



INTERNAL REVENUE MANUAL UPDATES PROVIDE WELCOME GUIDANCE FOR FEDERAL ESTATE TAX LIEN RELEASE PROCESS

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Real property owned at the time of an individual's death is subject to a federal estate tax lien, which, in accordance with IRC section 6324, attaches to the property automatically and provides security for any estate taxes that may be owed. This lien remains attached to the property even if the real estate is sold to a new owner. For this reason, prior to any sale by an estate, a purchaser of real estate will want evidence that this federal estate tax lien has been released by the IRS or that the IRS has issued a Closing Letter to the fiduciary of the estate and the amount of federal estate tax liability has been fully satisfied. In order to provide marketable title to the purchaser, the estate seller must meet one of these criteria or must prove that the estate does not meet the threshold amount requiring filing of a federal estate tax return.

The IRS recently updated its Internal Revenue Manual ("IRM") sections 5.5.8.8 through 5.5.8.19, effective July 24, 2018, to reflect revisions in the procedures for applying for --and IRS guidelines for issuing-- a release of federal estate tax lien. In 2016, the process for applying for a release of federal estate tax lien was considerably changed with minimal guidance provided by the IRS. Among the most concerning of these 2016 changes was the strict requirement that, for taxable estates, the IRS now required that either the net proceeds of the sale be paid over to the IRS or that all sale proceeds be held in escrow by an escrow agent until the federal estate tax return is filed and the IRS completes its review by issuing a closing letter to the executor of the estate. The recent updates to the IRM provide helpful insight for practitioners and make clear that there is some flexibility in its approach.

Applying for a Release of Federal Estate Tax Lien:

Historically, the release of lien was issued approximately 10 days after submission of an application. Under current guidelines, the IRS requires Form 4422 ("Application for Certificate Discharging Property Subject to Estate Tax Lien") to be completed by the executor of the estate and submitted to the IRS *at least 45 days prior to the date of closing*.

The Instructions for Form 4422 direct that the following documentation should be submitted together with the form: (a) current title report, (b) legal description and appraisal of the property, (c) copy of short form of letters testamentary, (d) copy of will, (e) copy of sale contract, (f) copy of closing statement (or proposed closing statement), (g) copy of an appraisal, and (h) copy of the Form 706 (or, if the return is not filed, then a copy of the draft of Form 706, and/or a copy of the inventory and appraisal reflecting all assets of the estate, or Form 4768, Application for Extension of Time to File a return and/or Pay U.S. Estate (and Generation Skipping Transfer) Taxes.

Issuance of the Release of Federal Estate Tax Lien:

The Instructions for Form 4424 state that "If Form 706 has not yet been filed or if the Internal Revenue Service has not completed our review of Form 706, we will determine on a case by case basis the amount of funds, if any, the estate will be required to either pre-pay from the sale proceeds or have held in escrow."

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While, initially, this was strictly interpreted to require the estate to escrow all sale proceeds or pay proceeds over to the IRS, the recent updates to the IRM clarify that this is not applicable in all cases. Rather, various factors are taken into consideration by the IRS in making this determination. Revised Section IRM 5.5.8.9 identifies various “Considerations Regarding Estate Tax Lien Discharge Applications,” emphasizing that the issuance of a lien release is not evidence that the tax has been paid, but is issued “to permit the transfer of property free from the lien in case it is necessary to clear title.” The critical issue for the IRS to determine is whether the estate tax liability is “adequately provided for.” The IRS may consider

- whether estate tax liability has already been paid;
- whether the estate is even subject to a Form 706 filing requirement; and
- whether the value of other property disclosed on the Form 4422 that will remain subject to the estate tax lien is adequate to protect the government’s interest in the payment of the estate tax.

In determining whether the government’s interest is adequately protected, revised IRM Section 5.5.8.9 goes on to provide specific circumstances where a discharge of lien may be issued:

- when remaining property of the estate which is subject to the estate tax lien has a fair market value of at least double the amount of the unsatisfied liability secured by the estate tax lien (and all other liens upon such property which have priority over the estate tax lien);
- when a partial payment has been made (provided said partial payment is greater than the value of the IRS’ interest in the property to be discharged);
- when the property is determined to have no value, when taking into consideration other liens and encumbrances with priority over the federal estate tax lien (ie if the sale price, less the mortgage, leaves no remaining value); and
- when the sale proceeds can serve as a “substitute” for the actual property. In other words, if the seller holds all sale proceeds, net of closing costs, in escrow.

Estates Not Subject to Form 706 Filing Requirement:

If the gross estate is below the filing threshold (\$11,180,000 million for individuals dying in 2018) no lien release is necessary. However, if the purchaser of the real estate (or purchaser’s title company), requires a lien release in order to close, the executor of the estate may submit Form 4422 as described above. In this circumstance, revised IRM Section 5.5.8.12.3 dictates that the IRS may issue a letter (Letter 1352) stating that no estate tax is due and therefore no lien to release.

It should be noted that frequently in these circumstances, purchasers of real estate (and their title companies) will accept an affidavit from the fiduciary of the estate, stating that no federal estate tax is due.

Net Sale Proceeds Held in Escrow:

IRM Section 5.5.8.12 states that if “Form 4422 shows an estimated estate tax greater than the net proceeds from the property being sold, and no estimated payment has been made, then the net proceeds should be paid or escrowed before granting the discharge.” Similarly, IRM Section 5.5.8.12.3 advises that where the estate is requesting discharge of the lien early in the estate administration process, holding net sale proceeds in escrow may also be required. Where proceeds are required to be held in escrow, purchaser’s title companies will require an escrow agreement indicating that the net proceeds will be held by an escrow agent (often the title company or the seller’s attorney) until a closing letter or release of the federal estate tax lien is received.

In determining “net proceeds,” the revised IRM also provides guidance regarding what are “allowable expenses” that may be netted out of the funds to be held in escrow. IRM Section 5.5.8.13.1 summarizes these allowable expenses as follows:

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- Fees related to the application process, such as title report, appraisal, etc.
- Fees inherent to the transaction, such as realtor commission or loan origination fee.
- Costs associated with the administration of the proceeds.
- Payment of transfer taxes

While the IRM is intended to be a manual for IRS personnel, the revisions to this manual provide valuable guidance for attorneys and their clients who are selling estate-owned property. Certainly sellers of estate-owned real estate will want to be alerted that this application process may have the potential to delay a closing and that the proceeds of the sale may be held up for months or possibly years while the estate tax return is being reviewed.