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Clawback Under the New Tax Law: Part 2

Legislative history indicates there should be none.

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In Part 1 of this article , I introduced the potential for lifetime gift "clawback" under the new tax law should the sunset clause, which is currently part of the law, become effective in the year 2026. I mentioned that even though the new Internal Revenue Code Section 2001(g)(2), together with the accompanying Conference Committee Report, indicates that the Secretary is to issue regulations addressing the potential

disparity between the estate tax exemption in effect at the death of the decedent and the lifetime gift exemption in effect at the time gifts are made by the decedent, to carry out the purposes of IRC Section 2001, neither new Section 2001(g)(2) nor the Conference Report provides any indication of exactly what these "purposes" are. The purpose of this article is to examine further all aspects of this question, because the answers could have huge consequences.

Purposes of Section 2001

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Although the Conference Report doesn't elaborate on the purposes of Section 2001, one rather obvious purpose is to only tax the decedent's taxable estate and not tax lifetime donative transfers by the decedent. This conclusion draws from the fact that the first sentence of Section 2001(a) provides that: "[a] tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." For an asset to comprise a portion of a decedent's "taxable estate," IRC Section 2051 provides that it must first comprise a portion of his gross estate, and lifetime gifts generally aren't included as part of the decedent's gross estate.

The fact that Section 2001(b) refers to "adjusted taxable gifts" of the decedent during his lifetime has no relevance on this issue. Adding back adjusted taxable gifts to determine the tentative tax on the decedent's estate, and then reducing this amount by the gift tax that would have been owing on the adjusted taxable gifts had the rates in effect at the time of the decedent's death been in effect at the time of the gifts, serves merely to determine the tax rates imposed on the decedent's taxable estate. The Section doesn't actually tax lifetime gifts.

If the higher gift tax exemption amount in effect at the time of the lifetime donative transfers by the decedent, as opposed to the lower exemption amount in effect at the time of the decedent's death, is used in the Section 2001(b)(2) offset computation, then the lifetime donative transfers are effectively being taxed under Section 2001. Using the higher gift tax exemption amount in effect at the time of the lifetime

donative transfers therefore wouldn't carry out the purpose of Section 2001 to only tax assets comprising a portion of the decedent's "taxable estate" and not lifetime gifts by the decedent.

If, under this limited Congressional grant of authority, the Internal Revenue Service nevertheless issues regulations that use the exemption amount in effect at the time of the gift for purposes of determining the Section 2001(b)(2) offset amount, the problem is that significant estate taxes attributable to a gift in excess of $5.5 million could result—an "excess" gift that the donor may have reasonably assumed would be grandfathered despite the sunset clause. If, on the other hand, the IRS opts merely to use the gift tax exemption in effect at the time of the donor's death for Section 2001(b)(2) offset purposes, lifetime gifts in excess of $5.5 million will yield an estate tax benefit, while lifetime gifts of $5.5 million or less won't, which seems inequitable. Of course, who ever said the tax law is fair?

Possible Challenges

The above two examples illustrate why Congress most likely chose to direct the Secretary to issue "appropriate and necessary" regulations to carry out Section 2001, rather than attempt to grapple the competing issues itself. Although we can't predict with certainty exactly how the IRS will eventually handle the clawback situation, we do know that, should the IRS' regulations not recognize the above-outlined purpose of Section 2001, the regulations would be subject to multiple challenges for overreaching.

What this all means is that, if sunset does in fact occur in 2026, there could be a huge advantage to making lifetime gifts in excess of $5.5 million before this date (or potentially even an earlier date if the gift tax exemption amount were to change again before 2026), since in all likelihood, any regulation that doesn't give dollar-for-dollar credit for the excess gift amount would be viewed as exceeding the IRS' Congressional grant of authority.

Even in a worst case scenario, all post-gift appreciation attributable to the excess gift amount would still be removed from the decedent's estate. There may be an additional tax benefit to the large gift for individuals residing in states that impose an estate or inheritance tax, but which don't effectively impose a tax on lifetime transfers.

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