CLAWBACK RULE
SECTION 2001(b)(2), IRC of 1986
As modified by
The Tax Cuts and Jobs Act of 2017
by

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On Dec. 22, 2017, the Tax Cuts and Jobs Act (the Act) was signed into law. Under the Act, the exclusion for both federal gift and estate taxes (the o-called federal exemption amount) has been doubled from approximately $5.5 million per person to $11,180,000 million per person, indexed for inflation. For 2018, the exemption available to each individual under the new indexing is $11,180,000, allowing a married couple to transfer up to $22,360,000 free of the federal gift and estate tax.

Under the new law, the federal estate, gift, and GST tax rate remains at 40 percent. However, the increase exclusion is designed to end or “sunset” on January 1, 2026 and will revert back to approximately $5.5 million, indexed for inflation.

CLAWBACK RULE

Since the gift tax exclusion will be reduced if the sunset provision remains, the specter of the "Clawback Rule" is again raised when the estate tax calculation is made under section 2001(b). (Hereinafter all code sections refer to the Internal Revenue Code).

§2001(b)(1)(B) requires (and has always required) that adjusted taxable gifts be brought back into a decedent's estate as part of the estate tax calculation (this add-back of the lifetime adjusted taxable gifts has been referred to as the "Clawback Rule").

The second part of the Clawback Rule, found in §2001(b)(2) is the source of the confusion. The issue of the so-called "Clawback Rule" has again become a major discussion point among estate planners.

Section 2001(b) provides:

"(b) Computation of tax. The tax imposed by this section shall be the amount equal to the excess (if any) of—

(1) a tentative tax computed under subsection (c) on the sum of—

(A) the amount of the taxable estate, and

(B) the amount of the adjusted taxable gift, over

(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the modifications described in subsection (g) [2001(g)] had been applicable at the time of such gifts.

For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts(within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent."

History

Remember since 1977 we have had a unified rate system for the estate tax and gift tax. As part of this regime, section 2001(b)(1)(B) has always required that the adjusted taxable gift be added to the taxable estate to compute the "tentative tax" for estate tax purposes.

The current source of controversy arises from section 2001(b)(2). Section 2001(b)(2) provides that the tentative tax computed for estate tax purposes on the combined taxable estate and adjusted taxable gifts is reduced by <u>"the aggregate amount of the tax which would have been payable under chapter 12 [gift tax] with respect to gifts made by the decedent after December 31, 1976…"</u>

The issue is how to compute under section 2001(b)(2) the "aggregate amount" which would have been payable as a gift tax. The amount of the deduction will clearly impact the final estate tax that will be paid.

How does the calculation under section 2001(b)(2) to determine the aggregate amount of gift tax affect your 2018-2025 gifting strategies?

Today I will focus on section 2001(b)(2) and its ultimate impact on estate tax computation. I will try to make my discussion understandable through the use of a few hypotheticals. Remember numbers can be your friends in illustrating provisions of the Internal Revenue Code.

1. The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 was enacted into law on December 17, 2010. (Hereinafter TRA).

Prior to TRA, section 2001(b)(2) provided:
"(b)(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, <u>if the provisions of subsection (c) (as in effect at the decedent's death) had been applicable at the time of such gifts</u>." [Emphasis added].

2. After TRA, section 2001(b)(2) provided:

"(b)(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, <u>if the modifications described in subsection (g) had been applicable at the time of such gifts</u>." [Emphasis added].

Modifications to gift tax payable to reflect different tax rates. For purposes of applying subsection (b)(2) with respect to 1 or more gifts, <u>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--</u>

(1) the tax imposed by chapter 12 with respect to such gifts, and

(2) the credit allowed against such tax under section 2505, including in computing--

(A) the applicable credit amount under section 2505(a)(1), and

(B) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2)." [Emphasis added].

Tax Cuts and Jobs Act (the Act)

On Dec. 22, 2017, the Tax Cuts and Jobs Act (the Act) was signed into law. The Act added new subsection 2001(g)(2)

NEWLY ADDED:

“(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.”

QUESTIONS

What is this new subsection intended to do? Will the IRS have the authority to require that the "aggregate amount" to be subtracted under section 2001(b)(2) be calculated using the exclusion at the date of the gift rather than the exclusion at the date of the decedent's death? Why will this possible make a difference?

This issue only becomes important if the gift tax exclusion at the time of the gift differs from the gift tax exclusion at death.

EXAMPLE 1

Belle E. Up owned assets with a fair market value of $10,000,000. In 2015, she made a gift of $5,000,000 when the gift tax rate was 40% and the gift tax applicable credit amount was $5,000,000. Belle dies in 2017. She has a taxable estate of $5,000,000. In 2017, the maximum estate tax rate is 40% and the unified credit amount is $5,000,000.

ANSWER TO EXAMPLE 1

In this example, the exclusion at the time of the gift and at death are the same ($5,000,000).

(b) Computation of tax. The tax imposed by this section shall be the amount equal to the excess (if any) of—

(1) a tentative tax computed under subsection (c) on the sum of—

(A) the amount of the taxable estate, and

(B) the amount of the adjusted taxable gifts, over

(2) the aggregate amount of respect to gifts made by the decedent after December 31, 1976, if the modifications described in subsection (g) [2001(g)] had been applicable at the time of such gifts.

Taxable estate ($5,000,000) plus adjusted taxable gifts ($5,000,000) = $10,000,000; Tentative tax on $10 million = $345,800 + (40% x $9,000,000 = $3,600,000) = $3,945,800.

Calculate and subtract the "aggregate amount" under section 2001(b)(2). Under the TRA of 2010 use the exclusion at death ($5,000,000). The adjusted taxable gift ($5,000,000) at the tax rate at death = [$345,800 + 40% x $4,000,000 = 1,945,800] - $1,945,800 (credit at date of death) = 0 The "aggregate amount" would be $0.

Assume that the law required the exclusion at the time of the gift ($5,000,000). The calculation of the "aggregate amount" would still be the same, i.e. $0.

Estate Tax = $3,945,800 (tentative tax) - $0 (section 2001(b)(2) gift tax adjustment) - $1,945,800 (unified credit amount on $5,000,000) = <u>$2,000,000</u>.

EXAMPLE 2

The facts are the same except the gift tax exclusion in 2015 was $5,000,000 and was $3,000,000 in 2017. Under the TRA of 2010, section 2001(g) makes gift tax adjustments based on exclusion at <u>date of death.</u>

ANSWER TO EXAMPLE 2

Taxable estate ($5,000,000) plus adjusted taxable gifts ($5,000,000) = $10,000,000; Tentative tax on $10 million = $345,800 + (40% x $9,000,000 = $3,600,000) = $3,945,800.

Calculate and subtract the "aggregate amount" under section 2001(b)(2) using the gift tax exclusion at death ($3,000,000). The adjusted taxable gift ($5,000,000) at the tax rate at death = [$345,800 + 40% x $4,000,000 = 1,945,800] - (credit [exclusion amount $3,000,000] at date of death = 345,800 + 40% of $2,000,000= 1,145,800) = 800,000. Therefore under section 2001(b)(2) the "aggregate amount" would be $800,000.

Estate Tax = $3,945,800 (tentative tax) - $800,000 (section 2001(b)(2) gift tax adjustment) - $1,145,800 (unified credit amount on $3,000,000) = $2,000,000.

EXAMPLE 3

The facts are the same except the gift tax exclusion in 2015 was $5,000,000 and was $3,000,000 in 2017. Section 2001(g)(20 allows the IRS to make gift tax adjustments based on exclusion at date of the gift.

ANSWER TO EXAMPLE 3

Taxable estate ($5,000,000) plus adjusted taxable gifts ($5,000,000) = $10,000,000; Tentative tax on $10 million = $345,800 + (40% x $9,000,000 = $3,600,000) = $3,945,800.

Calculate and subtract the "aggregate amount" under section 2001(b)(2) using the gift tax exclusion at the date of the gift ($5,000,000). The adjusted taxable gift ($5,000,000) at the tax rate at death = [$345,800 + 40% x $4,000,000 = 1,945,800] - (credit [exclusion amount $5,000,000] at date of the gift = [$345,800 + 40% x $4,000,000 = 1,945,800] - $1,945,800 (credit at date of the gift) = 0
Therefore under section 2001(b)(2) the "aggregate amount" would be $0.

Estate Tax = $3,945,800 (tentative tax) - $0 (section 2001(b)(2) gift tax adjustment) - $1,145,800 (unified credit amount on $3,000,000) = $2,800,000.

Notice: In this Example 3, the benefit of the $5,000,000 exclusion rate is lost. It is as if the extra $2,000,000 given away during lifetime is added to the estate tax and taxed at 40%.

In other words, if Belle had died with a taxable estate of $10,000,000, her tentative estate tax (no gifts) would be $3,945,800. Her unified credit would be $1,145,800 and her estate tax would be $2,800,000.

The issue is, when lifetimes gifts were made and the gift exclusion amount at the time of the gifts exceeded the gift tax exclusion at death, which exclusion amount should be used to compute the aggregate gift tax to be subtracted under section 2001(b)(2).

Should the IRS use new section 2001(g)(2) to argue that the gift exclusion to be used in calaulating the "aggregate amount" will be the gift tax exclusion at the time of the gift?

In my opinion, the IRS should not take this position based on the purpose of the section 2001(b)(1) and (2) system.

The IRS should be compelled to use <u>the basic exclusion amount in effect the time of the decedent's death</u> for purpose of computing the offset under Section 2001(b)(2).

The purpose of section 2001 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.

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

Mr. James Blasé in an article entitled, Clawback Under the New Tax Law: Part 2, published on January 26, 2018, in WealthManagement.com stated:

“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.

Blase, continued:

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?"

EXAMPLE 4

Belle E. Up owned assets with a fair market value of $16,500,000. In 2019, she made a gift of $11,000,000 when the gift tax rate was 40% and the gift tax applicable credit amount was $11,000,000. Belle dies in 2026. She has a taxable estate of $5,500,000. In 2026, the maximum estate tax rate is 40% and the unified credit amount is $5,500,000.

ANSWER TO EXAMPLE 4

Taxable estate ($5,500,000) plus adjusted taxable gifts ($11,000,000) = $16,500,000; Tentative tax on $16.5 million = $345,800 + (40% x $15,500,000 = $6,200,000) = $6,545,800.

Calculate and subtract the "aggregate amount" under section 2001(b)(2) using the gift tax exclusion at death ($5,500,000). The adjusted taxable gift ($11,000,000) at the tax rate at death = [$345,800 + 40% x $10,000,000 = 4,345,800] - (credit [exclusion amount $5,500,000] at date of death = 345,800 + 40% of $4,500,000= 2,145,800) = 2,200,000. Therefore under section 2001(b)(2) the "aggregate amount" would be $2,200,000.

Estate Tax = $6,545,800 (tentative tax) - $2,200,000 (section 2001(b)(2) gift tax adjustment) - $2,145,800 (unified credit amount on $5,500,000) = $2,200,000.

EXAMPLE 5

Belle E. Up owned assets with a fair market value of $16,500,000. She did not make any lifetime gifts. Belle dies in 2026. She has a taxable estate of $16,500,000. In 2026, the maximum estate tax rate is 40% and the unified credit amount is $5,500,000.

ANSWER TO EXAMPLE 5

Taxable estate = $16,500,000; Tentative tax on $16.5 million = $345,800 + (40% x $15,500,000 = $6,200,000) = $6,545,800.

Estate Tax = $6,545,800 (tentative tax) - $0 (section 2001(b)(2) gift tax adjustment) - $2,145,800 (unified credit amount on $5,500,000) = $4,400,000.