LIABILITY FOR A DECEDENT'S U.S. TAX

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In certain circumstances, the IRS may hold an executor or a beneficiary of an estate personally liable for a decedent's unpaid US federal income, gift, and estate tax and for related interest and penalties. If a US citizen living in Canada does not file US returns or if those returns contain errors, the rules may generate unanticipated costs and burdens for family members and fiduciaries.

An estate representative who pays any part of an estate's debt before paying a US government claim is personally liable for the claim up to the lesser of the amount of the payment and the claim (31 USC section 3713(b)). An estate's debt includes a distribution to a beneficiary that is made when the estate is insolvent or that renders it insolvent.

The statute appears to impose strict liability on a fiduciary who pays a debt or makes a distribution that leaves an estate with insufficient funds to pay a debt to the US government, but the courts have interpreted the law to impose fiduciary liability only if the fiduciary had notice of the claim before making the distribution (Leigh, 72 TC 1105 (1979)). Thus, if an executor distributes estate assets after the executor had notice of the government claim and the estate then has insufficient funds to satisfy the claim, the government can hold the executor personally liable up to the amount of the unpaid claim.

Whether a fiduciary has notice depends on whether the fiduciary has (1) actual knowledge of the claim or (2) knowledge of facts that would lead a reasonable person to inquire about the potential existence of unpaid claims. If a fiduciary is put on inquiry, wrong or haphazard inquiries are no defence (New, 48 TC 671 (1967)). However, a fiduciary is not bound to inquire whether any taxes are due unless the facts would put a reasonable person on notice. A fiduciary is clearly put on notice if he or she has records that show that a US citizen has not filed US income tax returns or has received notices of adjustment.

Executor liability extends to tax that was not assessed before a decedent's death if the limitation period remains open: time does not start to run if a US citizen has not filed US income tax returns. As a result, after a decedent's death the IRS can assess preceding tax years and impose liability on an executor for tax, interest, and tax-related penalties. In Rev. rul. 79-310(1979-2 CB 404), the decedent had not filed

US federal income tax returns or paid US income tax for several years; the tax, penalties, and interest due exceeded the value of the estate's assets. The ruling indicates that the executor had or should have had knowledge of the tax liability, but paid other estate creditors without first paying the tax liability. The ruling determined that the tax liability was established and constituted a debt due to the United States even though the liability had not been assessed at the time of death: the executor was thus personally liable for the government's claim.

An executor may also be exposed to liability from a postdeath assessment of preceding years even if the individual had filed US returns on time. The IRS may continue to review and adjust tax returns within the normal limitation period and thus may issue an assessment after an executor has, in good faith, paid claims and distributed amounts to beneficiaries. In Estate of Henry Walker (90 TC 253 (1988)), an executor was held liable for unpaid federal claims that were assessed after the estate was closed under state law.

Executor liability for US government claims might extend to penalties imposed for errors in filing reports of foreign bank accounts (FBARs). Specific guidance has apparently not yet been released.

An executor can minimize potential personal exposure and also exercise due diligence by identifying and rectifying potential non-compliance. If an executor files form 56 ("Notice Concerning Fiduciary Relationship") with the IRS, it must send to the fiduciary any notices related to the decedent's tax matters, including a notice of proposed adjustments. An executor can also obtain information from the IRS regarding the status of previously filed tax returns, including gift tax returns, and may request the prompt assessment of a decedent's income tax liability related to returns filed before death. The prompt assessment request shortens the normal limitation period from three years to 18 months (26 USC section 6501(d)), but it applies only to returns filed before the decedent's death.

By filing form 5495, an executor can also request a discharge from personal liability. The form requires that the executor indicate each year and type of tax for which discharge is sought and attach copies of the relevant tax returns. Discharge is not available for unfiled tax returns. The executor is automatically discharged from personal liability if within 9 months of the filing of form 5495 the IRS does not notify the executor of an unpaid income, gift, or estate tax liability.

A beneficiary who has received estate distributions when a government claim has not been paid may also be liable as a transferee for payment of the claim, without being able to request information, prompt assessment, or discharge from personal liability (26 USC section 6324(a)).

As a result of these rules, a non-compliant individual may unknowingly place family members, friends, and institutional trustees in the difficult position of having to use estate assets to pay government claims rather than distributing them to the intended beneficiaries.