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Proposed Treasury Regulations Would Prevent the "Claw Back" of Gifts That Take Advantage of the Increased Federal Gift Tax Exemption Amount under the Tax Cuts and Jobs Act

On November 23, 2018, the IRS issued proposed regulations clarifying that a gift made after December 31, 2017 that is sheltered by the increased gift and estate tax exemption amount under the Tax Cuts and Jobs Act (the "Act") would not inflate the donor's gift and estate tax liability after 2025.

Background

Under the Act, for transfers occurring after December 31, 2017, the exemption amount applicable to federal estate and gift tax was increased to $10 million, indexed for inflation. The exemption amount will continue to increase with inflation annually until 2025. For 2019, the exemption amount is $11.4 million. On January 1, 2026, the increased exemption amount is scheduled to sunset and revert to the 2017 levels (as adjusted for inflation).

Proposed Regulations

The Act left open the possibility that a gift taking advantage of the increased exemption amount would be subject to estate tax upon the donor's death – or "clawed back" – if the estate tax exemption applicable at the donor's death were lower than the exemption amount at the time of the gift. The taxpayer-friendly proposed regulations, however, provide that if an individual makes a gift taking advantage of the increased exemption amount between January 1, 2018 and December 31, 2025, the exemption amount used in calculating the federal tax payable on the aggregate of the individual's lifetime gifts and taxable estate will be the greater of (i) the exemption amount at the time of the individual's death and (ii) the portion of the increased exemption amount previously applied to lifetime gifts. This proposed rule prevents the feared claw back of the sheltered gift (made between January 1, 2018 and December 31, 2025) that otherwise would cause increased estate tax. The proposed regulations further take a "use it or lose it" approach – a taxpayer's increased exemption is only preserved beyond 2026 to the extent the taxpayer utilized the increased exemption; any amount of the increased exemption amount that is not used prior to 2026 is lost.

If the proposed regulations are adopted, those who wish to take advantage of the current favorable wealth transfer tax rules may utilize their increased gift tax exemption without the risk that the gift will be clawed back at death.

Open Issues

The proposed regulations leave open a few issues that, presumably, will be addressed after the comment period. These open items include:

- Whether a taxpayer who takes advantage of the increased exemption amount before December 31, 2025 may make additional tax-free gifts after January 1, 2026 to take advantage of inflation increases to the otherwise reduced exemption amount;
- Whether the enhanced exemption amount that a surviving spouse may inherit from his or her deceased spouse (also known as the deceased spousal unused exclusion amount, or "DSUE") between January 1, 2018 and December 31, 2025 will be reduced on January 1, 2026; and
- Whether the federal generation-skipping transfer ("GST") tax exemption amount, which was increased along with the increased federal gift and estate tax exemption amount, may be allocated to gifts made prior to January 1, 2018.

Conclusion

Despite some uncertainty, the proposed regulations are quite favorable. If they can afford to do so, clients should consider making lifetime gifts up to the increased exemption amount prior to January 1, 2026. However, there are many factors in determining whether and to what extent to make a gift, which assets to transfer and how to structure a gift. The enhanced exemption is only one of these factors.

We welcome the opportunity to discuss these issues with you.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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