New IRS Release of Estate Tax Lien Requirements

The Sale of Homes or Apartments by an Estate Just Became a Little More Complicated

By Shaina S. Kamen and Michael S. Schwartz

The sale of a house or apartment can be very stressful for any prospective seller. Even with the help of a good broker or real estate attorney, the time and expense associated with a potential sale can seem daunting. This is especially true in the context of a sale of residential real estate by an estate, in which additional legal requirements may need to be satisfied to complete the sale.

It is not uncommon for an estate to be involved in the sale of real estate or interests in cooperative apartments, the latter being treated in many jurisdictions as personal property instead of real property. A sale may be directed by the will or may be necessary or desirable for other reasons, such as to aid in the distribution process when there are multiple beneficiaries or to generate liquidity to pay federal and state estate taxes or other estate administration expenses.

In general, before a sale of residential real estate by an estate can take place, the will must be admitted to probate, and an executor or other fiduciary must be appointed to administer the estate assets. (For simplicity, the representative of the estate is referred to throughout this article as an executor, notwithstanding the possibility that the fiduciary also may be an administrator, administrator c.t.a., personal representative, or other type of fiduciary.) In addition, a Certificate Discharging Property Subject to Estate Tax Lien (a "Release of Lien") may need to be obtained from the IRS and, depending on the jurisdiction, the state taxing authority.

New IRS rules have added further complexity to the already difficult sales process. In particular, before a Release of Lien will be issued, an estate must comply with new requirements designed to ensure the collectability of any federal estate tax that the estate may owe. These new rules could have a significant effect on the ability of an estate to sell real property or an interest in a cooperative apartment.

It should be noted at the outset that the Release of Lien requirement (and all the associated complications discussed in this article) will no longer be relevant if President Trump and Congress repeal the federal estate tax entirely. Federal estate tax repeal is still far from a certainty at this point, even if it is now more likely than it was a year ago. Thus, practitioners should continue to stay up to date on the Release of Lien requirement and be prepared to obtain Releases of Lien when needed.

This article reviews the reasons that Releases of Liens are often needed, outlines the new IRS requirements to obtain these releases, discusses some of the complexities associated with the new IRS rules, and proposes potential methods for dealing with them to best serve the objectives of your clients.

About the Estate Tax Lien

Internal Revenue Code § 6324(a) imposes an automatic estate tax lien on a decedent's property that is effective at the moment of death. The lien attaches to all assets of the estate but, unlike other forms of tax liens, does not have to be recorded to be valid. *United States v. Vohland*, 675 F.2d 1071, 1074 (9th Cir. 1982) ("§ 6324 makes no provision for recording the special estate tax lien nor does it condition the lien's enforceability against transferees upon recording"). At the close of the estate tax return examination proceedings, the IRS will issue, at the executor's request, a "closing letter" signifying that its review of the estate tax return has been completed (or any audit proceedings concluded) and that any federal estate tax due has been paid in full. An executor of an estate, however, may wish to sell estate property such as real estate before receipt of a closing letter, for a variety of reasons.

Shaina S. Kamen is an associate at the law firm of Stroock & Stroock & Lavan LLP in New York, New York, and **Michael S. Schwartz** is a partner at the law firm of Curtis, Mallet-Prevost, Colt & Mosle LLP in New York, New York.

Max Licht

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In general, the estate tax lien will remain attached to the estate property, which can create risk for purchasers. See *Evelpis Props. v. United States*, 97-1 USTC ¶ 60,272 (S.D. Ohio 1997). Of particular note, however, IRC § 6324(a)(2) provides that the estate tax lien will not remain attached in the case of the sale of certain nonprobate property, and, instead, a like lien will attach to the property received by the seller.

Thus, a party to a sale of estate property, such as the purchaser, title agent, or cooperative board, may require that the estate obtain a Release of Lien from the IRS specifically for the subject property. To that end, IRC § 6325(c) provides that "the Secretary may issue a certificate of discharge of any or all of the property subject to any lien imposed by section 6324 if the Secretary finds that the liability secured by such lien has been fully satisfied or provided for."

The Old Release of Lien Requirements

Before summer 2016, it was relatively simple to obtain a Release of Lien. The applicant, usually the executor of an estate, would file Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien, with the IRS. The instructions in effect at that time directed the applicant to include copies of the decedent's last will and testament, letters testamentary (which evidence the appointment of the executor), contract of sale and proposed closing statement, Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return (if filed), and an estate inventory. Once the application was reviewed by an IRS agent (and usually with limited further contact with the applicant), the IRS issued the Release of Lien, which the executor could use at the closing of a sale of real estate or a cooperative apartment owned by an estate.

The New Release of Lien Requirements

In early summer 2016, practitioners began to report that the IRS was requiring additional documentation beyond what was explicitly required in the instructions to Form 4422. In addition to the previous requirements discussed above, the IRS began insisting on submission of an appraisal of the property to be sold. This insistence presumably is intended to deter below-market sales to related parties to either syphon off the property from the reach of the IRS or artificially depress the value for estate tax purposes. In the normal course, however, when there is a third-party arm's length sale, obtaining a formal appraisal can be costly and unnecessary, because the sales price generally is arrived at after consultation with a real estate broker who is familiar with the market, as well as the negotiations with the buyer and the buyer's attorney, and typically is reflective of the market value. From practitioner commentary, it appears that a letter from a real estate broker confirming the value of the property based on at least two comparable properties is sufficient to fulfill the IRS requirement. Although such an appraisal letter arguably is unnecessary in the typical case in which an estate retains a real estate broker for the sale, at least the IRS does not appear to be requiring a more formal (and therefore more costly) appraisal.

In addition, before issuing the Release of Lien, the IRS apparently has been reviewing in detail the proposed closing statement, with particular focus on the reasonableness of attorney's fees and broker commissions in the pending sale even if those items are not shown as deductions on the federal estate tax return.

But the more significant additional requirement to obtaining a Release of Lien is that, for taxable estates, the IRS now insists either that the net proceeds of the sale be paid over to the IRS or that the estate enter into an escrow agreement with an escrow agent under which the escrow agent retains the funds until the time that the federal estate tax return is filed and the IRS completes its review of the return by issuing a closing letter to the executor of the estate.

Payment of the net proceeds to the IRS is fairly straightforward. But, depending on the facts of a particular situation, it may not make sense to have the entirety of the net proceeds tied up with the IRS until it finishes its examination of the estate tax return.

Not surprisingly, requiring an escrow agent to hold the sales proceeds also presents numerous complications. First, as of the date of the writing of this article, this new IRS requirement is not reflected in any section of the Code, in a Treasury Regulation, or in any other formal, publicly-available, written forum. Thus, understanding the contours of the requirement is particularly difficult, and practitioners must merely rely on other peer professionals or oral assertions from the IRS.

Second, the timing associated with obtaining a Release of Lien can be tight even without the new requirements. According to the instructions to Form 4422, the completed application for the issuance of the Release of Lien should be submitted to the IRS at least 45 days before the transaction date. The IRS's new requirements for a Release of Lien application, such as selecting and coming to an agreement with a prospective escrow agent (discussed further below), make meeting that time frame all the more difficult. Because it is necessary to submit a copy of a sales contract to the IRS when requesting a Release of Lien, a buyer must have executed or agreed to a contract of sale before an application can be made to the IRS. That contract will provide for a limited window of time before the closing is to take place. If a closing is scheduled too far after the contract date, the seller risks losing the buyer. If that window is too narrow, the seller may have difficulty completing the application for issuance of the Release of Lien at least 45 days before the transaction date. Under the IRS's new requirements, there is a lot to accomplish in a very limited window of time.

In addition, identifying and retaining an escrow agent can take time. It appears that the IRS is requiring that the escrow agent be someone other than the estate's attorney. Practitioners have reported, however, that the IRS has allowed the law firm of the attorney representing the estate (as opposed to the attorney himself or herself) to act as escrow agent.

The escrow agent must enter into the IRS-prescribed escrow agreement, which must be signed and submitted to the IRS to obtain the Release of Lien. Although IRS agents have indicated to practitioners that it may be possible to make changes to the prescribed form, in practice, making any changes to that form may prove difficult and may delay approval. Any change to the IRS form must be vetted by IRS counsel, thus adding further delay to an already time-sensitive process.

The IRS form escrow agreement contains numerous provisions that some potential escrow agents may reject. First, the IRS is a party to the escrow agreement. Payments of costs or expenses from the escrow funds are allowed, but only on written approval or instruction from the IRS. Under the escrow agreement, the IRS also has the right to seize the amount held in escrow at any time. The escrow agreement further disallows the provisions of any other agreement, whether the purchase contract or another escrow agreement, to the extent that those provisions are inconsistent with the IRS form. Thus, for example, an escrow agent that may request additional language beyond that language contained in the IRS form regarding release or indemnification of the escrow agent, or the forum for a dispute, may not be able to enter into a side agreement as to those items to the extent that the side agreement is deemed to be somehow inconsistent with the IRS form.

The IRS form escrow agreement further allows the escrow agent to collect a fee, either in a stated dollar amount or as a percentage of the amount in escrow. It also allows the escrow agent to pay for attorney's fees related to its obligations as escrow agent. In general, these additional expenses are borne by the estate and reduce the amount of estate assets ultimately passing to the beneficiaries.

In addition, the funds remaining in the escrow account are to be held until the IRS has accepted the filed federal estate tax return. But, because of separate new procedures instituted by the IRS in 2015, the IRS is no longer automatically issuing closing letters to estates. For estate tax returns filed on or after June 1, 2015, closing letters will be provided only at the taxpayer's request. Although the IRS used to send closing letters automatically after completing the examination of the estate tax return, the taxpayer is now directed to contact the IRS no earlier than four months after filing the federal estate tax return to request the closing letter. In practice, however, it can take potentially months or even years after the request for the IRS to issue a closing letter under the new procedure. The estate therefore presumably must go through the additional process of requesting that the IRS issue an estate tax closing letter to confirm that the IRS has in fact accepted the return, and then supplying a copy of the closing letter to the IRS agent who is tasked with overseeing the escrow agreement.

Finally, the IRS form escrow agreement requires that the funds be held at a federally insured U.S. commercial bank, credit union, or savings and loan institution in an account with the "highest rate of interest."

A prudent executor may question whether agreeing to hold significant sales proceeds in a savings account under an escrow agreement meets the executor's duties to prudently invest estate assets. Interest rates on savings accounts (even the highest ones available) are currently at very low levels, and the federal estate tax process can often take several years. Requiring that net proceeds be held and invested entirely in low-interest bearing accounts may not be in the best interest of the estate beneficiaries from an investment perspective. Because this appears to be an IRS requirement, however, presumably the risk is low that an executor would be held to have breached its fiduciary duty by allowing estate assets to be invested in this manner. Nonetheless, the estate beneficiaries still may suffer because of the restriction on the investment of the assets for what could be a significant period of time.

How to Deal with the New IRS Requirements

What should a prudent practitioner or executor do in light of these daunting new requirements? One potential option would be to transfer the property out of the client's name before death. There are multiple iterations of this option. For example, before death, the property can potentially be transferred to an appropriately structured trust or re-titled in such a way so as to fall under the IRC § 6324(a)(2) rule, which should exempt certain nonprobate property from the need for a Release of Lien.

Similarly, the property could be transferred to an intermediate entity before the client's death. There is at least some case law that seems to support the proposition that if the property held by the intervening entity is sold, as opposed to the intervening entity itself, the estate tax lien may not follow the sold property, and if that is the case, presumably no Release of Lien would be needed. See *Beaty v. United States*, 937 F.2d 288 (6th Cir. 1991) (note that in this case, the intervening entity was a partnership interest, and the court noted that under applicable state law, the partnership property could not be used to satisfy the debts of the individual partners).

A final iteration of this alternative would be for the client to simply give away the property to those who were to receive the proceeds of the sale, rent back the property during the balance of the client's lifetime, and then have the intended beneficiaries sell the property instead of the executor of the estate.

Pre-death planning for the Release of Lien, however, is not without its complications and drawbacks and will often not be worth the hassle absent other benefits of the restructuring of the title to the property. Any such planning done just to avoid the Release of Lien requirements may result in the incurrence of pre-death expense and efforts that exceed the post-death benefit.

Similarly, care must be taken to ensure that the restructuring does not result in unanticipated consequences. For example, if property is transferred to a trust, or given away, gift tax or the use of the client's lifetime gift tax exemption may result, and the property may no longer receive a "step-up" in basis at the client's death. Also, in the event of a lifetime gift by the client, the benefit of potentially sidestepping the Release of Lien requirements after death may be outweighed by the client's desire to retain control of the property. In addition, while estate tax lien concerns may be eliminated by giving away the property, this may raise gift tax lien issues under IRC § 6324(b). Care also must be taken to ensure that by transferring title to the property out of the client's name, tax and other benefits, such as the homestead exemption that the client may enjoy depending on the applicable jurisdiction, would not be jeopardized. Further limitations may exist in the case of cooperative apartments, because the cooperative board may not allow a transfer of the property to a trust or other entity. Finally, even if not technically required, and despite clear statutory language to the contrary, it is conceivable that if the property is included in the gross estate, an extremely cautious prospective buyer, cooperative board, or title agent may nonetheless continue to insist on proof of satisfaction of payment of the estate taxes, perhaps in the form of a Release of Lien.

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Instead of pre-death planning, an alternate post-death option would be for the executor to hold off on the sale of the property entirely until after a federal closing letter is obtained. This avoids the need to jump through the hoops of getting the Release of Lien or lining up an escrow agent. Yet, although some savings may be associated with this approach (for example, there would be no need to incur the legal fees to obtain the Release of Lien and no need to retain and pay an escrow agent), the estate will be responsible for maintaining the property until it is sold. These maintenance costs often can exceed the costs associated with obtaining the Release of Lien. It is also possible that the property will need to be sold to generate liquidity to pay estate administration expenses or taxes, in which case this would not be a viable option.

Yet another way of trying to bypass the new IRS requirements is to seek to have the prospective buyer dispense with the need for a Release of Lien. Although there may be some risk on the buyer's part that the estate tax lien will carry with the sold property if the estate does not fulfill its estate tax obligations, perhaps an executor's affidavit or copy of the estate tax return will provide enough comfort to a buyer that estate taxes have been paid and that sufficient funds are in reserve if additional estate tax is assessed. This would certainly simplify the process and expedite the sale, but not every buyer would agree to such an informal arrangement. This is especially true when title agents or cooperative boards are involved.

If a Release of Lien is to be obtained, practitioners and executors may consider bypassing the new escrow requirements by paying over the proceeds of the sale directly to the IRS. Though this seems on its face to be a less desirable alternative, it may be worth considering in certain situations. For example, this may be a particularly attractive alternative when the real estate is to be sold very early in the estate administration process, particularly before the nine-month anniversary of the decedent's death when estimated estate tax is payable to the IRS. The net proceeds of sale could be shown on the estate tax return as a partial payment. An added bonus the IRS is obligated to pay interest to the estate on any overpayment! And the IRS rates often are higher than what can be obtained in the current low-interest savings account rate environment (whether in escrow or otherwise). But again, to the extent that the proceeds of the sale are needed to provide the estate with liquidity to pay estate administration expenses, this may not be a desirable option.

For those who choose to move ahead with the escrow arrangement to obtain the Release of Lien, the best way of dealing with these requirements is to plan in advance. An escrow agent should be lined up before a buyer is found or a sales contract entered into, and certainly in advance of the filing of the Form 4422 to obtain the Release of Lien. In addition, the executor should be informed of the additional costs associated with the sale at the beginning of the sales process.

In any event, whether practitioners choose to muddle through the new requirements, try sidestepping the Release of Lien requirement altogether, or simply pay over the proceeds of sale to the IRS, practitioners should be prepared to inform executors and beneficiaries of the new requirements at the onset of the administration to manage expectations so that any delay in distributing the proceeds, or closing on the sale, is not unexpected.

Conclusion

With almost no notice, and limited written guidance, the IRS has increased the obligations on an estate when the executor seeks to sell real property or an interest in a cooperative apartment. Although these new conditions to obtaining a Release of Lien are designed to ensure the collectability of any federal estate tax that the estate may owe, they place a significant burden on the estate. Even though the prospect of outright repeal of the federal estate tax—and, thus, the Release of Lien requirements—looms more prominently than it did a year ago, unless and until that happens, it is important for practitioners to understand these new requirements. Otherwise, they may be caught by surprise when the cooperative board, title agent, or buyer's attorney asks for a Release of Lien, and they realize, after it is too late, that under these new rules, it could take significantly more time and expense to obtain a Release of Lien than they had expected. ■

UPCOMING MEETINGS

29th Annual Spring Symposia & Leadership Meeting
April 19–22, 2017
Four Seasons, Denver, CO

2017 Fall Leadership Meeting
October 12–14, 2017
Monterey Plaza Hotel & Spa
Monterey, CA

30th Annual Spring Symposia & Leadership Meeting
May 9–12, 2018
Four Seasons, Orlando, FL

2018 Fall Leadership Meeting
September 27–29, 2018
Chicago, IL

31st Annual Spring Symposia & Leadership Meeting
May 8–11, 2019
Boston, MA