

IRS Clarifies No Clawback of Large Lifetime Gifts

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Estate and Gift Tax Exclusion

For those interested in transferring wealth to future generations or other loved ones, now is the time to take advantage of temporary opportunities to limit tax liability for donations. The Tax Cuts and Jobs Act (the "TCJA") doubled the federal gift and estate tax basic exclusion amount ("BEA") from \$5 million to \$10 million, indexed for inflation. When computing federal gift and estate tax, the BEA is a critical number. The BEA is the amount any taxpayer can transfer free of gift and estate tax (\$11,400,000.00 in 2019). Surviving spouses and same-sex spouses have opportunities to increase their respective exclusion amounts if certain conditions are satisfied. However, this increased BEA is a "use it or lose it" proposition. On January 1, 2026, the BEA is scheduled to revert to the original \$5 million BEA, indexed for inflation.

Estate and Gift Tax System

The scheduled January 1, 2026 reversion has the potential to complicate gift and estate tax matters due to the structure of the transfer tax system. Federal estate and gift tax are "unified" under a single transfer tax system, with a unified rate (40%) and a unified applicable exclusion amount (unified credit). Taxable gifts made during the donor's lifetime thus reduce the amount of the applicable BEA available for estate tax purposes at death. Generally, taxable gifts are those gifts that exceed the annual exclusion amount (\$15,000 per person, per donee for 2019), are not subject to the marital or charitable deduction, and are not made to pay qualified tuition or medical expenses. The estate and gift tax system is designed to ensure that a combined tax is imposed on a donor's lifetime gifts plus assets included in the donor's estate at death. Taxable gifts must be brought back into a decedent's estate as part of the estate tax calculation. Adding taxable gifts back into the taxable estate causes the tax rate imposed on the combined sum to be determined under a single graduated structure.

Taxpayer Uncertainty

Because of the structure of the unified gift and estate tax system, taxpayers were concerned that large taxable gifts made before 2026 that take advantage of the temporarily increased applicable BEA to shield them from gift tax (payable), would nevertheless be "clawed back" and taxed anyway in a post-2026 estate tax calculation.

Anti-Clawback Legislation

The 2017 TCJA amended the Internal Revenue Code, directing the IRS to prescribe regulations as may be necessary or appropriate to address any difference in the BEA at the time of the gift and at the time of death. The IRS released the anti-clawback proposed regulation on November 20, 2018. 83 Fed. Reg. 59343, 59347 (November 23, 2018) (to be codified at 26 C.F.R. pt. 20). The IRS explained that the proposed regulation provides a special rule that allows the estate to

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compute its estate tax credit using the higher of the BEA applicable to gifts made during life or the BEA applicable on the date of death.

To illustrate the operation of this special rule, suppose Mr. A (a single taxpayer) has never made gifts before 2018. In 2019, he implements an estate plan that involves making annual gifts up to the annual exclusion amount. In addition to the annual exclusion gifts, he plans to make large gifts of assets worth \$10 million to his three sons in 2019. Mr. A uses \$10 million of his available BEA under the TCJA to shield these gifts to his sons from gift tax. Mr. A dies in 2026 when the BEA is \$5 million. The IRS's proposed special rule would allow Mr. A's estate to calculate its estate tax based on the higher \$11,400,000 BEA in effect at the time of the 2019 gifts, resulting in the \$10 million gifts being shielded from both gift and estate tax.

Planning Opportunities and Considerations

Current estate and gift tax law provides historic opportunities to transfer wealth. The anti-clawback proposed regulation affords taxpayers contemplating substantial lifetime gifts more certainty in proceeding with their estate planning. Taxpayers should review their existing estate plans with their tax advisers to consider these temporary gifting opportunities.