Gift and Estate Tax Update: Making Large Gifts Now Should Not Harm Estates After 2025

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The U.S. Treasury Department and the Internal Revenue Service recently issued proposed regulations, addressing a major concern of practitioners and their clients stemming from changes made under the 2017 Tax Cuts and Jobs Act (the ?2017 Tax Act?). The major takeaway is that individuals looking to take advantage of the temporary increased gift and estate tax exclusion amount now by making large gifts between 2018 and 2025 may do so without fear that they will lose the benefit of the increased exclusion amount or otherwise be subjected to double taxation after 2025 when the basic exclusion amount is scheduled to drop to 2017 levels in 2026.

I. A QUICK NOTE ABOUT CALCULATING GIFT AND ESTATE TAX LIABILITY AND THE BASIC EXCLUSION AMOUNT

In general, gift and estate taxes are calculated on taxable transfers of money, property, and other assets. Any resulting tax due is determined after applying a credit, which is based, in part, on an individual?s ?basic exclusion amount.? The credit is applied first against the gift tax, on a cumulative basis, as taxable gifts are made. Then, if any credit remains at the individual?s death, it is applied against any estate tax. Thus, the higher the individual?s basic exclusion amount, the more money, property, and other assets the individual may transfer during life and at death without paying gift or estate taxes.

Under the 2017 Tax Act, an individual?s basic exclusion amount was increased from $5 million to $10 million for tax years 2018 through 2025, as adjusted annually for inflation. For 2018, the inflation-adjusted basic exclusion amount is $11.18 million. This means that a married couple may shelter a combined amount in excess of $22 million worth of assets from gift and estate taxes beginning in 2018.

In 2026, the basic exclusion amount will return to the 2017-level of $5 million, as adjusted for inflation, assuming no changes in the tax law at that time.

II. TREASURY, IRS: AREAS OF CONCERN, BUT ONLY ONE REQUIRES CHANGES IN REGULATIONS

The 2017 Tax Act directed the IRS and Treasury to issue regulations that address this specific issue, because it was a source of concern in 2010 and again in 2012, when we had the possibility of a drop in the basic exclusion amount from $5 million to $1 million.

The preamble to the regulations notes that practitioners and clients have worried about several scenarios that could result in inconsistent tax treatment or double taxation of transfers once the basic exclusion amount returns to the 2017 levels. Treasury and the IRS found that only one such concern warranted changes to the regulations that are currently in place.

The concern arises where an individual makes gifts between 2018 and 2026 that are sheltered from gift tax by the increased basic exclusion amount and then that individual dies in 2026 or thereafter. Without the changes in the proposed regulations, the estate tax calculation rules, applied literally, would impose estate tax on the portion of aggregate gifts made between 2018 through 2025 that was sheltered from gift tax by the increased basic exclusion amount allowable at that time. In this way, the gift taxes sheltered by an individual?s increased basic exclusion amount would be subject to the ?clawback? penalty in the form of an increased estate tax. Here is an example from the preamble of the proposed regulations (using, for simplicity?s sake, numbers unadjusted for inflation):

Suppose that Individual *A* makes a gift of $11 million in 2018, when the basic exclusion amount is $10 million. *A* dies in 2026, when the basic exclusion amount is $5 million, with a taxable estate of $4 million. In applying the estate tax calculation rules, the estate tax would be approximately $3.6 million. This is equal to a 40 percent estate tax on $9 million ($4 million taxable estate + $5 million of the 2018 gift sheltered from gift tax by the increased basic exclusion amount from 2018 through 2025). In short, the statutory requirements for computing the estate tax, in effect, retroactively eliminate the benefit of the individual?s increased basic exclusion amount that was available for gifts made beginning 2018 through 2025. The proposed regulations take the taxpayer friendly position that the estate tax due in this case would be 40 percent of $4 million or $1.6 million.

III. THE FIX UNDER THE PROPOSED REGULATIONS

To guard against any clawback penalty, Treasury and the IRS propose a special rule, in the proposed regulations, that allows the estate of a decedent to compute the estate tax credit using the greater of the individual?s basic exclusion amount applicable to gifts made during life or the individual?s basic exclusion amount applicable on the date of death.

For example, suppose Individual *A* (never married) has made cumulative gifts of $9 million, all of which were sheltered from gift tax by the $10 million basic exclusion amount allowable on the dates of the gifts. *A* dies after 2025, and at *A*?s death, the basic exclusion amount is $5 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on *A*?s gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on *A*?s date of death, then the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million (and not the actual $5 million basic exclusion amount at death). By calculating the estate tax using this $9 million basic exclusion amount, the gift taxes would not be subject to a clawback in the form of an increased estate tax.

CONCLUSION

While these proposed regulations are not final, they are a step in the right direction, leading to an intuitively correct result. That is, making large gifts now should not harm estates after 2025.

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