Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2689

Date:17-Dec-18

Subject: Austin Bramwell - Treasury Squashes the Reverse Clawback Bug

"Some have warned that estates of decedents who had paid gift tax during lifetime could effectively have to pay tax on those same gifts a second time at death. According to this theory, known as 'reverse clawback,' if a decedent made gifts that exceeded the then-available lifetime gift tax exclusion and paid gift tax, and died in a year when the exclusion amount had increased, the increased exclusion amount would be used to determine the amount of gift taxes payable for estate tax computation purposes. As a result, the gift taxes payable would be reduced to zero (or a much smaller non-zero amount), yet the gifts would still be added to the estate tax base. Estate tax would then effectively be imposed on the gifts, even though the decedent had already paid gift tax.

*Few, if any, practitioners appear to have taken the threat of reverse clawback seriously. As discussed in detail in **LISI** Estate Planning Newsletter #2155 (October 28, 2013), the theory not only was contrary to language of Code but, to adopt it, the IRS would need to disavow its own decades-old guidance on the estate tax computation procedures. Reverse clawback also would have arbitrarily punished taxpayers who had paid gift taxes during lifetime. Not surprisingly, the IRS showed no interest in pursuing it.*

Fortunately, Treasury and the IRS have now put all doubts to rest, if there ever were any. As correctly explained in the preamble to the recently proposed anti-clawback regulations, the equivalent of a credit for gift taxes payable will be allowed, notwithstanding later increases in the exclusion amount. The theory of reverse clawback, unleashed into the gracious drawing rooms of estate planning like a harmless but ugly silverfish bug, has been squashed."

Austin Bramwell provides members with his analysis of the "clawback" regulations that were released on November 21st.

Austin Bramwell is a partner in the trusts and estates department of **Milbank, Tweed, Hadley & McCloy LLP**, an **Adjunct Professor of Law at New York University School of Law**, a fellow of the **American College of Trusts & Estates Counsel**, and a former **Senior Advisor in the Treasury Department's Office of Tax Policy**. He has written previously for **LISI**. The views expressed herein are his own.

Here is his commentary:

EXECUTIVE SUMMARY:

Some have warned that estates of decedents who had paid gift tax during lifetime could effectively have to pay tax on those same gifts a second time at death. According to this theory, known as "reverse clawback," if a decedent made gifts that exceeded the then-available lifetime gift tax exclusion and paid gift tax, and died in a year when the exclusion amount had increased, the increased exclusion amount would be used to determine the amount of gift taxes payable for estate tax computation purposes. As a result, the gift taxes payable would be reduced to zero (or a much smaller non-zero amount), yet the gifts would still be added to the estate tax base. Estate tax would then effectively be imposed on the gifts, even though the decedent had already paid gift tax.

Few, if any, practitioners appear to have taken the threat of reverse clawback seriously. As discussed in detail in **LISI** Estate Planning Newsletter #2155 (October 28, 2013), the theory not only was contrary to language of Code but, to adopt it, the IRS would need to disavow its own decades-old guidance on the estate tax computation procedures. Reverse clawback also would have arbitrarily punished taxpayers who had paid gift taxes during lifetime. Not surprisingly, the IRS showed no interest in pursuing it.

Fortunately, Treasury and the IRS have now put all doubts to rest, if there ever were any. As correctly explained in the preamble to the recently proposed anti-clawback regulations, the equivalent of a credit for gift taxes payable will be allowed, notwithstanding later increases in the exclusion amount. The theory of reverse clawback, unleashed into the gracious drawing rooms of estate planning like a harmless but ugly silverfish bug, has been squashed.

FACTS:

As expected, Treasury and the IRS have proposed regulations that would foreclose the possibility that estates of taxpayers dying after 2025 who used up the temporarily increased gift and estate tax exclusion amount available before 2026 would effectively have to pay an estate tax on gifts that used up the increased amount. The technical risk, known as "clawback," was that, in computing estate taxes under the procedures set forth in section 2001(b), the estate would be denied the section 2001(b)(2) credit-equivalent for gifts that had been sheltered against tax by the temporarily increased exclusion amount. The proposed regulations elegantly eliminate this risk by adding the exclusion amount used up prior to 2026 to the basic exclusion amount available at death under section 2010. The decedent's gifts would still be added to the estate tax computation base (either as gifts pulled back into the gross estate at death or as "adjusted taxable gifts" defined in section 2001), but, under the proposed regulations, there would be an offsetting credit under section 2010, with the result that the extra exclusion amount available through 2025 would still effectively shield those gifts from tax.

In the preamble to the proposed regulations, Treasury and the IRS have also foreclosed any risk of reverse clawback. Explaining why recent increases in the exclusion amount would not have the effect of double-taxing gifts made in earlier years when the exclusion amount was less, Treasury and the IRS stated the issue as follows:

> The concern raised is whether the estate tax computation will apply the increased BEA to the pre-2018 gifts, thus reducing the BEA otherwise available against the estate tax during the increased BEA period and, in effect, allocating credit to a gift on which gift tax in fact was paid.

Although Treasury and IRS do not use the term "reverse clawback" (or "clawback," for that matter) it is clear that they are concerned here with the theory of reverse clawback.

LISI Estate Planning Newsletter #2155 (October 28, 2013) describes the theory of reverse clawback in detail. Here, it is sufficient to say that Treasury and the IRS have now correctly concluded that, if gift taxes were owed on gifts made in a year when the exclusion amount was less, the

donor's estate will get the equivalent of a credit for the gift taxes payable, notwithstanding that the donor dies in a year when those same gifts would have been shielded by the exclusion amount. As the preamble explains:

> [S]ection 2001(b)(2) and (g) require the determination of a hypothetical gift tax (a gift tax reduced, but not to below zero, by the credit amounts allowable in the years of the gifts) on all post-1976 taxable gifts, whether or not included in the gross estate. The credit amount allowable for each year during which a gift was made is the tentative tax, computed using the tax rates in effect at the decedent's death, *on the AEA for that year*, but not exceeding the tentative tax on the gifts made during that year. Section 2505(c). The AEA is the sum of the BEA as in effect *for the year in which the gift was made*, any DSUE amount as of the date of the gift as computed pursuant to § 25.2505-2, and any restored exclusion amount as of the date of the gift as computed pursuant to Notice 2017-15. This hypothetical gift tax is referred to as the gift tax payable (Step 2).
>
> [S]ection 2001(b) requires the gift tax payable determined in Step 2 to be subtracted from the tentative tax determined in Step 1 to arrive at the net tentative estate tax (Step 3). . . .

In other words, by the underlined language (not highlighted in the original), to compute the credit-equivalent for gift taxes payable, an estate uses the exclusion amount available at the time of the gift, rather than any increased exclusion amount available at death.

The preamble later makes this conclusion explicit when it states that the "only time that the increased BEA enters into the computation of the estate tax is when the credit on the amount of BEA allowable in the year of the decedent's death is netted against the tentative estate tax, which in turn already has been reduced by the hypothetical gift tax on the full amount of all post-1976 taxable gifts . . . ." The increased exclusion amount, in other words, is only used to compute the estate tax that remains when the section 2010 unified credit is subtracted. It is not used to compute the amount to be subtracted under section 2001(b)(2) as gift taxes payable on post-1976 taxable gifts.[i]

In short, gifts will not be double-taxed at death just because gift taxes were paid when the exclusion amount was less. The *coup de grâce* comes when Treasury and the IRS state that no regulations or further guidance

are needed to correct the perceived reverse clawback problem. The law, they say, already prohibits a reverse clawback computation.

COMMENT:

Ironically, if Treasury and the IRS had wanted to embrace reverse clawback, the Tax Cuts and Jobs Act actually give them a chance to do so. Section 2001(g)(2), which was added by the Act, requires Treasury to issue regulations on the computation of estate tax when there is a difference between the exclusion amount available at the time of a decedent's gifts and at the time of death. The regulatory mandate is broad enough to allow Treasury and the IRS, by regulation, to require gift taxes payable to be computed using the higher exclusion amount available at death, so that no credit-equivalent for gift taxes payable would be allowed. While reverse clawback previously had no chance of becoming law, it might in theory have been adopted by regulation under section 2001(g)(2). Yet Treasury and the IRS wisely chose not to do so.

Those who warned of reverse clawback no doubt sincerely believed that it should be feared. In the end, however, it was not the savage beast that the reverse clawback theorists imagined. It was, rather, a harmless pest, seldom noticed and now properly squashed.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell

CITE AS:

LISI Estate Planning Newsletter #2689 (December 17, 2018, 2018) http://www.leimbergservices.com Copyright 2018 Leimberg

Information Services, Inc. (LISI). Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Permission.

CITES:

Tax Cuts and Jobs Act, Pub. L. No. 115-97, 12/22/17; REG-106706-18; IRC §§ 2001, 2010, 2505.

CITATIONS:

---

[i] The Treasury and IRS explanation of the estate tax computation procedures is somewhat muddled at times. For example, the preamble states that “the full amount of the gift tax liability on the pre-2018 gifts is removed from the estate tax computation, regardless of whether that liability was sheltered from gift tax by the BEA and/or was satisfied by a gift tax payment.” The word choice “removed from” in that sentence is confusing; what is apparently meant is “subtracted in.” Further, if a liability was “sheltered from gift tax” by the exclusion amount, as the sentence posits, it would not be a liability that could be subtracted in the computation of estate taxes. The preamble also concludes its reverse clawback discussion by stating that “the increased BEA is not reduced by the portion of any prior gift on which gift tax was paid, and the full amount of the increased BEA is available to compute the credit against the estate tax.” That sentence is loosely true, though, technically, there was never any danger of the exclusion amount actually being reduced. Lifetime gifts do not reduce the applicable credit amount available under section 2010. The technical issue, rather, is whether the equivalent of a credit for “gift taxes payable” would be denied under section 2001(b)(2) as a result of later increases in the applicable credit amount, even though the gifts generating tax are added to the estate tax computation base under section 2001(b)(1).