

Executor and Beneficiary Liability for Unpaid Income, Gift, and Estate Taxes of a Decedent

By Jerald David August

Tax advisors of estates are generally aware that the executor or personal representative of the estate is personally liable for the payment of federal estate taxes not only with respect to the probate estate, but also for estate taxes attributable to other assets includible in the taxable estate [Internal Revenue Code (IRC) section 2202; Treasury Regulations section 20.2002-1]. This duty applies not only to the entire estate, but also to any outstanding unpaid gift taxes, regardless of whether the gross estate contains any property not within the possession of the executor or administrator, such as lifetime transfers to trusts, survivorship transfers, takers under the exercise of a power of appointment held by the decedent, or life insurance proceeds paid to a named beneficiary other than the estate (IRC sections 2035–2042, 2044). For assets passing outside of the estate, the will or state law will control which individuals will be required to bear the economic burden of the tax. Even so, the executor will, in the absence of a discharge from liability issued by the IRS, be held personally liable for payment of the estate tax even if the estate is solvent.

If no executor or administrator is appointed to the estate, any person in actual or constructive possession of any property of the decedent is required to pay the entire tax to the extent of the value of the property in his possession (IRC section 2203). This “constructive executor” is not only saddled with personal liability for the transfer tax liability of the decedent, but generally will not be permitted to file a request for discharge with the IRS.

Executors' Personal Liability

The personal liability of the executor of an estate, trustee of a trust, or even an officer or director of a corporation to pay claims owed to the government, such as unpaid taxes of a decedent, is broadly prescribed under the Federal Claims Priority Act. This statute provides the United States with a direct cause of action against the fiduciary, be it an executor or trustee, for making preferential payments to other creditors or beneficiaries of an insolvent estate or trust over the tax (or other federal claims) owed to the government.

Under 31 USC section 3713(b), the executor is personally liable for any unpaid taxes of the decedent to the extent of the value of other debts paid by the executor over the outstanding priority claims of the United States. A debt for this purpose

includes a distribution of a bequest or a portion of the residuary estate to the named beneficiaries under the decedent's will or under the law of intestate distribution. This personal liability attaches even where there may be a beneficiaries' agreement to pay the unpaid tax, or where the executor is contractually indemnified by the beneficiaries. (There are federal reimbursement statutes that may be applicable as to property subject to estate tax that passes outside of probate; see IRC sections 2204–2207.) The liability amount is based on the excess value of the transferred property over the unliquidated claim for taxes, plus penalties and interest, as of the date of the offending transfer. Interest is then added to such amount from the applicable transfer date. The statute of limitations is six years.

The event that triggers application of 31 USC section 3713(b) is the transfer of property to a beneficiary or creditor of an estate other than the United States, provided: 1) the estate is insolvent or is rendered insolvent at the date of transfer, and 2) the executor had actual or constructive knowledge of the outstanding liability to the IRS. Such liability need not have been assessed by the IRS at the time; for example, if a lawyer or accountant working for the estate or an IRS agent informs the executor that there is or may be an assessment for unpaid taxes against the decedent before the subject distribution is made, the knowledge criterion is satisfied. Actual notice is not required, so long as the executor had sufficient notice of the claim that would cause a reasonably prudent person to inquire further. The fiduciary liability provision can also be applied where the executor or successor executor defaults on the payment of estate tax installments on closely held business interests under IRC section 6166.

An executor's exposure for personal liability for unpaid taxes of the decedent can be mitigated in several ways. First, an executor who is appointed and qualified to act under state law as such can apply for and receive a discharge from personal liability for estate tax by written application and early determination by the IRS of the tax owed. The determination must be made within nine months after the return is filed, or within nine months after the written application is made for the determination by the executor, whichever is later; upon determination and payment of the tax, the executor is discharged. If the payment of the tax is extended, IRC section 2204(a) allows

the executor to receive a discharge after the tax is determined upon the furnishing of a bond (if so required by the IRS). The IRS may later issue a notice of discharge, thereby relieving the executor or personal representative from liability for the payment of the estate tax.

The executor is also responsible for payment of any unpaid gift tax due for lifetime transfers made by the decedent. If the IRS furnishes the executor with copies of gift tax returns under IRC section 6103(e)(3), and if the executor relies on those returns in good faith in determining the decedent's adjusted taxable gifts, the executor may be released from any liability for estate taxes attributable to adjusted taxable gifts made more than three years before the decedent's death that were not shown on the returns. Note, however, that such a discharge does not release any part of the estate from an estate tax lien under IRC sections 6324(a)(1), 6324(a)(2), or 6324(b).

There are other related provisions in IRC section 6905 and the accompanying regulations permitting a fiduciary to apply for a prompt assessment of income and gift tax liabilities. It is important to provide prompt notice of termination of the fiduciary relationship as well under IRC section 6903(a) [see *Huddleston v. Comm'r*, 100 T.C. 17 (1993)].

Where there are coexecutors acting on behalf of an estate, both must be fully informed as to their obligations and duties, and both must participate in decisions on payment of taxes, filing of protests, negotiation of settlements, and litigation against the government. In general, one coexecutor can bind the other, even where the nonacting coexecutor was unaware of the actions taken. Where one coexecutor takes a passive role, such individual can still be held personally liable for the unpaid federal estate, gift, or income taxes of the decedent.

Transferee Liability

When the executor fails to pay estate tax, the IRS has the option of also pro-

ceeding against transferees under special lien statutes contained in IRC section 6324 for the collection of any unpaid taxes with respect to property included in the gross estate. As defined in IRC section 6901(h), "transferee" includes donees, heirs, devisees, and distributees, as well as anyone who is personally liable for estate tax under the terms of the special estate and gift tax lien statute. The transferee's personal liability is to the extent of the value of such property at the time of the decedent's death. The statute of limitations is 10 years; however, if no gift tax return for the applicable year was filed, the statute

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of limitations will not expire [IRC section 6324(b)].

The government may also pursue transferees of gifts or estate property for unpaid taxes of the decedent under the general transferee liability provision contained in IRC section 6901. This is referred to as a "procedural" provision and allows the government to simultaneously pursue alternative avenues for the collection of unpaid taxes; see *Russell v. U.S.* [461 F.2d 605 (10th Cir. 1972)]. For example, the government may file an action in federal district court for collection of the tax owed under a special lien provision, as previously mentioned, and also pursue an alter-

native remedy of transferee liability under IRC section 6901.

The statute of limitations under IRC section 6901 will generally expire (unless extended by consent) earlier than the 10-year special lien statutes, since it is one year after the expiration of the period of limitation for assessment against the transferor and an additional year with respect to a transferee of a transferee. As with other creditors, debtors who attempt to defraud, hinder, or delay the collection efforts of the IRS enable the agency to assert the same rights as private creditors under state (as well as federal) law fraudulent conveyancing statutes.

Protecting the Executor's Interests

Executors, trustees, and beneficiaries should seek the advice of an attorney with substantial experience and background in this area of tax law in addressing their potential personal liability. Indeed, the presence and application of the special lien statutes are, in this author's experience, sometimes overlooked or misinterpreted—both as to their application and amount of potential personal liability. The benefit of an indemnification or beneficiary agreement may prove short-sighted, as the case law demonstrates. Indeed, in some cases it may be advisable for the executor to resign prior to making distributions to beneficiaries if such distributions would leave unpaid obligations of the IRS outstanding.

The issues raised above require due diligence to investigate the decedent's unpaid tax obligations, understanding of the correct amount of the estate tax liability and potential for additional assessment, informing beneficiaries of any special lien and transferee liability exposure, and attempting to mitigate the executor's personal liability by requests for prompt assessment and discharge. □

Jerald David August, JD, LLM, is a partner, specializing in federal taxation, at Kostelanez & Fink LLP, New York, N.Y.

