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Latest Techniques for Middle Class Estates

by

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Is a License to Sell required if the owner is deceased?

No. A license to sell is required only if the decedent's Will is insufficient and the property was in the decedent's name individually at death. A properly drafted Will would provide the executor with the authority to sell at a public or private sale without the need to obtain a license to sell. If the decedent died without a Will, then a license to sell would be required.

What are the rules relating to obtaining a license to sell?

A license to sell generally is required if property is to be sold within one year following the date of appointment of the executor. The procedures set forth in Massachusetts General Laws Chapter 202 must be followed. A petition must be presented to the Probate Court, with the consent of all interested parties or after notice, together with a copy of a duly signed purchase and sale agreement and an affidavit containing the names of all interested parties. The executor is under a duty to obtain the highest possible price, which means the price set forth in the purchase and sale may not be the final price. This can present a problem for a buyer, but in practice, the purchase price set forth in the purchase and sale agreement will govern.

The license to sell will provide that the executor has the right to sell for the price set forth in the purchase and sale agreement or at a higher price.

Is there an estate tax lien against property owned by a decedent?

The Commonwealth of Massachusetts and the Internal Revenue Service have estate tax liens. A lien is statutory and arises automatically upon death. No filing is required by either government agency.

How is the estate tax lien released?

In Massachusetts, the lien is released either by filing an affidavit in compliance with Massachusetts General Laws, chapter 65C, or by obtaining a Form 792 (Estate Tax Release of Lien). The procedure to be used depends upon the value of the decedent's estate on the date of death and the amount of so-called "taxable gifts" made by the decedent before death. If the

decedent's assets, together with taxable gifts, meaning those in excess of $12,000 per year per donee, an estate tax return is required to be filed and an M-792 is required. If, however, the amount is less than the Massachusetts exemption amount, no estate tax return needs to be filed and an affidavit setting forth that the decedent's estate did not require the filing of a Massachusetts estate tax return signed under the pains and penalties of perjury and duly recorded at the Registry of Deeds is all that is needed to release the Massachusetts estate tax lien.

Is there a federal estate tax lien?

A procedure to obtain a federal estate tax lien is in place, but this usually is not required as part of the conveyance since, under federal law (unlike Massachusetts law), the lien attaches to the sale proceeds provided the sale was to a third party in a bona fide sale for fair and adequate consideration. Some conveyancing attorneys will require that the sellers produce a release of federal estate tax lien as well as a release of the Massachusetts estate tax lien.

What are the Massachusetts and federal estate tax filing thresholds?

Year	Mass. Exemption	Federal Exemption	Maximum Federal Rate
2003	$700,000	$1 million	49%
2004	$850,000	$1.5 million	48%
2005	$950,000	$1.5 million	47%
2006	$1 million	$2 million	46%
2007	$1 million	$2 million	45%
2008	$1 million	$2 million	45%
2009	$1 million	$3.5 million	45%
2010	$1 million	No Federal Estate Tax	35% (gift tax only)
2011	$1 million	$5 million*	35%
2012	$1 million	$5 million*	35%
2013	$1 million	$1 million	55%

* The gift tax exemption is also $5 million per person in 2011 and 2012.

When are estate tax returns due?

Estate tax returns are due within nine months of the date of death, but the Department of Revenue has an expedited process where an M-792 could be obtained promptly upon payment of any estate taxes due with a copy of the purchase and sale agreement. The Department of

Revenue has a walk-in procedure so that the release of lien Form M-792 can be obtained immediately.

When does title to real property vest in the heirs?

Under Massachusetts law, title to real property vests in the heirs as of the date of death of the decedent, subject only to the rights of the surviving spouse and the rights of creditors. Newhall, Settlement of Estates §86 (4th Ed., 1958)

How does the seller in the case of inherited property determine gain?

The gain is determined in the same manner as in the case of any other sale, that is by comparing the total amount realized, less selling expenses, less the property's adjusted basis. Usually, there will be no gain, however, since the heir's basis in property acquired from the decedent is equal to the fair market value of the property on the date of death under IRC § 1014. This is the so-called "step-up in basis" often referred to in estate tax matters. Step-up in basis may also be a misnomer since the heir's basis equals the fair market value whether the property is stepped up or stepped down (meaning the fair market value my be less than the decedent's basis).

Does property have to be inherited in order to obtain a step-up in basis?

Generally, yes, but there are certain exceptions when property was given away during life and the decedent either retained a "life interest" or "life estate" or merely continued to use the property without paying rent. IRC § 2036(a)(1) requires that the fair market value of the property be includible in the decedent's estate for estate tax purposes, even though the property would not be includible for probate purposes. This can actually provide a benefit as long as the value of the property included in the decedent's estate does not exceed either the Massachusetts or federal estate tax thresholds.

> In Rev. Rul. 70-155 and *Estate of Guynn*, 437 F.2d 1148 (4th Cir. 1971), it was ruled that the transfer by the decedent of property before death was includible in the decedent's estate for estate tax purposes if the donor continued to use the property before death and did not pay fair rent. On the theory that there was an "implied life estate."
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> This theory has been followed recently in the *Estate of Maxwell*, 98 T.C. 39 (1992) in which the decedent had "sold" property to his children before death and had received approximately 50% of the sale proceeds, but continued to live in the property after the purported sale. The decedent's Will forgave the note at death and the decedent was canceling $20,000 of the note each year. The Tax Court ruled that the full fair market value of the property was includible and that the sale transaction should be ignored under IRC § 2036 using an implied life estate theory. This retained life estate may be avoided if the decedent owned property as a tenant in common with his children within the theory of *Estate of Powell v. Commissioner*, 63 T.C.M. 3192 (1992). See also, *Estate of Wineman*, 79 T.C.M. 2189 (2000).
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> These rules can provide potentially good news to heirs who are selling property after the donor died, but where the property was gifted before death. Usually, the donee's basis is equal to the donor's basis, increased by any gift taxes paid under IRC § 1015.

How do you determine the basis of property inherited by a surviving spouse rather than children?

This depends upon how the property was owned on the date of death, but in the case of jointly owned property, if the property was acquired after 1977, one-half of the fair market value of the property is includible in the estate of the first spouse to die so that the surviving spouse would receive a partial step-up equal to that amount includible in the estate of the first spouse to die. This would then be added to one-half of the original cost to determine the surviving spouse's basis. There is a special rule, however, which may be applied in the case of property acquired by a couple before 1976.

If the property was acquired before 1977 and is held jointly on the date of the death of the first spouse to die, the full fair market value of the property would be includible in the estate of the first spouse so that the surviving spouse would acquire a "full" step-up in basis. *Gallenstein v. United States*, 91-2 U.S.T.C. ¶60,088 (ED KY 1991), aff'd 975 F.2d 286 (6th Cir. 1992). See also, *Patten*, 96-1 U.S.T.C. ¶60,231 (DC CA 1996) and *Anderson*, 96-2 U.S.T.C. ¶60,235 (DC MD 1996). In both of these cases, the estate tax return was filed incorrectly, but the Tax Court ruled that the amount reported on the decedent's estate tax return was not determinative of basis, rather, basis is equal to the amount that should have been includible had the estate tax return been filed properly.

Memorandum In Support of Taxpayer's Position

The taxpayer submits that in this case the property obtained a full step-up in basis and the case of *Treat v. Commissioner*, 52 Mass. App. Ct. 208 (2001) does not apply.

In *Treat v. Commissioner*, the Massachusetts Appeals Court declined to follow the general rule of *Gallenstein v. United States*, 575 F.2d 286 (6th Cir. 1992) where the Sixth Circuit Court of Appeals found that, with respect to real estate owned jointly by a husband and wife acquired before 1977, the surviving spouse obtained a step-up in basis equal to the full fair market value of the property on the date of the decedent's death rather than a basis equal to one-half of the fair market value on the date of the decedent's death plus one-half of the taxpayer's original cost.

The basis for the ruling by the Sixth Circuit Court of Appeals stems from IRC § 1014(a), which provides that the basis of property acquired from a decedent is equal to the fair market value of the property that is includible in the decedent's estate for federal estate tax purposes. Moreover, as to property owned jointly between a husband and wife, IRC § 2040(b) provides that, at least with respect to property acquired prior to 1977, the surviving joint tenant obtains a so-called full step-up in basis because the property was includible in the estate of the decedent at 100% of its value.

Following the decision in *Gallenstein*, the Massachusetts Appeals Court addressed the basis of property acquired by a surviving spouse in the case of a decedent who died in 1993. In *Treat v. Commissioner*, the Court ruled that, since the Massachusetts estate tax

system required that only 50% of the value of the property owned by the decedent and his spouse be includible pursuant to General Laws chapter 65C, §1, the surviving spouse would acquire only a 50% step-up in basis.

The taxpayer's position in this case is that the ***Treat*** case does not apply to the facts of this case inasmuch as General Laws chapter 65C, § 1 became applicable by virtue of the changes in the Massachusetts estate tax for decedents dying on or after January 1, 1997. In this case, the decedent died in 1999.

The decision in ***Treat*** is based upon General Laws chapter 65C, § 1(d), which is applicable to deaths occurring before January 1, 1997. This section provides:

> "Federal Gross Estate, the gross estate, as defined under the Code, except that (1) notwithstanding Section 2035 of the Code, the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has, at any time made a transfer, relinquished the power or exercised or released a general power of appointment, except in case of a bona fide sale for adequate and full consideration in money or money's worth, by trust or otherwise, during the three year period ending with the date of the decedent's death, provided, however, the value of such property or interest therein so transferred or subject to the power so relinquished, exercised or released, exceeds $10,000 for any person during a calendar year, and (2) notwithstanding Section 2040 of the Code, one-half of the value of any interest in any property shall be included in the gross estate if such interest is held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with rights of survivorship, but only if the decedent and the spouse of the decedent are the only joint tenants.

This Section, however, does not apply to the decedents who died on or after January 1, 1997. Under current law, the Massachusetts Estate Tax is based upon the Federal Estate Tax Credit for estate taxes pursuant to IRC § 2011.

For deaths occurring prior to January 1, 1997, Massachusetts followed the general Federal Rules of includibility, subject to the two foregoing exceptions, i.e., in the case of transfers made by a decedent within three years of the date of death and for property owned jointly between a husband and a wife, where the husband and wife were the only owners.

For deaths on or after January 1, 1997, no adjustments are made to the federal gross estate to determine the amount of the Massachusetts estate tax, which is equal to the federal estate tax credit for state death taxes, pursuant to IRC § 2011. (The Massachusetts statute was amended again for estates of decedents who died on or after January 1, 2003, in which case the Massachusetts estate tax was decoupled from the federal estate tax as it was modified by the federal Economic Growth & Tax Relief Reconciliation Act of 2001 (EGTRRA). As the Massachusetts estate tax stands today, the Massachusetts estate tax is to be computed pursuant to the provisions of the federal estate tax in effect on December

31, 2000, with the amount of the tax equal to the sum equal to the amount of the credit for state death taxes that would have been allowable to the decedent's estate, as computed under IRC § 2011, as in effect on December 31, 2000.)

While it is true that, General Laws chapter 65C, § 1(d) remains on the books, it is no longer applicable to decedents who die on or after January 1, 1997. The instructions to the Massachusetts Estate Tax Return for decedent's dying on or after January 1, 1997, make it clear that this is the result intended.

Since Massachusetts now requires that the Federal Rules of includibility be followed and the Massachusetts estate tax is based upon the exact amount of the state death tax credit allowable, the principles of Gallenstein now apply to determine Massachusetts basis as well as federal basis, since 100% of the property is includible in the estate of the first spouse to die on the facts of this case.

As an additional basis for the refund, it should be noted be noted that Massachusetts incorporates federal income tax provisions to determine the basis of property acquired from a decedent, which, under IRC § 1014, defines the basis of property as the fair market value at the time of death. Specifically, General Laws chapter 62, § 6F of the Massachusetts Income Tax Statute, sets forth the method to determining the basis in property. Here, § 6F(b)(2)(C), provides that:

> "Notwithstanding subparagraphs (A) and (B), in the case of property acquired from a decedent within the meaning of IRC § 1014 of the Internal Revenue Code, the initial basis of such property shall be determined under Section 1014 of the Code.

In Treat, the Court acknowledged the link between the federal basis and Massachusetts basis but, nevertheless, declined to follow the specific language of General Laws chapter 62, § 6F, since, in the Court's opinion, it would lead to an unfair result. This analysis no longer is valid inasmuch as for decedents dying on or after January 1, 1997, full includibility is required in the estate of the first spouse to die under Code Section 2040(b).

For the foregoing reasons, the refund claim should be allowed.

Time limits on rental of vacation property.

The rules depend upon the number of days during a taxable year that the property is rented.

1. If the property is rented for less than fourteen (14) days, the taxpayer does not have to report the income nor are any of the expenses deductible unless

the expenses otherwise would have been deductible such as property taxes, mortgage interest and the like.

2. If property is rented for fifteen (15) days or more and the personal use is less than the greater of fourteen (14) days or ten percent of the total days the property is rented during the year, then the property is considered rental property. This means that the income must be reported and expenses attributable to the rental portion would be deductible, including depreciation. If however, there is a loss, the loss may or may not be deductible depending upon the taxpayer's adjusted gross income. Generally, up to $25,000 in rental losses can be deducted against ordinary income in any given year provided the taxpayer actively manages the property meaning owns more than ten percent of the property. The $25,000 limitation however is phased out for taxpayers who have adjustable gross income in excess of $100,000 and is phased out completely for taxpayers who have an adjusted gross income in excess of $150,000. Essentially for a taxpayer who has adjusted taxable income of $125,000 and a $25,000 passive loss, $12,500 would be deductible under the phase out rules. The difference can be carried forward and used in future years for use when the property is sold to offset the capital gain. For this rule, adjusted gross income excludes taxable social security.

If the taxpayer's home is sold, does the taxpayer have to reinvest the proceeds?

No. For sales which occur after May 6, 1997, there is no provision to "rollover" the gain to a new larger home nor is there an opportunity for a taxpayer over age fifty five (55) to exclude $125,000 of the gain. New rules provide that a taxpayer may exclude up to $250,000 of gain incurred in connection with the sale of a principal residence ($500,000 in the case of a married couple filing a joint return). Certain other rules must be met. These are as follows:

a. Either spouse must have owned the property for a total of two of the five years preceding the date of the sale.
b. Both spouses must have used the property as their principal residence for a total of two of the five years preceding the date of sale.
c. Neither spouse sold a principal residence and elected to exclude the gain within two years prior to the sale.

This means that a taxpayer with three properties can sell one every two years and exclude $500,000 worth of capital gain for a total of $1,500,000. There is a special rule whereby the two-year ownership rule will be waived if the sale is required as a result of change in the place of employment or for health reasons.

What is a life estate?

A life estate is an ownership interest established when an individual who owns property transfers ownership of the property to another, while retaining for life rights to use, occupy or obtain income or profits from the property. A life estate is not a trust. A life estate is a property interest.

Can property held in a life estate be sold?

Yes. If property owned by life estate is sold before the death of life tenant, both the life tenant and the remainderman must sign the purchase and sale agreement and also sign the deed. The proceeds are allocated between the life tenant and the remainderman based on their actuarially determined interest in the property.

For example, if property held in a life tenancy was sold for $500,000 and the life tenant was age 80, the life tenant is entitled to 47% of the proceeds while the remainderman would be entitled to 52% of the proceeds.

Does the life tenant have to pay a capital gain tax on his portion?

This depends upon whether the property sold was a principal residence. If the property was the life tenant's principal residence, then the portion of the sale proceeds allocated to the life tenant would be eligible for the capital gain tax exclusion. As to the remainderman, this amount would not be eligible for the capital gain tax exclusion. The gain would be allocated to the remainderman and the remainderman would be able to use the capital gain tax rates. Rev. Rul. 71-122.

How do you determine basis?

Basis in the property is allocated between the life tenant and the remainderman using the same percentages based on the actuarially determined interests in the property.

How are life estates created?

Life estates are usually created as part of the Medicaid planning technique. A parent might consider transferring property to a child but is concerned about losing their home. A life estate solves this problem. The life estate also provides the children with a so-called step-up in basis thereby eliminating any post death capital gain tax, at least up to the fair market value on the property on the date of death, provides the donor with stability so that the life interest cannot be taken without the consent of the life tenant, the life estate is not a probate asset and therefore is not subject to the estate recovery under the Medicaid rules, and the amount of the so-called "penalty period" is shortened by taking into account that the remainderman is receiving only a small percentage of the property rather than the full fair market value of the property.

Is the property subject to "Estate Recovery"?

THIS HAS BEEN REPEALED EFFECTIVE RETROACTIVELY TO JULY 1, 2003.

Yes, for death occurring on or after July 1, 2003. The Division of Medical Assistance can recover against both probate and non-probate assets. Estate recovery may be deferred until after the death of the surviving spouse, if any, or while there is a surviving child who is blind, permanently and totally disabled, or under 21 years of age living in the property. 130 CMR 515.011(C).

Additionally, the Division of Medical Assistance must waive recovery for hardship if (a) a sale of the real property would be required to satisfy a claim against the member's probate estate; (b) an individual who was using the property as a principal place of residence on the date of the member's death meets all of the following conditions; (i) the individual lived in the property on a continual basis for at least one year immediately before the now deceased member became eligible for MassHealth, (ii) the individual was left an interest in the property under the deceased member's will or inherited the property from the deceased member under the laws of intestacy, (iii) the individual is not being forced to sell the property by other devisees or heirs at law, and (iv) at the time the Division first presented its claim for recovery against the deceased member's estate, the individual's annual gross countable income was less than or equal to 200% of the applicable federal property level income standard. 130 CMR 515.011(D).