AVOID FIDUCIARY TAX LIABILITY AT ALL COSTS

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It can be either a blessing or a curse to be appointed as the Fiduciary (Personal Representative of an estate or Trustee of a trust) of a decedent's estate or trust. One of the most over looked aspects of the job is the fact that the U.S. Government has a "general tax lien" on all estate and trust property when a decedent leaves assessed and unpaid taxes and a "special tax lien" for estate taxes on a decedent's death. As a result, when advising a Fiduciary on the estate and trust administration process it is important to inform them that with the responsibility also comes the potential for personal liability.

On many occasions a Fiduciary may be placed into a position where assets passing outside the probate estate (life insurance, jointly held property, retirement accounts, and pension plans) or trust, over which they have no control, constitute a substantial portion of the assets (real property, stocks, cash, etc.) subject to estate taxation. Without the ability to direct or assume control of the assets the Fiduciary may have both a liquidity problem and lack of means to satisfy the estates tax (income or estate) obligation. For this reason alone, a Fiduciary should be very reluctant to distribute any funds to a beneficiary before all statute of limitation periods expire for the Internal Revenue Service ("IRS") to assess a tax deficiency.

BEGINNING THE PROCESS

The first step of every Fiduciary should be to collect all estate and/or trust assets and liabilities so that they can be accounted for by them. Once the assets and liabilities are accumulated, the Fiduciary should obtain copies of all Federal Income and Gift Tax Returns filed by the decedent over the past seven (7) years). Analysis of this information will alert the Fiduciary to potential prior year income and/or gift tax issues that require immediate attention.

The next step will require the Fiduciary to gather all of the necessary financial information to file the decedent's final Federal Income Tax Return. Analysis of this information will alert the Fiduciary to a potential current year income and/or gift tax issue that requires immediate attention.

Liability for Income and Estate Taxes

Internal Revenue Code ("IRC") *§6012(b)* holds a Fiduciary responsible for filing the decedent's final income and estate tax returns. IRC *§6903(a)* further establishes a Fiduciary's responsibility for representing the estate in all tax matters upon filing the required Notice Concerning Fiduciary Relationship (IRS Form 56). Under IRC *§6321*, when the tax is not paid an IRS lien will spring into being. When an estate or trust possesses insufficient assets to pay all its debts, federal law requires the Fiduciary to first satisfy any federal tax deficiencies before any other debt (*31 U.S.C. §3713* and *IRC §2002*).

A Fiduciary who fails to abide by this requirement will subject themselves to personally liability for the amount of the unpaid tax deficiency (*31 U.S.C. §3713(b)*). An exception arises when an individual has obtained an interest in the property that would prevail over the federal tax lien under IRC *§6323* (*United States v. Estate of Romani*, *523 U.S. 517 (1998)*). When there are insufficient estate or trust assets to pay a federal tax obligation, as a result of the Fiduciary's actions, the IRS may collect the tax obligation directly from the Fiduciary without regard to transferee liability (*United States v. Whitney*, *654 F.2d 607 (9th Cir. 1981)*). If the IRS determines a Fiduciary to be personally liable for the tax deficiency it will be required to follow normal deficiency procedures in assessing and collecting the tax (IRC *§6212*).

Prerequisites for Fiduciary Liability

Under IRC *§3713*, a Fiduciary will be held personally liable for a federal tax liability if the following conditions precedent are satisfied: (i) the U.S. Government must have a claim for taxes; (ii) the Fiduciary must have: (a) knowledge of the government's claim or be placed on inquiry notice of the claim *(Huddleston v. Comm'r, T.C. Memo.1994–131, 1994 WL 100520 (U.S. Tax Ct.1994*) and *Leigh v. Comm'r, 72 T.C. 1105, 1110 (U.S. Tax Ct.1979*), and (b) paid a "debt" of the decedent or distributed assets to a beneficiary; (iii) the "debt" or distribution must have been paid at a time when the estate or trust was insolvent or the distribution created the insolvency; and (iv) the IRS must have filed a timely assessment against the fiduciary personally (*United States v. Coppola*, *85 F.3d 1015 (2d Cir. 1996)*). "The knowledge requirement … may be satisfied by either actual knowledge of the liability or notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim of the United States." *Leigh.*

For purposes of IRC §3713, the term "debt" includes the payment of: (i) hospital and medical bills; (ii) unsecured creditors; (iii) state income and inheritance taxes (conflict between *U.S. Blakeman, 750 F. Supp. 216, 224 (N.D. Tex. 1990*) and *In Re Schmuckler's Estate, 296 N.Y. 2d 202, 58 Misc. 2d 418 (1968)*); (iv) a beneficiary's distributive share of an estate or trust; and (v) the satisfaction of an elective share. In contrast, the term "debt" specifically excludes the payment of: (i) a creditor with a security interest; (ii) funeral expenses (*Rev. Rul. 80-112, 1980-1 C.B. 306*); (iii) administration expenses (court costs and reasonable fiduciary and attorney compensation) (*In Re Estate of Funk*, *849 N.E.2d 366 (2006)*); (iv) family allowance (*Schwartz v. Commissioner*, *560 F.2d 311 (8th Cir. 1977)*); and (v) a "homestead" interest (*Estate of lgoe v. IRS, 717 S.W. 2d 524 (Mo. 1986*)).

Collection

In order to collect the federal tax deficiency the IRS possesses the option to either file a lawsuit against the Fiduciary in federal district court, pursuant to IRC *§7402(a)*, or issue a notice of fiduciary liability under IRC *§ 6901(a)(1)(B*) and commence collection efforts. The statute of limitations for issuing a notice of fiduciary liability is the later of one year after the fiduciary liability arises or the expiration of the statute of limitations for collecting the underlying tax liability (IRC *§ 6901(c)(3)*).

Before collection efforts can be started the IRS must first establish that the decedent's estate or trust is insolvent (debts exceed the fair market value of assets) or possesses insufficient assets to pay the outstanding tax liability. "Insolvency" can only be established when the estate or trust possesses insufficient assets under the Fiduciary's custody and control to satisfy the tax liability. With regard to non-probate or trust assets included in a decedents gross estate, IRC *§2206-2207B* empowers a Fiduciary to obtain from the beneficiary the portion of the estate tax attributable to those assets.

While the IRS may pursue collection of an estate tax deficiency from the beneficiaries, the Fiduciary will only retain a right of subrogation if the IRS elects to pursue collection of the tax deficiency against them. Under IRC *§6324*, the IRS may seek collection of the federal tax deficiency from the Fiduciary in possession of the assets on which the tax applied, not to exceed the value of the assets transferred to any beneficiary. However, if the Fiduciary had no knowledge of the debt, they will not be liable for more than the amount distributed to the beneficiaries or other creditors, or for taxes discovered subsequent to any distributions (*Rev. Rul. 66-43, 1966-1 C.B. 291*). Regardless of the circumstances, a Fiduciary's failure to file a federal tax return will subject them to personal liability for the unpaid tax.

Burden of Proof

The burden of proof will then rest with the Fiduciary to prove their lack of knowledge of the unpaid tax (*U.S. v. Bartlett, 2002-1 USTC ¶60,429. (C.D. Ill. 2002*)). Once this element is established the burden will shift back to the IRS (*Villes v. Comr., 233 F.2d 376 (6th Cir. 1956*); *Estate of Frost v. Commissioner, T.C. Memo. 1993-94*). If the liability pertains to income or gift taxes relating to years before the decedent's death, a court may require the Fiduciary to have actual or constructive knowledge of the liability before holding them personally liable for the unpaid tax (*U.S. v. Coppola, 85 F.3d 1015 (2d Cir. 1996)*).

Statutes of Limitation:

Under IRC *§6901* and *§6501* the statutory period for assessing personal liability against a Fiduciary tracks the same as the underlying tax. The limitation period is: (i) three years from the date of a tax returns filing or the date the tax return is due (if filed early); (ii) six years if there is a substantial omission (25% or more) of gross income, gift or estate assets; or (iii) no limit if the IRS can prove fraud. Under IRC *§6502(a)*, once the IRS makes a tax assessment it has ten (10) years to collect the tax.

METHODS FOR REDUCING FIDUCIARY LIABILITY

A Fiduciary may only make a partial distribution to beneficiaries or creditors without concern of personal liability for estate tax deficiencies if sufficient assets are retained to pay all tax liabilities (including potential interest and penalties).

Income and Gift Taxes

The first step requires the Fiduciary to file IRS Form 4506, Request for Copy or Transcript of Tax Form, with the IRS. The response received from the IRS will educate the Fiduciary as to which tax returns (income, gift, etc.), if any, were filed by the decedent prior to his or her death. The request should include the Fiduciary's letters of administration, if applicable, and a Power of Attorney (IRS Form 2848).

To expedite the process, IRC *§ 6501(d)* authorizes a Fiduciary to file IRS Form 4810, Request for Prompt Assessment, to request a prompt assessment and review of all tax returns filed by the decedent with the IRS. The Form 4810 must detail the following: (i) type of tax; (ii) tax periods covered; (iii) name, social security or EIN on each return; (iv) date the returns were filed; and (v) letters of administration or comparable authority to act on behalf of the estate or trust. Filing Form 4810 will shorten the statute of limitations period for the tax return from three years from the date of filing or due date of the return to eighteen (18) months from the date of its filing with the IRS. It is important to note that the shortened statute of limitations period will not apply to: (i) fraudulent tax returns; (ii) unfiled tax returns (*IRC §6501(c)*); (iii) any tax return with "substantial omissions" (IRC *§6501(e)*); or (iv) any tax assessment described in IRC *§6501(c)*.

Once the decedent's federal income tax return(s) has been filed with the IRS the Fiduciary may file a written application requesting release from personal liability for income and gift taxes. The IRS will then be limited to nine (9) months (the "notification period") to notify the Fiduciary of any tax due. Under IRC *§6905*, upon expiration of the notification period, the Fiduciary will be discharged from personal liability for any tax deficiency thereafter found to be due and owing. The application should be filed with the IRS officer with whom the estate tax return was filed (or, if no estate tax return was required, to the IRS office where the decedent's final income tax return was filed).

Estate Taxes:

A Fiduciary administering an insolvent estate or trust may also consider filing, pursuant to *28 U.S.C. §2410(a)*, a federal district court quiet title action against the U.S. Government. The District Court will only have jurisdiction to address procedural challenges and not the underlying IRS tax liability (*Walker v. U.S. (N.J. 2-29-2008)* and *Robinson v. United States*, *920 F.2d 1157 (3d Cir. 1990)*). In *Estate of Johnson v. U.S.*, *836 F.2d. 940 (5th Cir. 1988*), a Texas fiduciary argued that he had a right to a quiet title action to determine if administration and funeral expenses had priority over federal tax liens. However, the Fiduciary should be cognizant that any quiet title court order may not protect them from an IRS assertion of personal liability under *§3713(b)*.

DISCHARGE FROM PERSONAL LIABILITY

Estate Taxes

IRC *§2204* authorizes a Fiduciary to submit a written request for discharge from personal liability from the federal estate tax. The IRS has nine months from the filing of the request, when filed after the estate tax return, to notify the Fiduciary of any estate tax due. Upon payment of the tax (the IRS will issue form 7990) and expiration of the nine-month period the Fiduciary will be discharged from personal liability for any estate tax deficiency. It is important to recognize that IRC *§2204* only discharges the Fiduciary from personal liability and will not shorten the time for assessment of tax against the estate or any transferee of estate assets.

IRC *§6903* provides that a judicial discharge is insufficient to relieve a Fiduciary of subsequent estate tax liabilities. Only the filing of IRS Form 56, Notice Concerning Fiduciary Relationship, informing the IRS of judicial discharge or other legal termination will terminate the Fiduciary duties. As a protective measure, most Fiduciary's require beneficiaries to enter into separate agreements guaranteeing indemnification for any subsequent tax deficiencies in exchange for the distribution of the estate or trust's assets to them.

Income and Gift Taxes

IRC *§6905* provides the method for a Fiduciary to be discharged from personal liability for income and gift taxes of a decedent. The Fiduciary will be required to make written application (filed after the tax return with respect to such tax is made) on IRS Form 5495 for release from personal liability. Upon payment of the tax or expiration of a nine-month period (if no notification is made by the Secretary during this period) after delivery of the application for release the Fiduciary will be: (i) discharged from personal liability for any deficiency in such tax thereafter found to be due; and (ii) entitled to a written acknowledgment (IRS Form 7990A for gift taxes) of such discharge.

TRANSFEREE LIABILITY

Estate and Trust Taxes:

Every estate and trust beneficiary (heir, legatee, and devisee) must be appraised of their potential for personal liability for unpaid estate taxes under IRC *§6901(a)(1)* (probate estate) and *§6324(a)(2)* (non-probate assets included in the decedent's gross taxable estate). Pursuant to IRC §6901, the liability of a transferee is similar to that of the transferor under *§3713*. A beneficiary's transferee liability will be limited to the value of assets transferred to them (*Commissioner v. Henderson's Estate, 147 F.2d 619 (5th Cir. 1945)*).

Gift Taxes

Under IRC *§2501*, a donor (party making a gift) will bear primary responsibility for paying any tax liability associated with a gift. This will not preclude a donee, under IRC *§6324*, from being held liable for the applicable gift tax. Transferee liability will hold the donee personally liable for the applicable gift tax (the donor's tax deficiency), up to the value of the gift, even if the gift received did not contribute to the unpaid gift tax liability (*U.S. v. Botefuhr, 309 F.3d 1263 (10th Cir. 2002*).

IRC *§6324* further provides that the tax lien shall remain in place for ten-years from the date the gifts are made. The liability will immediately arise once the donor fails to pay the applicable gift tax (*Poinier v. Commissioner, 858 F.2d 917 (3d Cir. 1988)*).

OTHER LIABILITY

In *United States v. Guyton, Jr., 2010 WL 1172428 (11th Cir. March 26, 2010*), the 11th Circuit went so far as to hold the Personal Representative of an estate liable for unpaid taxes on assets that never became a part of a decedent's probate estate. In *Guyton*, the proceeds from the sale of the family business were deposited into a joint bank account owned by a father and one of his sons. Upon the father's death, another son was appointed as the Personal Representative for the estate. As Personal Representative, the son was responsible to report the sale of the family business on his father's final federal income tax return (IRS Form 1040) and pay the federal income tax triggered by the transaction.

The Personal Representative argued that his brother, the joint account owner, was liable for the tax on the sale proceeds as "income with respect to a decedent," under *26 U.S.C. §691*. The 11th Circuit did not accept that argument (only income realized by a taxpayer after their date of death is "income in respect to a decedent") and held that because the father realized the gain from the sale of the family business "prior to his death [and actually received the sales proceeds prior to his death], . . . his estate must pay the tax." Citing to *Blohm v. C.I.R., 994 F.2d 1542, 1549 (11th Cir.1993).*

BREACH OF FIDUCIARY DUTY

Even worse than Fiduciary liability is a lawsuit for breach of fiduciary duty. The IRS has standing, as an unpaid estate creditor, to sue a Fiduciary for breach of their fiduciary duty for failing to pay Federal income and estate taxes. *United States v. MacIntyre, ___ F.Supp.2d ___, 2012 WL 2403491 (S.D. Tex. June 25, 2012); In re Tomlin, 266 B.R. 350, 354 (N.D.Tex.2001).* The reason for bringing the cause of action would be to insure the Fiduciary could not avoid liability by filing for bankruptcy. Under *§523(a)(4)* of the Federal Bankruptcy Code a judgment predicated on breach of fiduciary duty is deemed the product of "fraud or defalcation while acting in a fiduciary capacity" and is not dischargeable.

FLORIDA PROBATE LAW

Under Florida law, a claim for federal taxes (income, estate or gift) will not be subject to F.S. *§733.702*, *§733.710* or the requirement that a creditor claim be filed in probate proceedings (*U.S. v. Stevenson*, *2001-2 USTC ¶50,371 (M.D. Fla. 2001)*). The IRS can provide notice of the tax liability to the fiduciary by sending Form 10492. The federal tax obligation will then receive preference over all other claims against and obligations (state inheritance taxes, and other expenses) of an estate (*Rev. Rul. 79-310*, *1979-2 C.B. 404*). As a result, even if the IRS fails to file a claim against an estate, the Fiduciary should actively assert the U.S. Government's priority under IRC *§3713*.

Florida Statutes:

Florida Statutes *§733.801* and *§733.802* may be utilized to protect a Fiduciary by limiting the circumstances under which they will be required to either pay or deliver a devise or distributive share to a beneficiary. The limitations include: (i) not earlier than five (5) months after the granting of letters of administration; and (ii) compelled, prior to final distribution, to pay a devise in money, deliver specific personal property, unless the personal property is exempt personal property. Even then, unless the beneficiary establishes that the assets will not be required for the payment of estate and inheritance tax, a claim (debts, elective share, expenses of administration, etc.), provide funds for contribution, or to enforce equalization in case of advancements. If the administration of the estate is not completed before the entry of an order of partial distribution (devise, family allowance, or elective share) a court may require the beneficiary to post a bond with sureties and require them to make contribution, plus interest, if it is later determined that there are insufficient assets.

Homestead Property:

Federal tax law, accept as provided under IRC *§6334*, Property Exempt from Levy, will preempt Florida's exempt property statutes and constitutional homestead protection laws. The preemption will allow the IRS to impose a federal tax lien or levy on personal assets of an estate or trust for collection (*In Re Garcia, (S.D. Fla. 2002*) or homestead property (*Busby v. IRS, 79 A.F.T.R. 2d 97-1493 (S.D. Fla. 1997*)).

IRC *§6331* permits the United States to collect taxes of a delinquent taxpayer by levy on all property and rights to property unless exempt under section IRC *§6334*. IRC *§6334* specifically provides that a "principal residence shall not be exempt from levy if a judge or magistrate of a district court of the United States approves in writing) the levy of such residence."

Under Florida law, a Fiduciary is obligated to notify the county property appraiser of a decedent's death and their property's ineligibility for the homestead tax exemption. F.S. *§193.155(9)* provides that a Fiduciary's failure could result in the assessment of penalties and interest. In addition, if the property was not entitled to a homestead property tax exemption, the statute provides for the imposition of: (i) a lien against the real property; and (ii) imposition of taxes, interest, and a penalty equal to fifty (50%) percent of the unpaid taxes resulting from the incorrect classification.

CONCLUSION

The best method for avoiding fiduciary liability is to not distribute a single estate or trust asset to any beneficiary or creditor until every conceivable tax issue has been identified and addressed. It is highly recommended that any Fiduciary faced with this type of scenario should follow F.S. *§733.707*, which lists the distribution priorities for an in-solvent Florida probate estate, and are consistent with the payment priorities under *31 USC § 3713(a).*