ADVANCED PLANNING

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Insights & Ideas

IRS Issues Proposed Regulations Concerning "Claw-back" of Certain Lifetime Gifts

On April 26, 2022, the IRS issued proposed regulations addressing the basic exclusion amount allowable when computing federal estate taxes as applied to certain lifetime gifts. In brief, the proposal would require a donor's estate to use the basic exclusion amount in effect at death instead of the basic exclusion amount in effect in the year of the gift in specific lifetime gift scenarios. The newly proposed regulations would not apply to most completed lifetime gifts but could apply to enforceable promises to make transfers at death, and assets held in a grantor-retained annuity trust (GRAT) or similar trust - in other words, assets that are promised or entrusted as gifts, but still held by or enjoyed by the taxpayer at death.

Background

"Claw-back" is the potential for gifts made during life to be taxed unfavorably at death. As written, the Tax Cuts and Jobs Act of 2017 will reduce the allowable federal basic exclusion amount from $10,000,000 to $5,000,000 in 2026, adjusted for inflation. At the time of its passage, there was uncertainty around the application of the basic exclusion amount towards gifts made before January 1, 2026, when the exclusion amount is at a higher level, if death should then occur after 12/31/25 when the exclusion amount is lower.

Here is an example of what a claw-back would look like:

- Client makes a gift of $12,000,000 today
- At death, the basic exclusion amount is $6,500,000, less than the gift
- Result: $5,500,000 of the gift is taxed in the estate at death

However, final Treasury regulations published in November 2019 prevent most lifetime gifts, like the above example, that exceed the available basic exclusion amount at death from being "clawed back" and taxed as part of the donor's estate. In other words, if the client above made a completed gift this year and died in 2027 for example, when the basic exclusion amount is $5,000,000 (adjusted for inflation), the completed gift would not be subject to the estate tax exemption at death but instead get the full $12,060,000 exemption today. Even after these final regulations were issued, there was still an open question as to certain gifts that because of the nature of the gift may still be includible in the estate of the decedent for federal estate tax purposes.

2022 Proposed Rules

The proposed regulations make clear that transfers where the donor continues to have title, possession, or other retained rights in the transferred property during life will be treated as still owned by the donor upon death, and consequently not eligible to use the basic exclusion amount in effect in the year of the gift as otherwise may be allowed by the 2019 regulations. This would apply even if the decedent's interest were released at any time during the 18 months preceding death, meaning, for example, that a donor who releases their rights to transferred property at any time in 2025 and dies in the first half of 2026, after the Tax Cuts and Jobs Act of 2017 reduces the allowable federal basic exclusion amount,

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would not be able to use the basic exclusion amount from the year they made the gift. The 2022 rule would not apply to transfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer ("de minimis" rule).

Example*

Internal Revenue Code S. 2072 outlines the rules for Grantor Retained Annuity Trusts (GRATs), where assets can be placed in a trust paying the grantor a certain percentage of the assets' fair market value each year for a term of years. What remains in the trust after the term of years passes out of the grantor's estate to a remainder beneficiary or beneficiaries.

Suppose in June 2022 a grantor places $10,000,000 of assets into a GRAT paying the grantor 20% ($2,000,000) of the fair market value of the assets at the time of the transfer each year for five years. Since the discount factor for June 2022 of 3.6% allows the five annuity payments to be valued at only $9,004,600, the grantor has made a gift of $995,400 to the remainder beneficiaries and, if the grantor dies one month into the GRAT term, the assets remaining in it could be exempt from estate tax due to the basic exclusion amount of $12,060,000 available for 2022 decedents. Any assets held under the GRAT after the fifth year and satisfaction of the annuity payments is not subject to federal estate tax on the death of the Grantor.

But if the GRAT grantor dies in 2026, before the end of the GRAT term in 2027, some or all of the GRAT assets will be included in the grantor's estate due to the outstanding retained annuity interest. The new proposed regulations confirm that the basic exclusion amount for 2026 would apply to those assets, not the basic exclusion amount of $12,060,000 available for 2022 decedents. If the remaining GRAT assets have an appreciated value exceeding the 2026 basic exclusion amount, estate tax may be due.

On the other hand, if in the GRAT example above the grantor receives 22.21% ($2,221,087) of the fair market value of the assets at the time of the transfer, the discount factor for June 2022 of 3.6% allows the five annuity payments to be valued at only $9,999,999.96. In this scenario, the grantor has made a gift of just $0.04 to the remainder beneficiaries, qualifying the transfer for the de minimis exception. Because this example qualifies for the de minimis exception, the individuals in this example can use the basic exclusion amount at the time of the original transfer in 2022.

Other situations where the regulations proposed on April 26 would apply include when the donor of a qualified personal residence trust (QPRT) dies before the QPRT term has ended, or a landowner gifts real estate while reserving the right to occupy the gifted property for the rest of their natural life.

Significance

Whatever the outcome of the proposed rule, taxpayers hesitant to take advantage of today's unprecedented basic exclusion amount ($12,060,000 in 2022) need to be aware that they can make completed tax-free gifts today without penalizing their heirs when they die. The proposed regulations would still allow property that is completely separated from a donor's estate at the time of the gift to escape "claw-back" taxation. If the rule is made final, there will still be situations where retained interests are appropriate, but for those clients the risk of dying before their retained interest expires will need to be weighed against the potential cost to their estates.

Prudential's Advanced Planning team is available to help you navigate this potential development and discuss the proposed new rule's application with you. We look forward to being of assistance, and can be reached at 800-800-2738, Option 4.

**For the purposes of the example, it is assumed that the hypothetical estates have no other assets beyond what is being discussed.*

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