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AN UNCERTAIN FUTURE: HOW THE POTENTIAL CLAWBACK MUDDIES THE ESTATE AND GIFT TAX WATERS

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EXECUTIVE SUMMARY

The Tax Cuts and Jobs Act[2] (the "Act") was signed by the president on December 22, 2017. Despite simplification of the tax code being one of the Act's stated purposes, many of its provisions add complexity and ambiguity for both practitioners and taxpayers. This is particularly evident with respect to the Act's changes to the estate and gift tax scheme. Thus, clarification on several issues would be helpful. This includes the potential for additional estate tax due because of lifetime gifts made by the donor.

Specifically, the possible sunset in 2026 of the increased estate and gift tax exemption amount leads to uncertainty and insecurity that the possibility that a gift previously made by a decedent will be "clawed back" into his or her estate if death occurs in a year in which the exemption amount is less than it was in the year the gift was made. Conversely, a concern for practitioners and taxpayers involves the loss of a credit against estate tax on a donee's death with respect to previous gift tax paid by the donor during his or her lifetime when exemption amounts are increasing. Additional issues arise relative to the ordering of credit amount used—if an individual makes a gift in a year with a higher credit amount and then the credit amount subsequently decreases, does that individual still have unified credit remaining? The answer depends on whether the credit amount is reduced from the top down or the bottom up.

The Act added an additional provision to Internal Revenue Code section 2001(g)(1), to specifically address these issues as it mandates the Department of Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death. Contrary to the current law, any type of clawback is inconsistent with related regulations and contrary to current law. Hence, Treasury should address the above circumstances to provide that no additional estate tax should arise due to changing exemption amounts, but at minimum resolve ambiguities relating to potential differences in the exclusion amount on lifetime gifts and on death.

[2] Public Law No. 115-97

I. BACKGROUND

A. The Unified Credit and Applicable Exemption Amount

Calculating estate and gift tax is far less intuitive than one might think. The Code[3] allows all taxpayers a unified credit on lifetime gifts and transfers on death.[4] This unified credit offsets tax owed on these transfers, which is calculated using the applicable estate and gift tax rates in effect at the time of the transfer. This is referred to as the exemption amount. In simplified terms, to determine the amount of estate tax due on a decedent's death, the entirety of the decedent's gross taxable estate is determined (assets less liabilities and administrative expenses), then lifetime gifts are added in, at which point the estate tax due is calculated. Then, any gift tax previously paid by the decedent (as the donor of a gift made in excess of the applicable unified credit exemption amount in the year the gift was made), is credited back. What remains is the amount of estate tax due. Thus, variances (whether increases or decreases between the time of a gift and the donor's death) in the amount of the unified credit amount can vastly affect the estate tax owed on a donor's death. This causes uncertainly for taxpayers and difficulty for tax practitioners who are attempting to advise clients in connection with their estate tax liability on death.

B. The Unified Credit Under The Tax Cuts and Jobs Act of 2017

Formally called "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," the Tax Cuts and Jobs Act ("Act") represents the most dramatic overhaul to the nation's tax law since the Tax Reform Act of 1986. In terms of estate and gift tax, the Act provides taxpayers the ability to increase gifts during both life and bequests on death without gift or estate tax by doubling the exemption amount. Specifically, the new provisions under the Act increase the basic exclusion amount provided in Section 2010(c)(3) from $5 million to $10 million indexed for inflation occurring after 2011. The indexed amount for 2018 is $11.18 million but unfortunately, this may be fleeting. Under the Act, the transfer tax provisions relative to estate and gift tax are only effective for eight years (from January 1, 2018 to December 31,

[3] All references to the "Code" or to a "Section" herein are to the Internal Revenue Code.
[4] Section 2010.

2025) in the absence of congressional action.[5] After 2025, these new provisions sunset and beginning in 2026, the prior law returns.

Certainly, the increased unified credit amount decreases the need for many taxpayers to even consider the effects of lifetime gifts on post mortem transfers of property. Much like the confusion and uncertainty experienced by taxpayers attempting to plan for wealth transfers in 2012; however, these sunset provisions create significant insecurity for taxpayers whose gross estates lie somewhere between $6 million and $12 million, and further, may lead to inequities among Americans who die either before or after the beginning of 2026. While inequities always exist, i.e., repeal in 2010, any ambiguity and insecurity present when attempting to plan the transfer of wealth to beneficiaries should be clarified where possible.

II. CLAWBACK OF UNIFIED CREDIT USED DURING LIFE CREATING ADDITIONAL TAX ON DEATH

Just like in 2012, estate planners are facing the issue of how the government will treat a gift made by a donor of their entire $11.18 million unified credit, if the exemption amount decreases in the year of their death? Under the law, the donor's estate could be subject to estate tax on the amount of gifts made in excess of the exemption amount as of the date of their death. In effect, the amounts of prior gifts in excess of the exclusion amount, could be "clawed back" for the purposes of calculating estate tax owed on death, thereby turning a donor's previously untaxable estate (as of the year of the gifts) into a taxable estate on the donor's death. This issue turns on whether the offset for gift taxes payable uses the estate and gift tax exemption amount applicable at the time of the gift or at the time of the donor's death. This was the same issue that concerned practitioners and donors in 2012 when the possibility existed that the gift tax exclusion amount would be reduced from $5 million to $1 million. While the IRS, Treasury and staffers on the Hill indicated a clawback was not intended, no published clarity was ever provided.

The Act amends Section 2001(g) to add a new Section 2001(g)(2) directing the Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the

[5] This was done to satisfy the "Byrd rule" so the Act would pass with merely a majority vote in the Senate (as opposed to the usually requisite 60 votes to close debate on the Senate floor). *See* Section 310 of the Congressional Budget Act of 1974 (P.L. 93-344, as amended)

time of a gift and at the time of death. Section 2001(g)(2) provides as follows:

> (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.

Unfortunately, under prior law the calculation procedure described in the instructions to the Form 706 would have resulted in a "clawback." Section 2001(g) was added in 2010 to clarify that in making the second calculation under Section 2001(b)(2), the tax rates in effect at the date of death, rather than the tax rates in effect at the time of each gift are used to compute the gift tax imposed and the gift unified credit allowed in each year. The problem is that Section 2001(g) does not specify whether to use the exclusion amount at the date of the gift or at the date of death to determine the credit amount for prior gifts.

The estate tax calculation method under Section 2001(b) is partly as follows:

First, calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (after 1976).

Second, subtract the amount of gift tax that would have been payable with respect to the gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts.

The statute leads to uncertainty because it does not specify whether to use the credit amount that applied at the time of the gift or at the time of death. The instructions for the Form 706 in completing the "Line 7 Worksheet" specifically state that the basic exclusion amount available in each year the gifts were made, is used in calculating the gift tax that would have been payable in that year. The effect of this calculation is that the tentative tax on the value of the current estate plus adjusted taxable gifts would not be reduced by any gift tax payable on those gifts if the gifts were covered by the applicable exclusion amount in the years the gifts were made. This results in a tentative estate tax on the prior gifts. Thus, regulations should clarify that a clawback would not apply if the estate exclusion amount is smaller than an exclusion amount that applied to prior gifts.

III. THE REVERSE CLAWBACK—LOSS OF CREDIT ON DEATH FOR PREVIOUS GIFT TAX PAID DURING LIFE

A similar issue can occur if on the donor's death the unified credit amount has increased from prior years. Under the law, if a donor makes a taxable gift during life which exceeds the applicable exclusion amount and gift tax is owed, the donor's estate is then given a credit for the amount gift tax paid by the donor during life. But if the estate tax exclusion amount increases, then the credit for gift tax paid would be rendered meaningless on the donor's death. This is often referred to the "reverse clawback." Specifically, a decedent who paid tax on lifetime gifts, could lose the credit normally allowed for estate tax purposes under Section 2001(b)(2) for prior gift tax paid because the applicable exclusion amount in effect on their death is now higher.

For example, assume a donor made a $ million gift in a prior year when that the gift tax exemption was $1 million. The donor paid tax on the $2 million of taxable gifts ($3 million - $1 million). If the donor dies with a $20 million estate (including the prior $3 million gift), in the year of a $12 million credit, the donor could be subject to gift tax on the entire $8 million (20-12) with no credit for the prior gift tax paid on the $2 million, if the calculation for the gift tax payable on the $2 million gift is based on the exemption amount in the year of death.

Clearly there is no intent to impose double taxation on the $2 million prior taxable gift. To resolve this issue, the statute could state that the hypothetical gift tax payable on the adjusted taxable gift is calculated using the lesser of the following: the applicable gift tax exemption amount in the year of the gift, or the applicable estate tax exemption amount in the year of death. Thus, the higher exemptions amount would be used for estate tax purposes but would not be used to calculate the "hypothetical" gift tax payable. Alternatively, regulations could be issued or instructions to the Form 706 added to clarify these issues.

IV. CLAWBACK ISSUE ON PORTABILITY.

Some practitioners have concerns as to which DSUE amount applies on the second spouse's death. If the DSUE amount on the first spouse's death is higher than the exemption amount available on the second spouse's death, is the surviving spouse able to use the first spouse's DSUE amount, even if it is larger than the exclusion amount available under the law on the second spouse's death? Specifically, if the first spouse dies when the estate exclusion amount is $12 million, and a portability election is made, the DSUE is $12 million. If the surviving spouse dies when the exclusion amount is reduced to $6 million, will the DSUE from the first spouse remain at the higher level, or it is limited to the exclusion amount in existence at the second spouse's death? The existing portability regulations provide that a surviving spouse "shall be considered to apply [the] DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount." Treas. Reg. §25.2505-2(b). Thus, under the current temporary portability regulations, the DSUE remains at the exclusion amount in effect at the first spouse's death. Hence, as long as these provisions remain, once the temporary regulations are made permanent, no issues will arise.

V. HOW TO ORDER THE USE OF THE UNIFIED CREDIT—TOP UP, OR BOTTOM DOWN?

Currently there are no guidelines as to how the unified credit should be used and this is necessary to aid practitioners and taxpayers in properly planning both lifetime gifts and transfers on death. Simply, put, should the unified credit be calculated from the top up (i.e., based on the applicable exclusion amount as of the date of the gift), or the bottom down (i.e., based on the applicable exclusion amount as of the date of the decedent's death). This issue could arise when an individual makes a gift in a year with a higher credit amount. If the credit amount later decreases will they have credit remaining? Without guidance or regulations addressing these issues, practitioners and taxpayers are at a loss as to how to calculate the exemption remaining on death, if any.

To illustrate, a donor makes a first time gift of $6 million when the exclusion amount is $12 million. If the donor dies when the exclusion amount has been reduced to $6 million does the donor have $6 million of the exclusion amount remaining or none? The answer depends on the order of the gifts; whether it is from the top down $12 million - $6 million with $6 million remaining or from the bottom up $6 million - $6 million with $0 remaining. The Treasury should issue regulations providing that gifts come "off the top" of the exclusion amount, so that a donor who makes a $6 million gift when the exclusion amount is $12 million would still have all of his or her $6 million exclusion amount available if the exclusion amount is reduced to $6 million after 2025.

On the other hand, if a taxpayer makes a first time gift of $7 million when the exemption amount is $11 million, $4 million of exemption should remain. Assume the exemption amount then increases to $12 million and the taxpayer makes no further gifts. If the exemption amount then decreases to $5 million the taxpayer likely should only have $4 million of exemption not $5 million, as the taxpayer never used the increased million between $12 million and $11 million. So clarification is needed as to whether the exclusion amount is a use it or lose it credit.

There are obviously many more complicated situations that can arise. In the last example, what if the exclusion amount then increases from $5 million to $6 million. Once again, presumably the taxpayer has $4 million remaining not $5 million. $6 million - $5 million = $1 million + $4 million = $5 million. Again, clarification would be helpful, if not by regulations, via a worksheet utilized with Forms 709 or 706.

It is not clear whether Section 2001(g)(2) contemplated that this issue would be addressed because Section 2001(g)(2) directs that regulations should address the difference between the exclusion amount "applicable at the time of the decedent's death" and at the time of "any gifts made by the decedent." Section 2001 addresses the calculation of the estate tax as both the title and statutory language of Section 2001(g)(2) suggest that the focus is on the estate tax calculation. While the statutory language does not directly address how much exclusion would be left for gift tax purposes, however, because Section 2001 deals with the estate tax and Section 2001(g)(2) refers to "estate tax payable," this calculation does affect exemption remaining on death.

VI. REGULATIONS ADDRESSING THE ABOVE ISSUES ARE NEEDED

The 2017-2018 Priority Guidance Plan was updated on February 7, 2018. This updated Plan makes clear that there are “near term priorities” as a result of the 2017 Tax Act. Specifically, one of those new projects is guidance on the computation for estate and gift taxes to reflect changes in the basic exclusion amount”. Hence, IRS and Treasury realize the importance of this guidance. The guidance should address the clawback issues and ordering of the exemption amount. Assuming the current proposed portability regulations are finalized no further guidance will be needed in relation to these issues and portability.

A. Regulations on the clawback issues should make clear that no clawback or reverse clawback applies when the exemption amount increases or decreases. First, this is entirely consistent under the law. Section 2001(g) specifically provides that the rate of tax that shall be used is the “rates of tax… in effect at the decedent’s death.” It provides as follows:

> For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent’s death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute –
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> (A) the tax imposed by chapter 12 with respect to such gifts, and
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> (B) the credit allowed against such tax under section 2505, including in computing –
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> (i) the applicable credit amount under section 2505(a)(1), and
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> (ii) the sum of the amounts allows as a credit for all preceding periods under section 2505(a)(2).

This code section clearly specifies that in computing gift taxes payable under Section 2001(b)(2) the increase or decrease in rates shall be taken into account in computing gift taxes payable. This is because a change of rates will cause an increase or decrease in the exemption amount. Hence, by analogy, the increase or decrease of the exemption amount should also be taken into account. And, nowhere does the law provide for the use of an exclusion amount different than the one in existence at the time of the gift.

Additionally, any clawback is inconsistent with the Treasury's very own temporary portability regulations. The regulations specifically provide that any ported exemption is not decreased by any amount on which gift taxes were paid. These regulations make crystal clear that a surviving spouse will have complete use of both exclusion amounts, even if the first spouse paid gift tax because the exclusion amount at the time of the gift was lower than the applicable exclusion on the first spouse's death.

Further, nowhere in the history of estate and gift taxation, has a taxpayer ever been subject to double taxation. While Section 2001(b)(2) prevents taxpayers from receiving a refund in a situation where gift taxes were paid at a higher rate, it never intended that the same gift be taxed twice. Double taxation is also inconsistent with public policy and fairness in administering taxation. Thus, regulations should clarify that double taxation will not occur on any prior taxable gifts.

B. Last, but not least, regulations need to be issued clarifying that any gifts made reduce the exemption from the top down. This is for all of the reasons cited above, including current statutes, the portability regulations and public policy. One more additional reason remains and that is mathematical. In subtracting 2 from 12 we say there are 10 remaining, not that only two have been used. In other words, we subtract from the top down and we add from the bottom up. This would mean that if a taxpayer has $10 million of exemption remaining and makes a $5 million gift, there is still $ 5 million remaining. Hence, if the exemption decreases to $5 million or less after making gifts utilizing the lifetime exemption, the current decreased exemption amount should remain for future gifts or bequests on death.

VII. CONCLUSION

While none of the above issues will ever come to fruition if the sunset does not occur, and if the exemption amount does not fluctuate, history repeats itself, however, an increase or decrease in the exemption could very likely occur. The authors also recognize the current work load burden present at Treasury and IRS and the fact that resources are scarce to issue regulations quickly. Clarification however would provide needed guidance ahead of time for taxpayers and practitioners alike in the planning process to provide uniformity in application of the necessary calculations the remaining exclusion amount. While the authors frequently focused on enacting regulations to address the various and relevant issues, revisions to the Form 706 and/or its instructions and worksheets, may adequately address the issues. Obviously, legislative revisions would also assist.