reasonably equivalent value" standard. The IRS contended that his providing care for his father was "out of love" not as consideration and it did not create a legal obligation or a binding debt on his father.

The Tax Court found:

> Although petitioner's care of his father is commendable, unfortunately for petitioner it does not, under the relevant legal standard, constitute "reasonably equivalent value" for the transfer of the condominium. Under the FUFTA, "Value" is given for a transfer if "property is transferred or an antecedent debt is secured or satisfied". Fla. Stat. Ann. sec. 726.104(1). Under these provisions, "value" does not include "an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another Consistent with the UFTA's purpose "to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors", these provisions reflect that "Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition."

Thus the Tax Court held the care Scott provided for his father was not "reasonably equivalent value" for the condominium within the meaning of the FUFTA; therefore, the transfer was constructively fraudulent under the FUFTA.

3. Was the IRS equitably estopped from asserting transferee liability? Finally, Scott argued that the IRS should be equitably estopped from asserting transferee liability against him due to the offer-in-compromise process in 2002. As noted in the summary of the facts of the case, above, the IRS rejected Jerry's offer in compromise because the IRS decided he had too much reasonable collection potential. In a table attached to that determination notice, the condo's "net realized equity" value was listed as being zero. The reason for this is unclear, and the Tax Court does not offer a reasonable explanation for why that happened.

Nevertheless, the Tax Court disagreed with Scott, holding:

> As a general matter, "the doctrine of equitable estoppel is applied against *** [the Commissioner] with the utmost caution and restraint."[5] The Court of Appeals for the Eleventh Circuit, to which any appeal of this case would lie, has questioned whether equitable estoppel can ever be applied against the Government. See Savoury v. U.S. Atty. Gen., 449 F3d 1307 , 1318 (11th Cir. 2006) ("it is far from clear that the doctrine of equitable estoppel may even be applied against a government agency. The Supreme Court has never held that it may be.") The Court of Appeals has also held that insofar as a party may be permitted, as a matter of law, to invoke the estoppel doctrine against the Government, that party must prove four elements: "(1) words, conduct, or acquiescence that induces reliance; (2) willfulness or negligence with regard to the acts, conduct, or acquiescence; (3) detrimental reliance; and (4) affirmative misconduct by the Government."[6]

In its ruling, the Tax Court concluded Scott had proved none of the four essential elements.

> (1) The Tax Court held that the communication from the IRS to Jerry did not induce Scott to do anything.
> (2) The Tax Court found there was no evidence proffered of any willfulness or negligence involved in the IRS's issuance of the communication.
> (3) The Tax Court found there was no evidence of detrimental reliance, as Scott in no way ever relied on the communication. The Tax Court stated: "After all, it was Jerry Rubenstein, not petitioner, who transferred the condominium."[7]
> (4) The Tax Court found Scott offered no evidence showing affirmative misconduct by the IRS. "Affirmative misconduct requires more than governmental negligence or inaction.... Rather, affirmative misconduct requires ongoing active misrepresentations or a pervasive pattern of false promises, as opposed to an isolated act of providing misinformation. The IRS communication of which petitioner complains falls far short of affirmative misconduct."

Thus, Scott's arguments for equitable estoppel were also dismissed.

Conclusion

The *Rubenstein* Tax Court decision provides a valuable reminder of the limits of state asset protection statutes and fraudulent transfer laws. While the transfer of a Florida homestead interest might not be fraudulent as to most creditors, it was fraudulent as to the IRS due to the federal government's "super-creditor" status. As a "super-creditor" entitled to pierce the Florida homestead protections, the IRS was also allowed to impose transferee liability on the son, who in this case, received the transferred homestead without paying adequate consideration.

When advising clients and dealing with gift/transfer issues as well as asset protection concerns, planners should be reminded that not all creditors play by the same rules, and certain "super-creditors" like the IRS may pierce through the state law protections.

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For a discussion of another potential federal government "super-creditor" see the discussion of the SEC's powers in the Solow case. Baskies "*SEC v. SOLOW*: If the SEC is a "Super-Creditor" Then State Law Exemptions Don't Matter, Right?" Steve Leimberg's Asset Protection Planning Email Newsletter—Archive Message #153 (5/3/2010).

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134 TC No 13, Tax Ct Rep (CCH) 58235, Tax Ct Rep Dec (RIA) 134.13, 2010 WL 2300752 .

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28 AFTR 2d 71-5770, 450 F2d 62, 71-2 USTC ¶9677 (CA-5, 1971). Moreover, the Tax Court cited to an Eleventh Circuit opinion, which stated the Florida homestead exemption does not spare a residence from a federal forfeiture. United States v. Lot 5, Fox Grove, 23 F3d 359 (CA-11, 1994).

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FS §726.102(2)(b).

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Boulez v. Commissioner, 76 TC 209 (1981) (quoting Estate of Emerson, 67 TC 612 (1977)), *aff'd* 59 AFTR 2d 87-608, 810 F2d 209, 87-1 USTC ¶9177 (D.C. Cir., 1987).

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Citing to McCorkle, 321 F3d 1292 (CA-11, 2003).

[7] The Tax Court cited to Boulez, *supra* note 5 (holding that to establish equitable estoppel against the Government, there must be detrimental reliance by the party claiming the benefit of the doctrine).

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