Finseca Report
Marketplace

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The IRS Proposed Exception to the Elimination of Estate Tax Clawback.

Is the Clawback…back?

Market Trend: Since tax legislation seems unlikely, the IRS is moving ahead on this rule and a number of other fronts.

Synopsis: In legacy planning, the "clawback" 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 gift. If there is a lower exemption at death, without a special rule, the estate tax rules could recapture and tax the value of the gift that was originally sheltered from gift tax under a higher exemption. While final regulations issued in 2019 eliminated this clawback, the preamble to these final regulations acknowledged that the IRS needed to further consider whether gifts that they deem as not true inter vivos transfers should be excepted from this special rule. Newly issued proposed regulations address this question and create an exception for certain transfers that are includable in a donor's estate.

Take Aways: The Proposed Regulations re-emphasize the importance of planning to avoid impermissible retained interests. More specifically, there are three main take aways from the Proposed Regulations that advisors should consider: (1) have a heightened awareness of the risks imposed and implications of the Proposed Regulations with respect to existing and new estate planning transactions; (2) analyze and test outstanding transactions such as GRATs and QPRTs to determine whether such transactions fall within the scope of the five percent de minimis exception; and (3) determine whether it makes sense to transfer, relinquish or eliminate an interest, power or property to attempt to avoid the eighteen month rule for transactions within the scope of the Proposed Regulations.

Major Reference: 26 CFR Part 20, REG-118913-21.

Background

Increase (and Scheduled Sunset) of the Basic Exclusion Amount

The Tax Cuts and Jobs Act of 2017 increased the basic exclusion amount (the “BEA”) from $5 million to $10 million, adjusted for inflation annually. The increase is temporary and only applies to gifts made or decedents dying after December 31, 2017, but before January 1, 2026. The IRS estimates that the BEA will revert to approximately $6.8 million on January 1, 2026. This reversion in the BEA caused concern among the legacy planning community by creating a possible “clawback” that would effectively undercut the estate tax benefits of using the increased BEA for lifetime planning. The following example illustrates the concern.

Example 1: Adam is single and a Florida resident. He has made no prior taxable gifts. The applicable federal gift and estate tax rate at all times is 40%. Assume Adam gives his children $11 million when the BEA is $10 million. Adam 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 million versus when the BEA has dropped to $5 million.

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)
Less Unified Credit (40% of BEA at death)	($4,000,000)	($2,000,000)
Estate Tax Due	**$0**	**$2,000,000**

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 originally sheltered. In a worst-case scenario, as shown above, the clawback would impose an estate tax liability of $2,000,000 even on a taxable estate of $0.

Anti-Clawback Regulations

The legacy planning community had a collective sigh of relief when the IRS issued final regulations on November 26, 2019[1] (the "2019 Regulations"), that included a so-called "anti-clawback" rule. The 2019 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. The following example illustrates this rule.

Example 2: Assume the facts from Example 1, with Adam passing when the BEA has returned to $5 million. Under the 2019 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 from $2,000,000 to $0 under the anti-clawback regulations. The following chart illustrates the benefits of this anti-clawback rule.

Death after BEA Decrease	No 2019 Regulations (Clawback)	2019 Regulations (Anti-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**

The 2019 Regulations do not distinguish between (i) completed gifts that are not included in the donor's gross estate, and (ii) completed gifts that are treated as testamentary transfers and thus, are

[1] Treas. Reg. § 20.2010-1(c).

included in the donor’s gross estate. Such distinction has been on the IRS' radar as evidenced by the preamble to the 2019 Regulations, which provides that further consideration would be given to the issue of whether gifts that are not true inter vivos transfers, but rather are includible in the gross estate, should be excepted from the anti-clawback rule. Further, the IRS Priority Guidance Plan for 2021-2022 includes issuing regulations under Internal Revenue Code (“Code”) Section 2010 to address whether gifts that are includible in the gross estate should be excepted from the anti-clawback rule of Treas. Reg. § 20.2010-1(c).

Proposed Exception to the Anti-Clawback Rule

The Perceived Abuse and the IRS Response

The IRS has historically been concerned with a donor making a completed gift and retaining control or the beneficial enjoyment of such gift. Numerous Code provisions deal with the concern and force previously gifted assets back into a donor’s estate for federal estate tax purposes. A comment contained in the announcement of the 2019 Regulations noted that if all completed gifts are subject to the anti-clawback rule, then a donor could make a completed gift, using the increased BEA available against the donor’s estate tax despite the fact that the donor retained the beneficial use of or the control of the transferred assets. To address this concern, the IRS proposed regulations on April 27, 2022 (the “Proposed Regulations”), adding a new Treas. Reg. § 20.2010-1(c)(3) and modifying Treas. Reg. § 20.2010-1(f)(2). The Proposed Regulations create an exception to the anti-clawback rule for transfers includible in a donor’s gross estate, or treated as includible.
The following is an example of what the IRS perceives as a potential abuse.

Example 3: Adam makes a completed gift of his promissory note in the amount of $10 million when the BEA was $12.06 million. Adam later dies when the BEA has been reduced to $6.8 million. No other gifts were made by Adam during his lifetime. The promissory note remained unpaid as of Adam’s date of death.

The assets to be used to satisfy Adam’s promissory note are a part of Adam’s gross estate, resulting in the promissory note being treated as includible in Adam’s gross estate and not Adam’s adjusted taxable gifts.

A literal interpretation of the 2019 Regulations would suggest that the credit to be applied for purposes of computing Adam’s estate tax is $10 million; however, under the Proposed Regulations, the credit to be applied for purposes of computing Adam’s estate tax is based on the $6.8 million BEA as of Adam’s date of death, subject to the limitations of Code Section 2010(d).

Example 4: Taking the above Example one step further, assume the same facts as Example 3 and that Adam died with a taxable estate of $20 million, which included the $10 million promissory note. Assume Adam has made no other taxable gifts and the applicable federal estate tax rate is 40%. The following chart illustrates the difference in estate taxes with and without the Proposed Regulations. The Proposed Regulations impose a $1,280,000 tax.

Death After BEA Decrease	Proposed Regulations (Exception to Anti-Clawback)	No Proposed Regulations (Anti-Clawback Applies)
Taxable Estate	$20,000,000	$20,000,000
Gross Estate Tax (40% of taxable estate)	$8,000,000	$8,000,000
Applicable BEA	$6,800,000	$10,000,000
Allowable Credit Amount (40% of BEA)	$2,720,000	$4,000,000
Estate Tax Due	**$5,280,000**	**$4,000,000**
Benefit of Anti-Clawback Rule	**$0**	**$1,280,000**

Targeted Transactions

Without the Proposed Regulations, a donor could conceivably obtain the benefit of the increased BEA and continue to have title, possession, use, benefit, control, or enjoyment of transferred assets during their lifetime. To eliminate that situation, the following transactions are specifically subject to the exception to the anti-clawback rule:

1. Transfers includible in the gross estate of a donor such as: (a) a gift of an existing life insurance policy to an irrevocable trust within three years of death, (b) a transfer of stock in a controlled corporation while retaining the right to vote the stock, (c) a split-dollar arrangement with an irrevocable trust while retaining the power at any time to terminate the split dollar agreement, and (d) a transfer of a life insurance policy while retaining incidents of ownership such as the ability to change beneficiaries or cancel the policy;

2. Transfers made by enforceable promise to the extent such promise remains unsatisfied as of the date of a donor's death (for example, a lifetime completed gift of a donor's promissory note);

3. Transfers subject to the special valuation rules (for example, a transfer of a subordinate interest in a family entity while retaining certain preferred rights);

4. Transfers to a grantor retained annuity trust ("GRAT") or qualified personal residence trust ("QPRT"); and

5. The relinquishment or elimination of, an interest in any one of the foregoing categories within eighteen months of the decedent's death.

Example 5: Assuming the same facts as Example 3, but Adam pays off the note within eighteen months of his death. The result would be the same as Example 3 because of the eighteen month rule.

While the foregoing list of targeted transactions is comprehensive, the Proposed Regulations leave open the possibility of additional transactions being subject to the exception.

Exceptions to the Exception

The Proposed Regulations contain two exceptions to the general rule, which provide that the anti-clawback rule will continue to apply for certain transfers. First, a transfer includible in a donor's gross estate if the value of the taxable portion of the transfer determined as of the date of the transfer was five percent or less of the total value of the transfer (the "de minimis exception"). Second, a transfer, relinquishment or elimination of interest effectuated by the passage of time or the death of a person will be excepted from the new rule. For example, if a donor survived a GRAT term, no part of the assets transferred to such GRAT would be includable in the donor's estate and the eighteen month rule described above would not apply. The following examples illustrate how the foregoing exceptions could come into play in practice:

Example 6: Adam transfers $10 million to a GRAT, retaining a qualified annuity interest valued at $9.8 million. The taxable portion of Adam's transfer is $200,000. Adam dies during the term of the GRAT when the BEA has dropped to $6.8 million. The entire GRAT is included in Adam's taxable estate. Since the taxable portion of Adam's transfer is five percent or less than the total value of the transfer, the de minimis exception under the Proposed Regulations is satisfied.

Example 7: Adam transfers $10 million to a GRAT, retaining a qualified annuity interest valued at $3 million. The taxable portion of Adam's transfer is $7 million. Adam survives the GRAT term and later dies when the BEA has dropped to $6.8 million. Since Adam survived the GRAT term, no part of the GRAT is included in his taxable estate. Further, since the amount allowable as a credit in computing the gift tax payable on Adam's $7 million gift exceeds the credit based on the $6.8 million BEA, the anti-clawback rule applies and the credit to be applied for purposes of computing Adam's estate tax is based on a BEA of $7 million, which is the equivalent of an $80,000 difference in Adam's estate tax credit amount.

Effective Date

The Proposed Regulations would apply prospectively for a decedent dying after April 27, 2022.

Take Aways

The Proposed Regulations re-emphasize the importance of planning to avoid impermissible retained interests. More specifically, there are three main take aways from the Proposed Regulations that advisors should consider: (1) have a heightened awareness of the risks imposed and implications of the Proposed Regulations with respect to existing and new estate planning transactions; (2) analyze and test outstanding transactions such as GRATs and QPRTs to determine whether such transactions fall within the scope of the five percent de minimis exception; and (3) determine whether it makes sense to transfer, relinquish or eliminate an interest, power or property to attempt to avoid the eighteen month rule for transactions within the scope of the Proposed Regulations.