

**INSOLVENT DECEDENTS' ESTATES AND
FIDUCIARY/TRANSFeree LIABILITY UNDER
THE INTERNAL REVENUE CODE**

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A. Overview of Insolvency for Decedents' Estates.

1. The Federal Priority Statute (31 U.S.C. § 3713(a)):

- a. Under 31 U.S.C. § 3713(a)(1)(B), a claim of the United States shall be paid first when “the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.”
- b. Even though federal law trumps state law under the Supremacy Clause of the U.S. Constitution (Article VI, Clause 2), the Pennsylvania statute for the priority of claims against an estate, 20 Pa.C.S. § 3392, is expressly “subject to any preference given by law to claims due to the United States.”

2. The Meaning of “Insolvent”:

- a. “Insolvent” under 31 U.S.C. § 3713(a) means “balance sheet” insolvency, which occurs when the debtor’s liabilities exceed the debtor’s assets. *Lakeshore Apartments, Inc. v. United States*, 351 F.2d 349 (9th Cir.1965); *United States v. Golden Acres*, 684 F.Supp. 96 (D.Del. 1988); *United States v. Blumenfield*, 128 B.R. 918 (E.D. Pa. 1991).
- b. The inability or failure to pay debts as they become due does not, by itself, constitute “insolvency” under 31 U.S.C. § 3713(a). *United States v. Oklahoma*, 261 U.S. 253 (1923).
- c. The relevant time for testing insolvency is at the time of distribution of assets. Accordingly, even when a decedent’s estate is not insolvent at the outset of administration, the Federal Priority Statute can arise later on, when assets are distributed (e.g., to cover administration expenses, to pay lower-priority debts of the decedent, etc.). *Schwartz v. Commissioner*, 560 F.2d 311 (8th Cir. 1977); *Hatch v. Morosco Holding Co.*, 61 F.2d 944 (2d Cir. 1932).

3. Exceptions from the Federal Priority Statute:

- a. Generally, the federal priority statute does not apply to the extent a creditor obtained an interest in property that would prevail over the federal tax lien under Internal Revenue Code (“IRC”) Section 6323, 26 U.S.C. § 6323. See *United States v. Estate of Romani*, 523 U.S. 517 (1998).
- b. Although not required under the Federal Priority Statute, the Internal Revenue Service (the “Service”) generally allows reasonable administration expenses (e.g., court costs, attorneys’ fees and fiduciary commissions, etc.) to be paid ahead of the United States, because such

expenses are for the benefit of all creditors, including the United States. *Abrams v. United States*, 274 F.2d 8 (8th Cir. 1960).

- c. Additionally, funeral expenses and family allowances are generally permitted to be paid ahead of the United States. *Rev. Rul. 80-112, 1980-1 CB 306* (“Funeral and administration expenses and the one-year family allowance . . . are under state law not debts of the decedent, but are charges against the property of the decedent to be deducted before payment of debts.”).

B. Personal Liability of the Fiduciary under 31 U.S.C. § 3713(b).

1. Requirements for Imposing Personal Liability:

- a. 31 U.S.C. § 3713(b) imposes personal liability on a fiduciary (i.e., executor/trix, administrator/trix, etc.) of an insolvent estate if the fiduciary:
 - i. Has knowledge of the tax debt; and
 - ii. Pays other debts before paying the debt due the United States.
- b. The level of “knowledge” required is either (i) actual knowledge of the liability or (ii) notice of such facts as would put a reasonably prudent person on inquiry of the existence of the unpaid claim. *See Leigh v. Commissioner*, 72 TC 1105, 1109 (1979)

2. Amount of Liability:

- a. A fiduciary’s personal liability is limited to the value of the assets (of the estate) distributed in violation of federal priority. Moreover, “assets of the estate” generally does not include certain property passing outside of probate (i.e., “non-probate” property), such as jointly held property and property that passes by beneficiary designation (e.g., retirement accounts, transfer-on-death (TOD) accounts, etc.).
- b. Also, personal liability under 31 U.S.C. § 3713(b) arises only if the fiduciary uses estate assets to pay a debt in violation of the Federal Priority Statute, 31 U.S.C. § 3713(a). Thus, personal liability under 31 U.S.C. § 3713(b) is not triggered if:
 - i. The estate is solvent; and/or
 - ii. The debt paid has priority over the United States under IRC § 6323.

3. Enforcing Personal Liability:

- a. The Service may assert personal liability against a fiduciary either:
 - i. Through judicial proceedings, by filing a suit against the fiduciary in federal district court; or
 - ii. Through administrative procedures, by issuing a notice of fiduciary liability under IRC § 6901(a)(1)(B) (IRC § 6901 is discussed in more detail below), which notice gives the fiduciary the right to challenge the Service's determination in the U.S. Tax Court.

4. Defenses to Personal Liability:

- a. Defenses to personal liability under 31 U.S.C. § 3713(b) include:
 - i. Lack of knowledge of the federal tax debt;
 - ii. The estate was solvent when the distribution was made;
 - iii. The statute of limitations on collection of the underlying tax and for asserting liability under IRC § 6901 has expired (as explained below); and/or
 - iv. The distribution made by the fiduciary was for a claim with priority over the United States.

5. Burden of Proof:

- a. To establish personal liability under 31 U.S.C. § 3713(b), the Service has the burden to prove that the fiduciary paid a debt of the decedent or the estate before paying debts due the United States.
- b. Again, however, a fiduciary is not liable unless the fiduciary had "knowledge" of the tax debt. *See United States v. Coppola*, 85 F3d 1015 (2d Cir. 1996).

C. Transferee Liability under IRC § 6901.

1. Overview of Transferee Liability:

- a. Generally, transferee liability is a method of collecting an unpaid liability (tax or non-tax) of a transferor from the recipient (the transferee) of property transferred prior to or after the liability arises (e.g., upon assessment of the tax).

b. IRC § 6901 is the statute that sets forth the required procedure for the Service to collect a decedent's unpaid tax liability from a third party, including a fiduciary. However, IRC § 6901 does not, by itself, create any liability; the existence or extent of a transferee's (or a fiduciary's) liability is determined under applicable state or federal law. *See Commissioner v. Stern*, 357 U.S. 39 (1958).

2. Definition of "Transferee":

a. A "transferee" includes any transferee of property who is liable "at law or in equity" for the taxpayer's income, estate or gift tax, including a donee, heir, legatee, devisee and distributee. IRC § 6901(a)(1), (h). Thus, a fiduciary with personal liability under 31 U.S.C. § 3713(b) also falls under the definition of "transferee," as one who is liable "at law."

b. For unpaid income taxes of a decedent, the Service generally asserts transferee liability "in equity" against beneficiaries when the decedent's estate is insolvent or has been completely distributed. *See, e.g., United States v. Floersch*, 276 F.2d 714 (10th Cir.), cert. denied, 364 US 816 (1960) (New Mexico law). The underlying theory is that the decedent transferred property to the estate, which then transferred property to the beneficiaries. Of course, when the estate is insolvent, the Service also has the option to assert personal liability against the fiduciary under 31 U.S.C. § 3713(b).

c. Importantly, a surviving joint tenant or tenant by the entirety has generally been held not to be a "transferee" for purposes of IRC § 6901, because such joint owners succeed to full ownership by virtue of the creation of the tenancy and not merely the death of the deceased cotenant. *See, e.g., Irvine v. Helvering*, 99 F.2d 265 (8th Cir. 1938) (Minnesota law).

3. Amount of Liability:

a. Under IRC § 6901(b), a transferee's liability may be either the amount of tax shown on the transferor's return or the amount of the assessed deficiency or underpayment.

b. A transferee's liability "at law or in equity," including a fiduciary's liability under 31 U.S.C. § 3713(b), is determined under applicable state or federal law. *See Commissioner v. Stern, supra*.

c. Generally, for transferee liability "in equity," the Service proceeds under the particular state's law governing fraudulent conveyances (e.g., the Pennsylvania Uniform Fraudulent Transfers Act, 12 Pa.C.S. § 5101, et seq.). For state law purposes, the Service is a creditor for the amount of

the tax claim and has all the rights that a private creditor has under the state's law governing fraudulent conveyances; and, if a Notice of Federal Tax Lien has been filed, the Service is treated as a judgment creditor.

- d. A transferee's liability under IRC § 6901 is secondary to that of the transferor-taxpayer. Thus, courts generally have found that a transferee is not liable at law or in equity unless the transferor-taxpayer is liable for the tax *both* at the time of the transfer *and* at the time the Service asserts transferee liability against the transferee.
- e. Similarly, a transferee's liability is also reduced or eliminated to the extent the transferor-taxpayer (or another transferee) pays the tax liability. However, a transferee who pays the tax liability of the transferor-taxpayer often has a separate right of contribution enforceable against the non-paying transferee(s).

4. Method of Collection:

- a. Under IRC § 6901(a), the income tax liability for the transferee of property at law or in equity must be assessed, paid and collected in the same manner, and subject to the same provisions and limitations, as the tax due from the transferor. Thus, for purposes of IRC § 6901, the transferee is treated the same as the transferor-taxpayer, which means the transferee may contest the transferor-taxpayer's tax liability either in the U.S. Tax Court or in a refund suit. *See United States v. Williams*, 514 US 527, 539 (1995).
- b. Additionally, once the assessment "hardens" (i.e., after the transferee or fiduciary exhausts the available avenues of administrative and judicial appeal), the Service is permitted to use all administrative collection procedures, including filing a Notice of Federal Tax Lien, which attaches to all property of the transferee or fiduciary.
- c. Just as explained above concerning fiduciary liability under 31 U.S.C. § 3713(b), the Service may assert transferee liability either:
 - i. Through judicial proceedings, by filing a suit against the transferee in federal district court; or
 - ii. Through administrative procedures.
- d. If the Service opts to assert transferee liability through administrative procedures, the Service must send the transferee a notice of liability, which notice must explain the transferee's right to:

- i. File a petition in the U.S. Tax Court (in order to obtain prepayment judicial review of the Service’s determination of transferee liability); or
 - ii. Pay the amount of the assessed tax liability and sue for refund (in federal district court or the Court of Federal Claims).
5. Defenses to Transferee Liability:
 - a. Expiration of statute of limitations (described below);
 - b. Return of all or part of the transferred property; and
 - c. Any other defense that can be raised for the type of liability asserted (e.g., for transferee liability “in equity,” state law generally requires a showing of “actual intent to hinder, delay or defraud”).
6. Statute of Limitations:
 - a. Generally, under IRC § 6901(c), the applicable statute of limitations for the assessment of transferee liability (including a fiduciary’s personal liability under 31 U.S.C. § 3713(b)) is as follows:
 - i. For an initial transferee, one (1) year after the assessment period for the transferor expires.
 - ii. For a transferee of a transferee, one (1) year after the assessment period for the preceding transferee ends, but not more than three (3) years after the period for assessment against the transferor ends.
 - iii. For a fiduciary, one (1) year after the fiduciary liability arises or the period for the collection of the tax expires, whichever is later.
7. Burden of Proof:
 - a. Under IRC § 6902(a), in proceedings before the U.S. Tax Court, the Service has the burden to prove that the transferee is liable as a transferee of the taxpayer-transferor’s property, and the transferee has the burden to prove that the taxpayer-transferor was not liable for the tax.
 - b. In the context of decedents’ estates, the transferee might not have much, if any, knowledge of the facts concerning the taxpayer-transferor’s tax liability. However, under IRC § 6902(b), the transferee has certain statutory rights to examine the “books, papers, documents,

correspondence, and other evidence of the [taxpayer-transferor] or a preceding transferee of the [taxpayer-transferor's] property.”

- c. When the Service seeks to establish transferee liability under state law (e.g., liability “in equity”) in proceedings before a federal district court, the Service has the burden of establishing such liability by making out a prima facie case under the relevant state law.

8. Differences between Liability under IRC § 6901 vs. 31 U.S.C. § 3713(b):

- a. The procedures for enforcing transferee liability under IRC § 6901 and fiduciary liability under 31 U.S.C. § 3713(b) are very similar. Nevertheless, there are some differences between the two types of liability.

b. Scope of Liability:

- i. Under 31 U.S.C. § 3713(b), a fiduciary is liable for the amount of claims paid (or distributions made), improperly, before payment of the debt due the United States.
- ii. For transferee liability “in equity” under IRC § 6901, a transferee is liable for the value of the assets that the transferee received when the taxpayer-transferor (or a preceding transferee, such as the deceased taxpayer-transferor’s estate) was insolvent or was rendered insolvent. However, the extent of the transferee’s liability (i.e., the “value” of the assets) is generally determined under state law.

c. Nature of Liability:

- i. Fiduciary liability necessarily derives from the fiduciary’s own actions. Thus, even if the fiduciary receives no personal benefit from the improper payment(s) or distribution(s), the fiduciary is liable if the fiduciary has sufficient knowledge of the debt due the United States.
- ii. A transferee’s liability “in equity” generally depends on the particular state’s law governing fraudulent conveyances.

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