Proposed Estate Tax Rules Would Protect Against Decrease in Estate Tax Exemption

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
May 2022
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
Used with permission from the Law Professor Blog Network

Overview

The Treasury has proposed regulations that would prevent certain decedents' estate from being subject to federal estate tax if the federal estate and gift tax applicable exclusion amount drops to $5 million (adjusted for inflation) for deaths after 2025 as it is set to do so under current law. The Tax Cuts and Jobs Act enacted in late 2017 set the applicable exclusion amount at $10 million for deaths occurring and taxable gifts made after 2017 (adjusted for inflation). *I.R.C. §2010(c)(3).* The amount, for 2022, is $12.06 million per person/estate.

A proposed estate/gift tax regulation on the applicable exclusion amount – it's the topic of today's post.

Background

Historical. Estate and gift taxes were unified into a single system in 1976 and remained unified through 2003. The systems are re-unified for transfers occurring after 2010. Under this unified system, gift taxes are calculated based on accumulated taxable gifts made by an individual during life. Estate taxes are calculated on the decedent's taxable estate at death, reduced by gift taxes paid on post-1976 taxable gifts (except for gift taxes paid within three years of death). A "unified" estate and gift tax credit is available to offset estate tax liability and is a function of the amount of applicable exclusion available at death. In other words, the credit will be an amount that offsets the tax liability to the extent of the applicable exclusion available to the decedent's estate at death.

Computation of federal estate tax. A decedent's taxable estate is determined by subtracting from the decedent's gross estate (adjusted for gifts and gift tax within three years of death except for amounts covered by the federal gift tax annual exclusion), costs of estate administration, allowable losses, the marital deduction, and charitable deduction. Taxable gifts after 1976 (those not covered by the federal gift tax annual exclusion, marital deduction or charitable deduction) are included in the taxable estate for purposes of determining the amount of prior use of the unified credit and the point to begin figuring federal estate tax on the graduated tax schedule.

Potential problem. Based on this manner of calculating a decedent's taxable estate, a question arises if the applicable exclusion amount that applies at the time of a decedent's death is different from the amount that applied with respect to any post-1976 taxable gifts made by the decedent during life. For example, assume a donor made a large taxable gift in 2020 what was completely offset by the unified credit. If the donor died in 2026 (under current law) when the applicable exclusion amount is lower, would those prior gifts now be deemed to be taxable gifts that are pulled back into the estate for estate tax purposes? In other words, would those prior taxable gifts be "clawed back" and treated as includible in the decedent's estate under I.R.C. §2001(b)?

2019 final regulations. In 2019, final regulations were issued specifying that gifts made at a time when the applicable exclusion exceeded the amount of the exclusion at death would *not* be pulled back into the estate at death. *84 Fed. Reg. 64995 (Nov. 26, 2019) creating Treas. Reg. §20.2010-1(c).* The regulations addressed the situation of persons that make lifetime gifts after 2017 and before 2025. The basic idea of the final regulations is that a donor's estate is not to be taxed on completed gifts that were not subject to gift tax when made because of a higher applicable exclusion amount than applies at the time of death. In other words, if a person makes a $12.06 million gift in 2022 (the full exclusion amount) and dies after 2025, the applicable exclusion amount will be $12.06 million rather than $5 million (adjusted for inflation from 2011 to the year of death).

Note: Specifically, the final regulations specify that the portion of the unified credit allowed in computing estate tax that is attributable to the applicable exclusion amount is the sum of the amounts attributable to the exclusion amount that is allowed as a credit when computing the gift tax payable on gifts the decedent made during life.

If a person makes a lifetime gift that is less than the full applicable exclusion amount for the year of the gift, but the gifted amount exceeds the exclusion amount for the year of death, there is no recapture. Instead, the exclusion for computing estate tax at death will be the amount of the exclusion for the year of death. For example, if an individual makes a $5 million gift in 2022 (when the applicable exclusion amount for estate and gift tax purposes is $12.06 million) and dies after 2025 when, under current law, the exemption will be $5 million (adjusted for inflation from 2011), the individual's estate tax liability will get the benefit of the exclusion as of the date of the gift. In the example, that would be $12.06 million and a taxable gift amount of the difference between the exclusion at the time of the gift and the exclusion as of date of death will not be pulled back into the estate for estate tax purposes.

Note: Under current law, the applicable exclusion amount is a "use it or lose it" concept. It works to the benefit of a person that lives beyond 2025 to the extent gifts made after 2018 and before 2026 exceed the applicable exclusion amount at the time of death.

The final regulations also clarify that the rule allowing the surviving spouse to "port" any unused amount of the applicable exclusion at the first spouse's death (known as the deceased spouse unused exclusion amount (DSUEA) to be added to the surviving spouse's exclusion amount is retained. This means that the applicable exclusion amount for the first spouse to die will increase the exclusion available to the surviving spouse. For instance, assume Mary dies in 2022. The applicable exclusion amount for 2022 is $12.06 million. Assume that her husband, Dave, elects portability. If Dave dies after 2025, his applicable exclusion will be the exclusion amount for the year of death (assume $5 million plus an inflation adjustment) plus the $12.06 million DSUEA from Mary's estate. If Dave were to make taxable gifts, any DSUEA is deemed to be applied to those gifts before his exclusion amount is applied. If Dave dies after 2025, the DSUEA applied to his taxable gifts isn't reduced. The total amount of applicable credit that was used in computing Dave's gift tax based on the DSUEA, plus the credit determined without claw-back would be available for computing estate tax in Dave's estate. *Treas. Reg. §20.2010-1(c).*

The 2019 regulations, however, didn't address the issue of how to treat incomplete gifts such as retained life estates or transfers subject to powers of appointment. These testamentary transfers are also included in the decedent's gross estate at death (as "includable gifts") and could be "clawed-back" into the estate at death if the applicable exclusion amount were lower at that time than it was at the time of the transfer.

Note: The 2019 regulations also didn't address whether the post-2025 reduction in the applicable exclusion amount will impact allocations of the generation-skipping exemption made during 2018-2025.

Proposed Regulations

The proposed regulations remove these "includable gifts" from the estate tax computation. *NPRM Reg-118913-21 (Apr. 26, 2022); 87 Fed. Reg. 24918 (Apr. 27, 2022).* Specifically, the proposed regulation would remove from being clawed back into the decedent's estate, the value of: (1) gifts that were subject to a retained life estate or subject to other powers or interests *(See I.R.C.§§2035-2038 and I.R.C. §2042)*; (2) gifts made by enforceable promise to the extent unsatisfied at death; (3) transfers of certain applicable retained interests in corporations, partnerships or trusts. *(I.R.C. §§2701-2702)*; and (4) transfers that would have been include in (1)-(3) above but for the transfer, relinquishment or elimination of an interest, power or property within 18 months of the decedent's death by the decedent alone or in conjunction with any other person, or by any other person. *Prop. Treas. Reg. §20.2010-1(c)(3*). These transfers are removed from the possibility of claw back to the extent the taxable amount is 5 percent or less of the total amount of the transfer (as of the date of the transfer).

The proposed regulations contain numerous explanatory examples. Example 1, Prop. Treas. Reg. §20.2010-1(c)(3)(iii) is reproduced below and is based on the assumption that "the basic exclusion amount on the date of the gift was $11.4 million, the basic exclusion amount on the date of death is $6.8 million, and both amounts include hypothetical inflation adjustments. The donor's executor does not elect to use the alternate valuation date and, unless otherwise stated, the donor never married and made no other gifts during life."

Example 1:

"Individual A made a completed gift of A's promissory note in the amount of $9 million. The note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because the note is treated as includible in the gross estate and does not qualify for the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section, the exception to the special rule found in paragraph (c)(3) of this section applies to the gift of the note. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d). The result would be the same if A or a person empowered to act on A's behalf had paid the note within the 18 months prior to the date of A's death."

The Proposed Regulations also include examples of gifts to a grantor-retained annuity trust and a grantor retained income trust.

Effective Date

The proposed regulation, once finalized, is applicable to estates of decedent's dying on or after April 27, 2022. The proposed rules are open for comments and requests for a public hearing for the 90-day period beginning April 27, 2022.

Conclusion

The proposed regulation is an important one for larger estates that face potential estate tax liability because of prior taxable gifts. If the applicable exclusion amount does drop after 2025, the IRS position will result in these estates not having an estate tax burden caused by prior tax-free gifts made when the exclusion was higher being pulled back into the estate and taxed at death because of a lower exclusion amount at that time. Certain "includable gifts" may also escape claw back.