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Clawback Under New Tax Law

We can only speculate how the IRS will handle this issue.

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As recently as a little over five years ago, estate planners were facing the issue of how the Internal Revenue Service would handle the situation if, say, their client made a gift of $5 million under the available gift tax exemption at the time, but the amount exempt from estate tax reverted to some lesser number prior to the client's death. Simply put, the issue was whether the Internal Revenue Code Section 2001(b)(1) offset for gift taxes payable would use the estate and gift tax exemption amount applicable at the time of the gift or at the time of the client's death. If the former was used, the client effectively hadn't taken full advantage of the larger lifetime gift tax exemption.

The Senate introduced at least one bill at the time that would have had the general effect of restoring the full exemption used by the client at the time of the gift.[1] This bill provided:

(2) DECREASING EXCLUSIONS.—

(A) ESTATE TAX ADJUSTMENT.—Section 2001 is amended by adding at the end the following new subsection:

"(h) ADJUSTMENT TO REFLECT CHANGES IN EXCLUSION AMOUNT.—

"(1) IN GENERAL.—If, with respect to any gift to which subsection (b)(2) applies, the applicable exclusion amount in effect at the time of the decedent's death is less than such amount in effect at the time such gift is made by the decedent, the amount of tax computed under subsection (b) shall be reduced by the amount of tax which would have been payable under chapter 12 at the time of the gift if the applicable exclusion amount in effect at such time had been the applicable exclusion amount in effect at the time of the decedent's death and the modifications described in subsection (g) had been applicable at the time of such gifts.

"(2) LIMITATION.—The aggregate amount of gifts made in any calendar year to which the reduction under paragraph (1) applies shall not exceed the excess of—

"(A) the applicable exclusion amount in effect for such calendar year, over

"(B) the applicable exclusion amount in effect at the time of the decedent's death.

"(3) APPLICABLE EXCLUSION AMOUNT.—The term 'applicable exclusion amount' means, with respect to any period, the amount determined under section 2010(c) for such period, except that in the case of any period for which such amount includes the deceased spousal unused exclusion amount (as defined in section 2010(c)(4)), such term shall mean the basic exclusion amount (as defined under section 2010(c)(3), as in effect for such period)."

Although at first blush, this Senate bill language seemed to adequately cover the estate planner's concerns, this isn't the approach the Senate adopted in their most recent legislation. Instead of adding an entirely new subsection (h) to Section 2001, the Senate added the following new subparagraph to subsection (g):

"(2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—

"(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and

"(B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent."

The Conference Committee Report makes two clarifying additions to the bill language itself. First, it inserts the words "the purposes of" after the words "carry out" in the introductory clause.[2] Second, it adds words that make clear that the basic exclusion amount referred to in paragraph (B) is the basic exclusion amount in effect "at the time of" any gifts made by the decedent.

Why Leave Decision to the IRS?

The obvious question is: Given the potential magnitude of the issue, why did the Senate choose to leave the different basic exclusion amount issue up the IRS to decide, when they had previous bill language available to them that they could have adopted? One reason might be that the 2012 bill language may not have gone far enough.

Assume, for example, that in 2018, an individual with an $11 million net worth gifts all of his assets to his children and pays no federal gift tax. The individual then dies in 2026, with a $0 estate and when the basic exclusion amount has reverted to $5.5 million (on an inflation adjusted basis). Under the 2012 bill, the decedent's estate would arguably pay no estate taxes.[3]

Assume instead that the same individual only gave away $5.5 million of assets in 2018 and died in 2026 with a taxable estate of $5.5 million, again when the basic exclusion amount has reverted to $5.5 million (on an inflation adjusted basis). Under the 2012 bill, the decedent's estate would pay approximately 40 percent estate tax on $5.5 million.

Is this a fair system, or is further thought needed, especially in light of the fact that many of our clients made $5 million taxable gifts before this exemption level was made permanent at the beginning of 2013? Congress may be thinking the same way, as evidenced by its directing the IRS to prescribe "necessary or appropriate" regulations with respect to any difference between the basic exclusion amount in effect at the time of any gifts made by the decedent and at the donor's death.

Another reason the Senate may have chosen to defer to the IRS on the different basic exclusion amount issue is that the "limitation" language they employed in proposed Section 2001(h)(2) of the 2012 bill is confusing, at best. Assuming the 2018 gift in the above example was of $11 million, what does it mean to say "the aggregate amount of gifts made in any calendar year to which the reduction under paragraph (1) applies shall not exceed the excess of (A) the applicable exclusion amount in

effect for such calendar year, over (B) the applicable exclusion amount in effect at the time of the decedent's death?" It sounds like this number is $5.5 million, but the gift tax on $5.5 million is $0, so the limitation on the additional tax reduction is $0?

Gleaning the Purposes of Section 2001(g)

Regardless of Congress' reasons for deferring to the IRS on the different basic estate tax exclusion issue, one thing we do know at this point is that, once again, we unfortunately still have no certainty on the dreaded "clawback" issue. Although the Conference Report tells us that Congress wants the IRS to draft such regulations as may be necessary or appropriate to carry out "the purposes" of Section 2001(g), Congress has given us no express guidance as to what those purposes are.

One could argue that the "purpose" of Section 2001(g)(1) [previously Section 2001(g)] is to arrive at a unified estate and gift tax system at an individual's death, that is, through treating all gifts as though they were made at the time of the decedent's death by using the tax rate that's in effect at the decedent's death versus at the time of the gift, for purposes of the Section 2001(b)(2) offset. One could also argue that the purpose of Section 2001(g)(1) is to provide fairness to the decedent's estate by reducing the estate tax owing by the larger number in a situation in which gifts had been made under a more favorable gift tax, for example, 35 percent rate versus 40 percent rate.

Under either formulation of purpose, that is, the "unified" approach or the "fairness" approach, in issuing its regulations, the IRS would be compelled to use the basic exclusion amount in effect the time of the decedent's death for purpose of computing the offset under Section 2001(b)(2), assuming the decedent's death occurred after 2025. However, the problem remains that Congress has provided us with no express purpose to Section 2001(g), and therefore we can still only speculate as to how the IRS will ultimately handle this issue.

My next article will address steps an estate planner can take today to best protect his clients in the event the regulations that are eventually issued by the IRS

aren't entirely favorable.

Endnotes

1. S. Senate. 112th Congress. 2d Session. Middle Class Tax Cut Act. S. 3393, Section 201(b)(2) (July 17, 2012).

2. Note that the Conference Report actually refers to Internal Revenue Code Section 2010(g), which does not exist.

3. But see the argument below where not even this much is clear under the language of the 2012 Senate bill.

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