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May 17, 2022 - IRS Looks to Limit Estate Tax Break For Large Gifts in Tweak to Anti-Clawback Regulations

By: William A. Morgan

The Treasury Department issued proposed regulations[1] on Tuesday, April 26, 2022 in follow up to the anti-clawback regulations published on November 26, 2019. The 2019 anti-clawback regulations were in response to the Tax Cuts and Jobs Act (TCJA) increase of the federal estate tax exemption from $5.45 million to $11.4 million for 2019, which is currently $12.06 million in 2022, but drops back to an inflation-adjusted $5 million on January 1, 2026.

First, some background context. What happens to gifts over $5 million made between January 1, 2018, the effective date for the TCJA, and January 1, 2026, when the higher exemption automatically goes away? The formula used in calculating estate tax takes into account a decedent's lifetime gifts. Therefore, under the formula, there was concern that gifts made with the larger exemption could be 'brought back' into the taxpayer's estate and become subject to estate tax at death. This was referred to as the 'clawback,' meaning that what Congress provided in 2019, it might take back in 2026.

The 2019 anti-clawback regulations adopted a special rule in these cases where the gift and estate tax exemption amount was larger at the time of the gift than at the donor's later date of death. This special rule allows the taxpayer's estate to compute its estate tax credit using the higher exemption amount in force for gifts made during life or the date of death exemption amount. This ability to use the higher exemption amount in force when the gift was made stopped the clawback potential.

Fast forward to 2022. The new proposed rules seek to clarify whether gifts made during life but treated as testamentary transfers should receive the benefit of this 2019 anti-clawback special rule. Essentially, the new rules are designed to cover gifts where the donor has reserved a way of accessing the funds directly in the future. The rules thus target gifts with strings attached that allow continued access and that cause estate tax inclusion based on that access. Examples of these 'gifts with strings' include Grantor Retained Annuity Trusts (GRATs), Qualified Personal Residence Trusts (QPRTs), and Grantor Retained Income Trusts (GRITs) of artwork. The rules would **NOT** affect most Spousal Lifetime Access Trusts (SLATs), Irrevocable Life Insurance Trusts (ILITs), Charitable Remainder Trusts, Marital Trusts, Special Needs Trusts, and Credit Shelter Trusts (also known as Bypass Trusts).

Under the new proposed rules, the 2019 anti-clawback special rule would generally not apply to transfers that are includible in gross estates. However, the special rule will continue to apply to transfers includible in gross estates when the value of the taxable portion of the transfer was no more than 5% of the transfer's total value.

Gifts treated as testamentary transfers and includible in gross estates are:

- Gifts within three (3) years of death (IRC § 2035);
- Transfers with a retained life estate (IRC § 2036);
- Certain transfers at transferor's death (IRC § 2037);
- Revocable transfers (IRC § 2038);
- Certain life insurance proceeds (IRC § 2042);
- Gifts made by enforceable promise to the extent they remain unsatisfied as of the date of death;
- Gifts of 'freeze partnerships' (IRC § 2701);
- Grantor retained interest trusts such as GRATs, GRUTs, GRITs, and QPRTs (IRC § 2702); and transfers within 18 months from date of death that would have been completed as described in the preceding bullet points.

To use an IRS example, suppose that in 2021 when the exemption was $11.7 million, Joe transferred $8 million to a 10-year GRAT, with the taxable portion of the transfer valued at $1 million. The whole GRAT trust corpus is includible in Joe's estate under Treas. Reg. §20.2036-1(c)(2) if he dies before it terminates. Because the value of the taxable portion of the transfer exceeded five percent (5%) of the total transferred value on the date of the gift, the five percent (5%) de minimis rule does not apply, and the special rule therefore will not apply either. Suppose Joe then dies in 2026, after the exemption has dropped to $6.8 million adjusted for inflation. The credit to use in computing the estate tax is based upon the $6.8 million exemption at the date of death, not the higher value when Joe made the gift.

Using another IRS example, suppose that in 2021 when the exemption was $11.7 million, Joe transferred $7 million to a GRAT, with the taxable portion of the transfer valued at $2 million. Joe outlives the GRAT term but dies in 2026 when the exemption is 6.8

million. Because Joe survived the GRAT term, no part of the GRAT is includible in Joe's estate, and no exception to the special rule applies. Since the amount allowed as a credit in computing the gift tax payable on Joe's $7 million gift exceeds the $6.8 million date of death exemption, the special rule applies, allowing the Joe's estate tax to be calculated on an increased exemption amount of $7 million.

Now is a good time to review previous large gifts made since 2018 and to strategize future gifts to obtain the maximum results for your family.

Please contact your Murtha Cullina estate planning attorney to discuss the impact of these developments on your estate plan in more detail.

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[1] REG-118913-21, RIN 1545-BQ22

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