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TOPIC: Retracting the Claws – Proposed Regulations Seek to Eliminate Estate Tax Clawback

MARKET TREND: Proposed regulations clarify that taxpayers won't be penalized later for using current increases in the federal gift/estate tax exemption.

SYNOPSIS: In legacy planning, "clawback" generally refers to the additional estate taxes that could be triggered by lifetime gifts if the unified federal gift and estate tax exemption is less at the time of death than at the time of the gift. If there is a lower exemption at death, the current estate tax rules would recapture and tax in the estate the value of the gift that was not originally subject to gift tax under a higher exemption. Proposed regulations issued by the IRS late last year, however, eliminate this clawback, assuring taxpayers that lifetime use of the increased gift/estate tax exemption will not be undermined by a subsequent reduction in the exemption amount. Yet it remains uncertain whether gifts made during the higher exemption period will be attributable first to the increased amount (i.e. "come off the top") or applied to reduce the base exemption amount when it drops in 2026.

TAKE AWAYS: Planning with the higher federal gift and estate tax exemption may be a "use it or lose it" proposition. With the elimination of clawback and the limited window for higher exemptions, families able to make significant lifetime gifts may want to fully exhaust their exemptions before 2026, such as by using large gifts to fund dynasty trusts, implement business succession plans, and/or fund exit plans for existing planning arrangements (e.g., installment sales to grantor trusts or split-dollar arrangements).

MAJOR REFERENCE: 26 CFR Part 20, REG-106706-18.

WHAT IS "CLAWBACK"?

In legacy planning, "clawback" generally refers to the additional estate taxes that could be triggered by lifetime gifts if the unified federal gift and estate tax exemption — the basic exemption amount ("**BEA**") — is less at the time of death than at the time of the gift.

The issue arises because of the technical rules for calculating the federal estate tax. These rules first require a determination of the tentative estate tax on the gross value of the decedent's estate at death plus all prior taxable lifetime gifts (post-1976). This tentative tax is then reduced by (1) any prior gift tax paid and (2) the unified credit against estate tax, which equals the estate tax that would be due (at the estate tax rate on date of death) on the BEA in effect on the date of death (adjusted for inflation and by any deceased spousal unused exclusion ported to a surviving spouse or any restored exclusion amount for certain prior gifts between same-sex spouses (known as the "applicable exemption amount")).

WHY DOES CLAWBACK MATTER?

Clawbacks effectively undercut the estate tax benefits of applying the increased BEA to lifetime planning. A simplified example can best illustrate clawbacks' potentially adverse implications (applicable inflation and other adjustments to the BEA are disregarded):**[1]**

Example 1: Adam is a divorced father of three who lives in Florida. He has made no prior taxable gifts. The applicable federal gift and estate tax rate at all times is 40% (applied at a flat rate for simplicity). Assume Adam gives his children $11 million when the BEA is $10 million. He pays $400,000 of gift tax on the $1 million excess gift. Adam later dies with a taxable estate valued at $0. Compare the potential federal estate tax if Adam's death occurs when the BEA is still $10,000,000 versus when the BEA has dropped to $5,000,000.

BEA at Adam's Death	**$10 Million**	**$5 Million**
Lifetime Gifts	$11,000,000	$11,000,000
Taxable Estate	$0	$0
Total Estate Tax Base ***(Estate + lifetime gifts)***	$11,000,000	$11,000,000
Tentative Estate Tax ***(40% of total tax base)***	$4,400,000	$4,400,000
Less Gift Tax Paid ***(40% of $1 million)***	($400,000)	($400,000)

BEA at Adam's Death	**$10 Million**	**$5 Million**
Less Unified Credit *(40% of BEA at death)*	($4,000,000)	($2,000,000)
Estate Tax Due	**$0**	**$2,000,000**

Accordingly, with a lower BEA at death, the required estate tax computation "claws back" and taxes in the estate the value of the lifetime gift that was not originally subject to gift tax using the higher BEA. In a worst-case scenario, as shown above, clawback could impose a significant estate tax liability even on a taxable estate of $0.

WHY THE CONCERN NOW?

Clawback concerns initially arose in 2012, when the $5.12 million BEA was set to drop to $1 million in 2013. Enactment of the American Taxpayer Relief Act of 2012 skirted the issue because it set the BEA at $5 million, with annual adjustments for inflation, thereby avoiding any future drop in the BEA. The passage of the Tax Cuts and Jobs Act ("TCJA") in 2017, however, revived the clawback concerns by increasing the BEA to $10 million (inflation-indexed) in 2018 but returning it to $5 million in 2026 (inflation-indexed). Recognizing the clawback problem, the TCJA also directed the IRS to prescribe regulations that address the potential difference between the BEA at the time of a decedent's lifetime gifts and at death. The IRS issued proposed regulations late last year.

DO THE REGULATIONS FIX THE PROBLEM?

Yes. The proposed regulations provide that the BEA used to determine the unified credit against estate tax at a decedent's death will equal the larger of (1) the BEA as of the decedent's death or (2) the cumulative BEA allowed in determining the gift tax payable on prior lifetime gifts. Essentially, when calculating the estate tax liability, a decedent's estate will use the BEA as of death, plus any BEA used for prior lifetime gifts.

Example 2: Assume the facts from Example 1 above, with Adam passing when the BEA has returned to $5 million. Under the proposed regulations, all computations remain the same, **except** that Adam's unified estate tax credit will equal 40% of $10 million, the BEA applied to his prior gifts, since it exceeds the $5 million BEA applicable at his death. In this case, Adam's estate tax liability will drop to $0 under the proposed regulations.

Death after BEA Decrease	**No Regs. (Clawback)**	**Prop. Regs. (No Clawback)**
Lifetime Gifts	$11,000,000	$11,000,000
Taxable Estate	$0	$0
Total Estate Tax Base *(Estate + lifetime gifts)*	$11,000,000	$11,000,000
Tentative Estate Tax *(40% of Total Tax Base)*	$4,400,000	$4,400,000
Less Gift Tax Paid *(40% of $1 million)*	($400,000)	($400,000)
Less Unified Credit *(40% of applicable BEA)*	($2,000,000)	($4,000,000)
Estate Tax Due	**$2,000,000**	**$0**

WHAT ABOUT "REVERSE CLAWBACK?"

The TCJA's increase in the BEA also raised the possibility of "reverse clawback" for individuals who had made and paid gift tax on gifts in excess of the BEA before the increase, and then made additional gifts or died after the increase. The concern was whether, in calculating the subsequent gift or estate liability, the tax rules would allocate the increase in the BEA's to the prior gifts on which gift tax had been paid, essentially double taxing the donor.

Example 3: Betty is single with two children. She has made no prior taxable gifts. In 2017, when the BEA is $5.49 million, Betty gives her children $6 million, paying gift tax on the excess $510,000. In 2018, when the BEA has increased to $11.18 million, she gives her children another $5.69 million (i.e., $11.18 million less $5.49 million) to use the full amount of the increase. If reverse clawback applied, the $11.18 million BEA would be reduced by the total of Betty's prior gifts ($6 million), leaving her with only $5.18 million of the higher BEA, meaning she again would be deemed to make a gift of, and be taxed on, $510,000 in 2018.

The preamble to the proposed regulations, however, confirms that rules for calculating federal gift and estate tax liability do **not cause reverse clawback**, ensuring that the increased BEA will not be reduced by prior gifts that required gift tax payments.

USE IT OR LOSE IT?[2]

While clawback issues have been clarified, it remains unclear whether gifts made during the increased BEA period come "off the top," since there is no ordering rule for the application of the higher BEA to lifetime gifts.

Example 4: Assume a donor makes a $5 million gift while the BEA is $10 million. When the BEA reverts to $5 million, will that donor still have $5 million of remaining exemption (because the prior gift used the increased portion of the BEA first) or $0 (because the increased BEA applies last)?

Unfortunately, the proposed regulations do not provide any additional clarity here, and it is uncertain whether the IRS will issue further guidance.

Accordingly, families with the resources to make significant gifts may want to implement planning that maximizes the use of the full BEA before 2026, including:

- Gifts to dynasty trusts that will continue to preserve the gifted assets and appreciation there on from future estate and generation-skipping transfer ("**GST**") taxes (assuming allocation of an equivalent amount of the currently higher GST exemption).
   - Trusts that offer lifetime benefits to the donor's spouse (i.e., spousal lifetime access trusts or "SLATs") can still allow the donor to indirectly benefit from a trust during life, if desired.
   - Where the trust holds life insurance, the use of large gifts also eliminates the administrative hassles of other funding approaches (e.g., annual gifts).
- Implementing business succession plans for those with concentrated positions in closely-held businesses, using the increased exemption to cover the gifts of business interests to desired successor family members.
- Using gifts to create side funds that can help support exit planning for other planning transactions like installment sales to grantor trusts or split-dollar arrangements.
- For married couples, having one spouse make all gifts and avoiding split-gift elections, so the full BEA of at least one of the spouses may be used before it expires in 2026.**[3]**

TAKE AWAYS

Planning with the higher federal gift and estate tax exemption may be a "use it or lose it" proposition. With the elimination of clawback and the limited window for higher exemptions, families able to make significant lifetime gifts may want to fully exhaust their exemptions before 2026, such as by using large gifts to fund dynasty trusts, implement business succession plans, and/or fund exit plans for existing planning arrangements (e.g., installment sales to grantor trusts or split-dollar arrangements).

NOTES

[1] The tax rules applicable to gifts within three years of death, the potential growth in the estate between the time of gift and the time of death and similar technicalities are also disregarded.

[2] See Steve R. Akers, *Estate Planning Current Developments and Hot Topics*, Bessermer Trust, November 2018, §2.d(3) for a more technical discussion of this issue.

[3] See Note 3, above.