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## FEATURED ARTICLES

# Avoiding the Trustee's "Personal Liability" for Estate Taxes

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### Introduction

This article describes the trustee's personal liability for estate taxes. It does not cover the trustee's liability for other taxes, duties to beneficiaries, or apportionment of taxes among beneficiaries. For those topics, there are other excellent sources, including the CEB Trust & Estates Library; Pennell, *Transfer Tax Payment and Apportionment,* 834–2d Tax Management Portfolio (2001); and California Civil Practice: Probate & Trust Proceedings (Thompson Reuters 2021).

### Trusts: A "Who" or a "What"?

First, a point of vocabulary. In some states, a trust is a distinct entity. Like a corporation, it can sue, be sued, and own property in its own name. See 76 Am Jur 2d, *Trusts* §601. However, in most states—including California—these functions are technically performed by the trustee, *acting in a trustee capacity*. *Presta v Tepper* (2009) 179 CA4th 909.

Mostly, this is a matter of labels. Even if the trust is not a separate *entity,* the trustee is a legal *person,* distinct from the individual occupying that role. *Han v Hallberg* (2019) 35 CA5th 621, 636 ("[I]t does not matter whether we identify the partner as the trust or as the trustee that transacts business for the trust. The result is the same"). Still, in states like California, it can be unclear whether a statement about the "trustee's" liability refers to liability in a trustee capacity (which would be limited to assets held under trust), or to personal liability (which would include the individual's or corporation's own assets). This article is about the latter.

This article describes the person administering a decedent's will as the "personal representative." Under California law, that person is also often considered an "executor." But the latter term has a different meaning in federal tax law, so this article uses "executor" only in its federal sense.

### The Meaning of Limited Liability

When an investor has "limited liability," their losses cannot exceed invested capital. See Corp C §2011 (shareholders), §15903.03 (inactive limited partners), §17703.04 (LLC members). Similar treatment applies to grantors of trusts, unless the trust is revocable. See Prob C §18200; *Steinhart v County of Los Angeles* (2010) 47 C4th 1298; *Carolina Cas. Ins. Co. v L.M. Ross Law Group, LLP* (2010) 184 CA4th 196.

However, a different rule applies for the officer, director, manager, or general partner of these business entities—that is, the person most analogous to a trustee. Assuming no indemnities, when will these people be liable for the torts or contracts of the entities they manage? In a limited partnership, the general partners are personally liable (Corp C §15904.04). In an LLC, the manager is generally not liable, but may be liable for their own personal wrongful conduct, including participation in tortious or illegal conduct and including when they have authority over, or are responsible for, the wrongdoing. Corp C §17703.04; *People v Pacific Landmark* (2005) 129 CA4th 1203, 1216. In a corporation, the rule is similar. *United States Liab. Ins. Co. v Haidinger-Hayes, Inc.* (1970) 1 C3d 586, 595.

In this regard, trustees resemble their fiduciary counterparts in LLCs and corporations (but not limited partnerships). A trustee "is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administration of the trust unless the trustee fails to reveal the trustee's representative capacity or identify the trust in the contract." Prob C §18000(a). A trustee is "personally liable for obligations arising from ownership or control of trust property," or for "torts committed in the course of administration of the trust," only if "the trustee is personally at fault." Prob C §§18001, 18002.

### Who Is Liable for Estate Taxes?

The preceding discussion focused on torts and contracts. However, tax liability is a creature of statute; there is nothing to stop a legislature from imposing trust-related taxes on a person other than the trustee, or on a trustee personally.

With the federal income tax, this is rarely done. Generally, this tax is calculated with reference to, and paid out of, the assets in the possession of the trustee. IRC §§1(e), 641(b). The exception is when the trust's income

is reported on the tax return of the grantor (IRC §§671–679) or of the deceased grantor's estate (IRC §645).

With the estate tax, things get more complicated. Nominally this tax is paid by the "executor." IRC §2002. However, that term need not describe the person in control of the decedent's assets. In particular, the Code provides that if a personal representative has been appointed under state law, that person is the federal "executor" who owes the taxes—even if the decedent's assets are held in a trust, and even if the personal representative and trustee are different persons. In that case, if a personal representative cannot make a complete return, the personal representative must give the IRS "all the information he has as to such property, including a full description, and the name of every person holding a legal or beneficial interest in the property." Treas Reg §20.6018–2.

If, instead, no personal representative has been appointed (as is often the case with California clients using pour-over wills), then the federal executor is "any person in actual or constructive possession of any property of the decedent." IRC §2203. These are informally referred to as "statutory" executors. Of course, this group includes the trustee. It could also include the decedent's family, friends, employers, and so on. It also includes "the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country." Treas Reg §20.2203–1. In one case, the decedent's son was held to be a statutory executor when he fraudulently acquired property of the decedent through forged checks and forged signatures on stock certificates. See *Allen v Commissioner,* TC Memo 1999–385.

As a practical matter, when there is a pour-over will, the trustee generally pays the entire estate tax and files the sole estate tax return. However, if they do not do so, these other statutory executors are theoretically on the hook. Each is liable for the estate tax, up to the value of the assets in their possession. Treas Reg §20.2002–1. "Although it strains the statutory language," this obligation includes any property included in the decedent's gross estate, even if the decedent did not literally own it. See Stephens, Maxfield, Lind & Calfee, Federal Estate & Gift Taxation, 8.02; see also IRC §2203. Each must file an estate tax return as to these assets. Treas Reg §20.6018–2 ("every person in actual or constructive possession of any property of the decedent situated in the United States ... is required to make and file a return"). By implication, this obligation only arises when an estate tax return is required—*i.e.,* "where the gross estate at the death ... exceeds the basic exclusion amount in effect under section 2010(c) for the calendar year which includes the date of death." IRC §6018(a)(1).

Suppose, for example, that when the decedent father dies, his taxable estate is worth $100 million, and will be taxed at a 40 percent rate. Further, suppose that his taxable estate includes a lifetime gift of $1 million to his daughter, under IRC §2036. If so, then she would be one of her father's statutory executors, and she would owe $1 million in taxes—*i.e.,* the entire amount in her possession.

Note that she might be separately liable as a "transferee" under IRC §6901(a)(1)(A), because she is a beneficiary. Also, note that—assuming the IRS did extract this amount from her—she might still be entitled to $1 million from the trustee. However, both topics are outside the scope of this article: A trustee cannot be a transferee, because the latter term is reserved for the beneficial owner of property (see 4 Casey Fed Tax Prac §12:34, *Who Are Transferees* (Thomson Reuters)), and the daughter's claim against the trustee for reimbursement generally arises under state law (though the amount of her claim may be reduced by the apportionment provisions in IRC §§2205–2207B).

### Personal Liability

So how does the estate tax liability become personal to the trustee? Suppose that 6 months and a day after the decedent died, there was a market crash, such that the assets held in trust were insufficient to pay the estate tax. (That extra day is important; under a law tracing back to the Great Depression, estates may value their assets at the lower of date-of-death or 6 months after death. IRC §2032.) Could the IRS recover the deficiency from the trustee personally?

Generally, no. Under 31 USC §3713(b) and IRC §6901(a)(1)(B), the trustee becomes personally liable only to the extent they make distributions while the taxes are unpaid. Thus, as long as the trustee liquidated all the assets in the trust and used the liquidated assets to pay the trust's tax obligations, without making any distributions, the trustee would have no personal liability.

### Three Unanswered Questions

These rules for trustee estate tax liability have some unanswered questions. First, they make sense when we are talking about a true fiduciary (*e.g.,* a trustee); but what if we are talking about the daughter in the example above—*i.e.,* a beneficiary who is neither a trustee nor a personal representative under the will? It is not obvious whether she is a "representative" and/or a "fiduciary," as those terms are used in 31 USC §3713(b) and IRC §6901. When Congress used the words "representative" and "fiduciary," it might have intended an executor in the traditional sense (*i.e.,* personal representative only). In *Allen v Commissioner, supra,* the court rejected that view,

and concluded that these terms would be met by a statutory executor under IRC §2203. Still, that case was extreme: The child acquired substantially the parent's entire estate, and the court reached this conclusion with minimal analysis. It is unclear whether the result would differ if a child held only a small fraction of the estate, as in our example.

Second, suppose the decedent made use of a pour-over will and an inter vivos trust; and suppose that some of the decedent's assets nevertheless fell outside the trustee's possession and control. Is the trustee obliged to round up those other assets? At least for tax purposes, the answer is no. The trustee, like each of the other statutory "executors" in possession of the decedent's assets, is simply liable to pay the lesser of [the total estate tax due] or [the amount of the decedent's assets in his possession]. Still, it is worth considering some state and federal laws, which, at first blush, challenge this conclusion.

Chapter 1 of Division 10 of the California Probate Code, entitled "Proration of Estate Taxes," instructs that, if "all property" does not come into the possession of the personal representative, then the personal representative "has the duty" to recover each person's proportionate share of the estate tax, as set forth in the decedent's written estate plan (or, when that is silent, federal and state law). Prob C §§20110, 20111, 20116. Thus, if property passes prematurely to a beneficiary, Prob C §20116 seems to make the personal representative a creditor of that beneficiary. If he forgives this liability, then arguably he has made a distribution and subjects himself to personal liability for estate tax purposes.

However, that interpretation seems unlikely. If it were true, then each beneficiary would have a mirror-image claim against the trustee, and against every other beneficiary. This would make every person with any of the decedent's assets responsible for the entire estate tax, a result that would make a mockery of the rule in Treas Reg §20.2002–1 that liability is limited to assets in the person's possession.

Third, as mentioned above, each statutory executor must file an estate tax return, if one is required, and a return is required when the gross estate at death exceeds the exclusion amount then in effect. But if there are multiple statutory executors, how are they supposed to know the size of the gross estate? Control over the decedent's personal financial records generally passes to their (state-law) estate. If no personal representative is appointed, this information is often handed informally to the trustee of the decedent's revocable trust, particularly when the decedent's will nominates that same person as personal representative. But other statutory executors have no way of knowing what else was in the decedent's gross estate. It is unreasonable to expect them to execute their obligation to file a return, because they cannot know when they are obliged to. When it comes to statutory executors, the law as written has little connection to the law as actually practiced, and nobody seems to mind.

### Relief of Personal Liability

Once the trustee has filed the estate tax return and paid the corresponding tax, they can make "written application to the Secretary for determination of the amount of the tax and discharge from personal liability therefor." IRC §2204. This starts a clock; at the sooner of 9 months or the date notified by the IRS, the trustee will be "discharged from personal liability for any deficiency in tax thereafter found to be due." IRC §2204. As a practical matter, if the IRS could not complete the audit within the 9-month period and issue its report, it could ask the executor to withdraw the request. "Presumably, a refusal by the executor to withdraw the request would result in an assertion of the largest possible deficiency, based on the agent's judgment of the particular facts, which would leave the executor vulnerable for premature distributions." See August, *When a Tax Goes Unpaid: Understanding Fiduciary and Transferee Liability,* VCZB0711 ALI-CLE 1 (July 11, 2017).

In recent years, the IRS has experimented with an alternative to issuing closing letters. Under IRS Notice 2017–12, if the IRS account transcript shows that the IRS has examined the return, the IRS will allow the taxpayer to treat this "as the functional equivalent of an estate tax closing letter." Later, in the preamble to proposed regulations issued in December 2020, the IRS acknowledged receiving "feedback from taxpayers and practitioners that the procedure for requesting an estate tax closing letter can be inconvenient and burdensome." REG-114615–16. Responding to this, the proposed regulations promised to implement a "one-step, web based procedure to accomplish the request of the state tax closing letter"; at the same time, they imposed a $67 user fee on these letters.

### Bonds: Backdoor Personal Liability

Finally, trustees should be wary of any provision that requires the posting of a bond.

The estate tax return must be filed, and the tax paid, within 9 months of the decedent's death. IRC §6075(a) (return), §6151(a) (payment). There is an automatic 6-month extension to file. Treas Reg §20.6081–1(b). Payment may be extended for reasonable cause or undue hardship. Treas Reg §20.6161–1. The executor can elect to pay the estate tax in up to ten equal annual installments, and commencing up to 5 years after the usual deadline, if more than 35 percent of the value of the gross estate is comprised of family business assets. IRC §6166.

However, the IRS can condition the extension on receipt of a satisfactory bond. Treas Reg §20.6165–1; IRC

§6324A. The IRS may also require this bond before it approves the trustee's relief of personal liability. IRC §2204. The concern here is that if the IRS should ever need to draw on the bond, the surety company will seek reimbursement from the principal obligor. If the trustee plays that role, then they will face personal liability to the surety company, which is no better than personal liability to the IRS. For that reason, the trustee will want the beneficiaries to serve as the principal obligors. It also makes sense that they should do this, since they will be the ones whose performance (*i.e.,* making the deferred tax payments) is guaranteed by the bond.