Estate of Turco: Is There Clawback For Insufficient Estate Tax Funds?

by James F. McDonough, Jr. on August 15, 2013

The lack of liquidity is a serious problem in the administration of an Estate, especially for a fiduciary with the potential for personal liability. The lack of liquidity can arise from no planning, illiquid assets or an unforeseen change in circumstances or market conditions. Federal estate tax is due nine months after death; however, it may not be possible to sell assets within that period. The dramatic decline in market values after death or the valuation date creates severe problems as seen below.

The New Jersey case, Estate of Turco, illustrates how adverse market conditions can harm an estate. The decedent died in March 2005 (or six months later with alternate valuation) and the appraisals of the estate produced a $30,000,000 gross estate for federal tax purposes. You may recall the tightening of the credit markets in 2007, followed by the collapse of Lehman Brothers in 2008. The estate is obligated to pay an estate tax calculated on asset values that could not be realized in the current marketplace.

There are two other important facts to note. First, there was $4.5m of life insurance that was paid to trusts for the decedent's grandchildren, who were designated as the primary beneficiaries of the proceeds. Second, the Will required that all taxes were to be paid from the residuary estate.

The court declared the estate insolvent at the administrator's request. The administrator requested that he be authorized to clawback funds from the non-probate assets and specific bequests. The Court held that it was too soon to consider clawback and instructed the administrator to seek a compromise with the IRS before requesting such authority.

The court's opinion noted that the administrator did not have the statutory power under federal or state law to recover taxes from non-probate assets, especially where there is a specific clause in the Will instructing on the source of funds for payment of taxes.

The nightmare for advisors is the rapid decline in asset values without the corresponding liquidity. One must remember the grandchildren's trust received life insurance proceeds which are non-probate assets. Clearly the grandchildren are better off having been named as primary beneficiaries of the policies and receiving the proceeds directly rather than through the estate. This group also benefits from the absence of statutory authority that would permit the fiduciary from pursuing non-probate assets.

Whether the IRS will refuse to compromise the tax bill and whether it will push the administrator to clawback funds from the trusts will be the next installment. The government has its own statutory authority to collect taxes from transferees, which the court did not address.