



WRMarketplace

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The WRMarketplace is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone. WRMarketplace #17-34 was written by Greenberg Traurig Shareholder Karen D. Yardley.

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TOPIC: No Good Deed Goes Unpunished – Does the Executor Know He Can be Personally Liable for Unpaid Taxes?

MARKET TREND: In the spirit of the IRS always gets theirs, a continuing trend, executors who pay general creditors or distribute property to beneficiaries before paying federal claims can be personally liable for any unpaid estate taxes.

SYNOPSIS: Protecting executors may start with life insurance. Executors are charged with paying the decedent's federal tax liabilities before paying general creditors or distributing assets to beneficiaries. Fiduciaries in possession of a decedent's assets can be held personally liable for unpaid taxes if they make such payments or distributions and then have insufficient assets to pay taxes. The IRS can also pursue beneficiaries who receive estate assets, including beneficiaries of non-probate assets such as life insurance. Each person serving as an executor or receiving property from a decedent needs to be thoroughly apprised of their potential liability and actions they can take to minimize such exposure, such as ensuring adequate estate liquidity.

TAKE-AWAY: Advisors can help executors reduce their exposure to personal liability for unpaid taxes by ensuring executors understand the priority given to the payment of federal claims and prioritizing the payment of taxes over the payment of general debts and distributions to beneficiaries. More importantly, advisors can assist by ensuring appropriate levels of liquidity using life insurance.

MAJOR REFERENCES: 31 U.S. Code § 3713; Internal Revenue Code (“Code”) §§ 2002, 2202-2207B, 6324 and 6901.

The primary responsibilities of an executor¹ are to collect the decedent’s assets, pay the decedent’s debts and taxes, and distribute the remaining assets to the beneficiaries. Most individuals who agree to serve as an executor (or as trustee of a decedent’s trust) significantly underestimate the time it will take and how much exposure there can be. Most executors do not fully appreciate the very real personal liability they have for unpaid taxes. Each person serving as an executor needs to be thoroughly apprised of their potential liability and actions they can take to minimize such exposure.

PERSONAL LIABILITY FOR UNPAID TAXES

When an individual passes, a special tax lien for any unpaid estate taxes attaches to all of the estate assets and continues for a period of 10 years.² In addition to this special lien, a general lien for unpaid assessed taxes (of any type) may be imposed upon the very same assets.³ Executors are charged with ensuring all such taxes are paid⁴ and can be held personally liable for unpaid taxes if:

- (1) The executor makes an unauthorized payment or distribution,
- (2) The payment or distribution is made at a time when the estate is insolvent or the payment renders the estate insolvent, and
- (3) The payment or distribution was made after the executor had actual or constructive knowledge of the federal tax claim.⁵

Example: X died in January 2017 with an estate valued at \$6,000,000. Pursuant to X’s Will, his estate passes equally to his children. At the time of his death, X had an unpaid federal income tax liability of \$4,000,000. Y is the executor of X’s estate. Y distributes \$3,000,000 to X’s children before paying the tax liabilities. If Y had actual or constructive knowledge (knew or should’ve known) of the unpaid income tax liability, Y will be personally liable for the payment of any portion of the income tax that remains unpaid along with any other unpaid federal taxes.

Personal liability only attaches if the executor makes an unauthorized payment. If the estate is already insolvent (or close to being insolvent), but no unauthorized payments or distributions are made, the executor will not be held personally liable.

Example: X died in January 2017 with an estate valued at \$2,000,000. Pursuant to X's Will, his estate passes equally to X's children. At the time of his death, X had an unpaid federal income tax liability of \$2,500,000. Y is the executor of X's estate. Y pays the income tax liability, using all of the assets available in the estate in Y's possession. Y will not be personally liable for the unpaid income tax liability.

Not all payments expose the executor to personal liability. Some expenses, such as funeral and administrative expenses, a family allowance, and secured debts, have priority for payment over federal tax liabilities.⁶ Payments that can trigger personal liability include the payment of unsecured debts, medical and hospital bills, and state and local taxes, as well as distributions to beneficiaries or the satisfaction of an elective share or a homestead interest.

ESTATE TAX CONTRIBUTION RULES

The executor is responsible for payment of estate taxes on all assets in the decedent's taxable gross estate, including non-probate assets.⁷ The Code specifically authorizes the executor to recover estate taxes paid by the executor that are attributable to certain non-probate assets from the beneficiaries of those assets. Accordingly, unless the decedent provides otherwise in his will, the executor may seek reimbursement from persons who receive non-probate assets included in the decedent's estate pursuant to a general power of appointment held by the decedent,⁸ assets transferred by the decedent during life in which the decedent had a retained interest,⁹ and assets in a qualified terminable interest trust (a so-called "**QTIP**" trust) included in the decedent's estate.¹⁰ State apportionment laws may authorize the executor to also seek contribution or reimbursement from persons who receive other types of non-probate assets.

TRANSFeree LIABILITY FOR TAXES

If estate taxes are not paid when due, then any person who receives estate assets, or who has possession of property included in the gross estate on the date of death, can also be personally liable for unpaid taxes, but only to the extent of the value of such assets.¹¹ This includes both beneficiaries receiving property from the probate estate and beneficiaries of non-probate assets, such as property held in joint tenancy or that passes pursuant to a beneficiary designation (like life insurance proceeds and retirement assets).

This so-called "**transferee liability**" allows the IRS to collect unpaid estate taxes directly from such transferees up to the value of the asset received. Transferee liability can occur if the executor doesn't pay the tax, if assets are discovered after the estate tax return is filed, or if the value of the estate is increased pursuant to an audit. Transferee liability can extend beyond the 10-year special lien period. The U.S. Tax Court in *Estate of Myers v. Commissioner*,¹² for example, recently confirmed that beneficiaries of non-probate assets may be personally liable as transferees for unpaid estate taxes more than 10 years after a decedent's death, to the extent these assets were included in the decedent's gross estate, and the assets in possession of the executor are insufficient to

pay the liability. Unlike the 10-year special tax lien, which applies to every asset of the gross estate but expires 10 years after the decedent's date of death, the 10-year collection period for transferee liability for the estate tax runs from the date of estate tax assessment.

Transferee liability also applies to unpaid gift taxes¹³ and can be used by the IRS to collect unpaid income tax liabilities.¹⁴

MANAGING PERSONAL LIABILITY

Ensuring the decedent has sufficient life insurance to cover estimated taxes, administration costs, and creditors—as well as providing for the decedent's family—can be key to minimizing the executor's exposure. Executors themselves can also take a number of actions to help reduce their liability for unpaid taxes.

- To ensure the executor receives notices from the IRS and has the authority to deal with the IRS, the executor should file a Form 56, Notice Concerning Fiduciary Relationship (“**Form 56**”) upon accepting the appointment as executor or other fiduciary. The Form 56 informs the IRS of the fiduciary relationship and requests that all tax-related documents, including tax assessments and liens, be sent to the executor at his or her address.
- The executor should confirm that the decedent has filed his federal and state income and, if applicable, gift tax returns and, if necessary, file any missing returns along with the decedent's final income tax returns. If the executor does not have copies of the decedent's prior income or gift tax returns, copies of the returns can be obtained by filing a Form 4506, Request for Copy of Tax Return.
- The executor should refrain from paying the decedent's debts and expenses (other than expenses that have priority over federal taxes) or making distributions to beneficiaries until federal and state tax liabilities are ascertained and paid or adequately provided for. Once the executor knows the estate tax liability, it may be possible to pay debts and make a partial distribution, but only if adequate funds are reserved to pay taxes, including any increase in taxes that may result from an audit. If the estate has hard to value assets (such as a family business) or has taken large valuation discounts, prudence would require that no distribution be made until the tax issues have been resolved. Final distribution of assets to the beneficiaries should not be made until the executor receives an estate tax closing letter, the IRS account transcript indicates the estate tax return has been approved as filed,¹⁵ or the limitations period for assessing additional taxes has expired.
- Once outstanding gift or income tax returns have been filed, the executor can request a prompt assessment of taxes due by filing Form 4810. Generally, the IRS has three years from the date a return is filed to audit returns and assess additional taxes. Filing a Form 4810 generally shortens the limitations period to eighteen months. Note that Form 4810 does not apply to estate taxes.

- After required income, gift, and estate tax returns have been filed, the executor can request a discharge from personal liability for the decedent's taxes by filing Form 5495, Request for Discharge From Personal Liability Under IRC Sections 2204 and 6905. The IRS will then notify the executor of the amount of taxes due within 9 months after receipt of the request. If this amount is paid, the executor will be discharged from personal liability for any future deficiencies. If the IRS does not notify the executor that an amount is due, the executor will be discharged from personal liability at the end of the 9-month period.
- Prior to making distributions to the beneficiaries, the executor should request an indemnity from the beneficiaries for any future tax assessments (including additional estate taxes that may arise on audit).
- Executors are also responsible for the payment of applicable state taxes. Accordingly, if estate tax values are changed as the result of an audit or additional assets are discovered, the executor may need to file amended state returns.
- At the conclusion of the executor's representation of the estate, the executor should file a new Form 56 to inform the IRS that the fiduciary relationship has terminated. This will help protect the executor from liability for future assessments.

TAKE-AWAY

- Advisors can help executors reduce their exposure to personal liability for unpaid taxes by ensuring executors understand the priority given to the payment of federal claims and prioritizing the payment of taxes over the payment of general debts and distributions to beneficiaries. More importantly, advisors can assist by ensuring appropriate levels of liquidity using life insurance.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

NOTES

¹ For estate tax purposes, an “**executor**” means the court-appointed executor or administrator of the decedent's estate or, if no executor or administrator is appointed, any person in actual or constructive possession of any property of the decedent, such as the trustee of the decedent's revocable trust, a surviving joint tenant or other person in possession of the decedent's property. See, Code § 2203. For purposes of this report, such individuals are collectively referred to as the “**executor**”.

² Code § 6324(a)(1). Similarly, when an individual makes a taxable gift, a special tax lien for unpaid gift taxes attaches to all gifts made during that year for a period of 10 years commencing with the date of the gift. Code § 6324(b).

³ Code § 6321.

⁴ See, 31 U.S. Code § 3713(b); Code § 6901(b); Code § 2002.

⁵ *Id.*

⁶ See, Rev. Rul. 80-112, 1980-1 C.B. 306.

⁷ See, Code § 2002.

⁸ Code § 2207.

⁹ Code § 2207B.

¹⁰ Code § 2207A.

¹¹ Code § 6324(a)(2).

¹² *Estate of Myers v. Commissioner*, T.C. Memo. 2017-11.

¹³ If gift taxes are not paid in full when due, the donee of any gift can be personally liable for such tax to the extent of the value of such gift. Code § 6324(b).

¹⁴ Code § 6901(a)(1).

¹⁵ Note that for estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon the request of the taxpayer. Such requests should be made no earlier than four months after filing the estate tax return. In lieu of an estate tax closing letter, account transcripts are available online to tax professionals or by filing a Form 4506-T with the IRS. See, IRS Notice 2017-12.