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IRS: trustees and donees personally liable for estate and gift taxes

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Normally, when parents leave an estate to their children, the estate tax, if any is imposed, is paid out of the parents' estate. If the assets are in a "family" (revocable) trust, it is the duty of the trustee to pay the estate taxes, and the trustee's liability is limited to the trust assets. Likewise, when a parent makes a gift to a child, the gift tax, if any, is paid by the donor. If the parent dies, the child's liability for the tax is limited to the amount received as a gift.

In two federal district court cases decided two weeks apart, what could go wrong, did go wrong, and the taxpayers - and their advisors - were left unhappy.

When Anna Smith died on Sept. 2, 1991, she left an estate valued at almost $16 million. *U.S. v. Johnson*, 109 AFTR 2d 2012-2253 (D. Utah, May 23, 2012). The trustees filed a federal estate tax return (IRS Form 706) acknowledging a $6.6 million estate tax liability. Because so much of the estate consisted of interests in a hotel, the trustees elected to defer payment of a portion of the liability over the 15-year period permitted for interests in a closely held business. Internal Revenue Code Section 6166. The last payment would have been due in 2006. However, the hotel filed for bankruptcy in 2002, and, as a result, the heirs received no value for their hotel shares. The estate defaulted on the $1.6 million unpaid balance and the Internal Revenue Service began a collection action again the children and the trustees.

The Internal Revenue Code provides that if the estate tax is not paid when due the transferee and "beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate ... to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax." Section 6324 (a)(2).

First the court addressed the potential transferee liability of the children for the estate tax. It concluded that the children were not liable as transferees because, technically, the trust property was not distributed to them immediately upon Anna's death. Second, the court addressed the potential transferee liability of the trustees and concluded that they received the property on the decedent's death and were, therefore, liable. Third, the court addressed the IRS's argument that the children were liable for the estate tax as beneficiaries. However, courts have held that "beneficiary" in this particular statute only refers to insurance policy beneficiaries. As a result, the children were only liable to the extent of the proceeds they received from an insurance policy on Anna's life, which was inadequate to pay the estate tax.

Interest on that personal liability cannot be capped due to the traditional rule that someone who possesses funds of the government must pay interest for the period that they enjoy the benefit of those funds.

Finally, the court concluded that the trustees were liable for the estate tax on a basis outside of the Internal Revenue Code. Title 31 of the United States Code, Section 3713,

imposes personal liability when the estate's representative allows someone to receive money from the estate before the tax has been paid. The trustees argued that they should not be liable under that section since they had an agreement in place with the beneficiaries to pay the estate tax as it became due. However, the court said that it is not the IRS' job to enforce that type of agreement as a third party beneficiary.

In 1995, J. Howard Marshall sold his stock in Marshall Petroleum, Inc. to the company at less than fair market value. *U.S. v. MacIntyre*, 109 AFTR 2d 2012-868 (S.D. Tex., June 7, 2012). As a result of his sale, the shares of the other shareholders - his children - became more valuable. In other words, that sale was an indirect gift to his children. Somehow the IRS became aware of the transaction, conducted an audit, and imposed a gift tax. The children originally contested the assessment in court, but eventually the parties reached an agreement about the amount due. Later, Marshall died and his estate did not pay the gift tax. In 2008 the IRS assessed the children for the tax due, which the children paid. However, the children refused to pay the interest assessed on the late payment.

The issue before the court was whether the children's liability could exceed the amount each of them received as a gift. In other words, if an individual donee received a gift of $50,000, could the donee be liable to the IRS for $62,000? The reason why the amount of the liability might exceed the gift is due to the amount of interest that accrues over time, in this case the 13 years from the date of the gift to the date of payment.

The court determined that the donees have two separate liabilities, one of which is capped and one that is not. The first liability is the obligation of the transferor, in this case the estate. The amount of that obligation, when it shifted to the donee, is limited to the amount of the transferred property. The second obligation is that of the transferee, in this case the donee. This is a personal liability of the general sort imposed by federal law. Interest on that personal liability cannot be capped due to the traditional rule that someone who possesses funds of the government must pay interest for the period that they enjoy the benefit of those funds. The court concluded that it is equitable to cap the donee's responsibility for the actions of another. However, if the donee chooses not to pay his own liability, that is a different matter.

Johnson and *MacIntyre* are only two of the latest frightening cases involving estate and gift taxes. In 2010, in *U.S. v. Kulhanek*, 106 AFTR 2d 2010-7263 (W.D. Pa. 2010), the IRS collected estate taxes from recipients of retirement benefits and life insurance 17 years after the decedent's death. So despite what we might think of as normal, obvious rules - estate taxes are paid out of the estate, and donor's pay the gift taxes - the rules regarding who is liable for estate and gift taxes remains, at best, tricky and, at worst, treacherous.

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