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## THE ANTI-CLAWBACK REGULATION AND ITS LIMITATIONS

A good estate plan is one that successfully protects an individual's assets from creditors or divorcing spouses, for example. A great estate plan also considers the ever-changing tax laws and regulations surrounding the estate and gift tax basic exclusion amount (BEA) that individuals are eligible to use either during their lifetimes or upon their deaths. In essence, the BEA is a credit against the total value of an individual's estate subject to estate tax, which can be as high as 40%.

For the 2022 tax year, the BEA is \$12,060,000, but it was not always this high. Prior to January 2018, the BEA was \$5 million and in December 2017, as part of the Tax Cuts and Jobs Act (TCJA), the BEA was increased to \$10 million, with an inflation adjustment increase each year thereafter. This increase is set to sunset on January 1, 2026, and the BEA will revert to \$5 million, subject to an inflation adjustment. Because the BEA amount of \$12,060,000 is not permanent and is set to sunset in several years, there has been a steady increase of lifetime gifts made by individuals to take advantage of the current credit.

### THE CLAWBACK

As some individuals contemplated making larger lifetime gifts to take advantage of the increased BEA credit, fears arose about what would happen after the BEA decreased in 2026. Would those individuals who took advantage of the high BEA credit become subject to a "clawback" (i.e., a recapture of estate taxes at time of death) if they died after 2025?

**Example.** To illustrate this concern, let's assume that the current BEA is \$12.06 million, and the taxpayer has current assets worth \$15 million. The taxpayer takes advantage of the current BEA and makes a \$10 million tax-free gift. Then, in 2026, when BEA drops down to \$6.8 million (i.e., \$5 million indexed for inflation), the taxpayer dies. Since the taxpayer died after 2026, the BEA available at her death (\$6.8 million) is less than the BEA she used during her life (\$10 million). A clawback could cause \$3.2 million of her tax-free gift to be reincluded in her estate at death.

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### THE ANTI-CLAWBACK REGULATION

Fortunately, the IRS addressed concerns with a "special rule" in anti-clawback regulation IRC 20.2010-1(c), which provided guidance for individuals, like the taxpayer in the above example, who would make lifetime gifts during the increased exemption amount period but then would pass away after the period lapsed. In short, the anti-clawback regulation permits a decedent's estate to use the credit calculated at the time the gifts were made (e.g., from 2018-2025) in place of a credit based on a lower date-of-death exclusion amount. Therefore, the portion of the credit against the tax attributable to the BEA would be based upon the greater of those two credit amounts at the decedent's death.

### HOW DOES THE ANTI-CLAWBACK REGULATION WORK?

Now, to illustrate how the anti-clawback regulation works, let's see how exactly the taxpayer can take full advantage of the higher BEA even though she died in 2026 when the BEA is lower. Using the same values as above, the BEA is \$12.06 million and the taxpayer has assets worth \$15 million. During her life, the taxpayer gifts away \$10 million and takes advantage of the then current BEA. Then in 2026, when the BEA reverts to \$6.8 million, the taxpayer dies and leaves behind a \$5 million estate. Because the taxpayer still has a left-over credit of \$2.06 million at death, she would only pay estate tax on \$2,940,000 of her \$5 million estate. Alternatively, if the taxpayer died in 2026 without making any prior gifts,

she would die with \$15 million in assets, a BEA of \$6.8 million, and a taxable estate of \$8.2 million.

### LIMITATIONS TO THE ANTI-CLAWBACK REGULATION

This special rule does not apply if the transferor of the gift retains a benefit or control over the property that he/she gifted until his/her death. The IRS addressed this issue in its proposed April 2022 regulation, REG-118913-21, and provided nine guidelines and limitations on gifts that are made during life but have obvious testamentary attributes which should therefore not receive the benefit of the anti-clawback regulation. The below limitations are the ones most commonly encountered by taxpayers:

- 1. Promissory notes unsatisfied as of death**
- 2. Transfers within 18 months from date of death**
- 3. Grantor retained interest trusts**

To explain how the above exclusions apply, let's continue to assume the BEA is \$12.06 million at the time gifts are made and the BEA at death is \$6.8 million.

In reference to No. 1 above, let's assume the taxpayer gives a promissory note to her son in the amount of \$9 million. In 2026, the taxpayer dies, and the note is still unpaid at her death. According to the proposed limitation, the unpaid note of \$9 million is treated as includible in the taxpayer's gross estate and not includible in her adjustable taxable gifts,

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*This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.*

even though she promised it to her son but did not relinquish her rights to this asset prior to her death. The credit that is used for purposes of computing the taxpayer's estate tax is based on the \$6.8 million BEA as of the taxpayer's death, instead of the \$12.06 million that was available to the taxpayer when the note was issued. The IRS limits the taxpayer's access to the \$12.06 million BEA here because the taxpayer still had legal ownership of the funds under the promissory note at her death and did not release ownership over the \$9 million during her life.

In reference to No. 2 above, the IRS further limits the anti-clawback regulation by making the taxpayer's promissory note includible in her estate if she made the \$9 million transfer within 18 months of the taxpayer's date of death.

The above example shows that using a promissory note is not an effective way to take advantage of the increased BEA. To use the increased exclusion amount payment must physically occur on the note, and such payment must occur 18 months prior to the taxpayer's death.

Lastly, in reference to No. 3 above, let's assume the taxpayer transferred \$9 million to a grantor retained annuity

trust (GRAT) for a term of three years and each year the taxpayer would receive an annuity payment of \$450,000. Upon termination of the GRAT, the taxpayer's son, the "beneficiary" of the trust, would receive the amount left in the GRAT free of estate tax. Unfortunately, in this example, the taxpayer dies before the GRAT term expires. In such a situation, the taxpayer did not make a completed gift by placing the \$9 million into the GRAT because she still retained control of it at her death. However, since the taxpayer died before the GRAT could terminate the question is what part of the GRAT assets are included in the taxpayer's estate and under what BEA threshold? The IRS proposed limitations state that the entire \$9 million of the GRAT is includible in the taxpayer's gross estate, including the \$450,000 annuity payments, and it would be subject to the \$6.8 million exclusion amount that is available at the taxpayer's death rather than the \$12.06 million exclusion amount when the taxpayer created the GRAT.

Considering the proposed limitations to the anti-clawback regulation, please consult with your Wiggin and Dana attorney regarding tax planning strategies to make sure the gifts that you make during your lifetimes are not clawed back into your estate at your death.