

New IRS Discharge of Estate Tax Lien Procedure

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To sell or not to sell: That is the question. Well, at least it may be for an executor presiding over an estate that owns real estate. In some cases, the testator explicitly instructs that his or her real estate be sold at death, and in other cases, the executors have the discretion to make this decision. In situations involving illiquid estates, the executors may have no choice but to sell real estate in order to pay estate taxes, bequests, and/or administration expenses. A new Internal Revenue Service (IRS) procedure now adds a significant layer of complexity to a testator's considerations when creating a new Will, and to the Executors' considerations when deciding whether to sell real estate held by the decedent's estate.

The Standard Procedure

Until recently, if an estate was subject to federal estate tax and the executors were preparing to close a sale of real estate held by the estate, the buyer's title company would request that the executors procure a Discharge of Estate Tax Lien (Discharge) obtained from the IRS. As background, if federal estate tax is owed to the IRS by a decedent's estate, then an estate tax lien attaches to all probate and non-probate assets that comprise the decedent's gross estate. Prior to June 1, 2016, the procedure to discharge this lien was simple: Complete IRS Form 4422 (Application for Certificate Discharging Property Subject to Estate Tax Lien), attach the relevant closing documents, and, voila, the IRS would issue a Discharge within about 10 days of receiving the completed Form 4422. The executors would provide the Discharge to the title company and buyer, and the closing could proceed as planned.

The Unannounced Radical New Procedure

As of June 1, 2016, and without any warning, the IRS radically changed the procedure to obtain a Discharge. The new procedure is described below:

Step 1: The executors complete and file Form 4422 and provide the relevant closing documents.

Step 2: After the IRS accepts the Form 4422, the executors either (1) enter into an escrow agreement with the IRS and appoint an escrow agent (e.g., the estate attorney) to hold the entire net proceeds of the sale; or (2) agree to deposit the entire net proceeds with the IRS to be held as a payment on account of the federal estate tax. If deposited with the IRS, the amount will accrue interest at the underpayment rate (currently 4 percent) commencing 45 days after a timely filed estate tax return (i.e., Form 706). The term “net proceeds”, as defined by the IRS, means the gross sale proceeds less senior encumbrances, attorney fees, broker fees, recording fees, and transfer fees.

Step 3: After choosing an option (escrow agent or IRS deposit), the IRS will provide the executors with a “conditional commitment to discharge certain property from federal estate tax lien” (Letter 5751). This document is then provided to the title company and buyer in order to consummate the sale.

Step 4: Provide a final closing statement of the sale to the IRS and either (1) provide proof that the proceeds have been deposited with the escrow agent or (2) send the IRS a check in the amount of the net sale proceeds.

Step 5: The IRS will issue the Discharge, which should then be provided to the title company and buyer to complete the closing.

Step 6: The escrow agent or IRS, as the case may be, releases the net proceeds (less any amount used to pay federal estate tax due) after an estate tax closing letter is issued by the IRS. Note that, as of June 1, 2015, executors have to make a request to receive a closing letter from the IRS. In a conversation with an IRS supervisor, we were informed that the net proceeds would be released earlier if, after a preliminary review of the estate tax return, an IRS auditor determines that the return will not be audited.

When we questioned the authority for this radical new procedure, the IRS explained this procedure is derived from Internal Revenue Code §6325(c), which provides that “[s]ubject to such regulations as the Secretary may prescribe, the Secretary may issue a certificate of discharge of any or all of the property subject to any lien imposed by section 6324 [i.e., lien for estate and gift tax] if the Secretary finds that the liability secured by such lien has been fully satisfied *or provided for*.” (emphasis added). The IRS explained that the “*provided for*” language authorizes the IRS to implement this new

procedure. The apparent policy reason for implementing this new procedure is that in numerous cases, the IRS had been unable to collect estate tax from estates that were issued Discharges.

What's even more distressing to trusts and estates attorneys is that the IRS informed us that they will not allow the net proceeds of a real estate sale to be released early for the payment of state estate/inheritance taxes, medical or living costs of a beneficiary, funeral expenses, etc. However, we were advised that these so-called hardship exceptions remain under consideration by the IRS National Office.

The Good News—When No Discharge Is Required

If a decedent's gross estate is below the filing threshold (currently \$5.45 million), no Discharge is necessary. In those cases where a title company requires a Discharge to close an estate sale, the IRS will issue a Letter (Letter 1352) stating that no estate tax is due and the estate is not subject to a lien. The executors simply file Form 4422 in order to obtain this Letter.

Using a Limited Liability Company to Avoid This Procedure

If the gross estate is over the filing threshold, and the real estate (or a cooperative apartment) was owned by the decedent in a limited liability company (LLC) or other investment vehicle, there is no need for the estate to procure a Discharge to close a sale; and no need to turn over the net sale proceeds to the IRS or an escrow agent. This is because the estate tax lien is placed on the LLC membership interest (intangible property) owned by the decedent as opposed to the real estate. However, certain factors may prevent the use of an LLC (e.g., refusal by a coop board or mortgage holder or adverse tax consequences). If the use of an LLC or other investment vehicle is not feasible, planners may want to engage in lifetime gift planning, as may be appropriate.

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<http://www.law.com/sites/almstaff/2016/12/14/new-irs-discharge-of-estate-tax-lien-procedure/>

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