The Estate Tax Clawback: Fact or Fiction

by Steven M. Weiser

For the first time since 1935, the estate tax applicable exclusion amount is scheduled to decrease. This will occur after December 31, 2012. This decrease has raised concerns among some practitioners that those taxpayers who used a larger unified credit during 2011 and 2012 and die in later years will become subject to a "clawback" or recapture of transfer taxes at the time of death. This article posits that current law already ensures that a clawback will not occur.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (TRA 2010)[1] was passed by the U.S. Congress on December 16, 2010 and signed into law by President Obama on December 17, 2010. TRA 2010 centered on the extension of the Bush-era tax cuts contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[2] and the Jobs and Growth Tax Relief Reconciliation Act of 2003.[3] In addition to extending the Bush-era tax cuts, TRA 2010 provided practitioners and their wealthy clients a surprise "gift" in the form of a reunified and significantly larger transfer tax credit and lower tax rates. This article examines the potential expiration of these changes and the reversion to pre-EGTRRA law. In particular, the article addresses concerns about whether a recapture (often referred to as a "clawback") of transfer taxes will occur in the case of decedents dying in years when a lower unified credit may apply.

Legislative Background

Because most practitioners are familiar with the transfer tax rollercoaster we have been on in recent years, only a very brief review of some legislative history is provided in this article. On June 7, 2001, President George W. Bush signed EGTRRA into law. This sweeping piece of tax legislation included some significant changes to the federal estate, gift, and generation-skipping transfer (GST) taxes, culminating in the 2010 repeal of the estate tax.[4]

Before EGTRRA, the estate, gift, and GST tax basic exclusion amount was unified at $675,000 and incrementally increased to $1 million in 2006.[5] Additionally, before EGTRRA the maximum estate, gift, and GST tax rate was 55%.[6] EGTRRA "de-unified" the estate, gift, and GST tax basic exclusion amount and called for a $1 million gift tax exclusion amount and larger estate and GST basic exclusion amount (gradually increasing to a $3.5 million exclusion in 2009), followed by repeal of the estate tax in 2010.[7] EGTRRA also reduced the top marginal estate, gift, and GST tax rate to 45% (gradually).[8] However, EGTRRA contained a very notable sunset provision (for budgetary reasons), which provided that for the estates of decedents dying after December 31, 2010, EGTRRA did not apply, and that the Internal Revenue Code of 1986 was to apply for those estates as if EGTRRA had never been enacted.[9]

EGTRRA's sunset provision is significant because although TRA 2010 extended many of the Bush-era cuts, it did not eliminate the eventual application of this sunset provision. TRA 2010 did not extend the repeal of the estate tax, but instead reunified the estate, gift, and GST tax exclusion amount, increasing it to $5 million while reducing to 35% the maximum transfer tax rate.[10]

Barring new legislation, the unified credit will decrease for the first time since 1935 as a result of EGTRRA's sunset. Some practitioners with clients who have taken or intend to take advantage of the current $5 million applicable exclusion amount, but stand to pass away in years in which the unified credit will be lower, fear that a recapture of transfer taxes will apply at death. The reasons for this fear and a conclusion as to whether it is warranted are examined below.

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Mechanics of Calculating an Estate Tax Liability

Before examining the specific statutory provisions in detail, a very general review of how the estate tax liability for a decedent is calculated on IRS Form 706, U.S. Estate (and GST) Tax Return (skipping a few lines for convenience) is warranted. Although IRS publications such as tax forms and instructions are no substitute for statutory and regulatory law, Form 706 provides an easier explanation of the estate tax liability calculation than diving straight into the statutory analysis.

On Form 706, the total taxable estate is reported on line 3(c). This is the value of all assets of the estate, less allowable deductions. To this figure is added the value (generally, as determined at the date of transfer and reported on a gift tax return[11]) of all taxable gifts made after December 31, 1976 (as reported on line 4), and the sum is computed on line 5. The add-back is designed to ensure that the decedent is able to take advantage of lower marginal tax rates only once.[12] Stated differently, the decedent may not receive the benefit of graduated transfer tax rates during life and then again at death. The tentative tax then is determined and reported on line 6 by multiplying the amount on line 5 by the appropriate marginal rates.

Against this tentative tax, gift taxes that were paid or payable with respect to the gifts reported on line 4 are deducted. These amounts are reported on line 7 and the excess of tentative tax, if any, is reported on line 8 as the gross estate tax. Against the gross estate tax, the unified credit is claimed (line 11) and the final tax liability is reported on line 16.

Assume taxpayer A made $1 million of taxable gifts in 2009 (for which no gift tax was paid due to the available exclusion), and dies in 2012 with an estate valued at $5 million. The estate tax liability is calculated as follows:

Line 3(c): Taxable estate	$5,000,000
Line 4: Adjusted taxable gifts	1,000,000
Line 5: Sum	6,000,000
Line 6: Tentative tax	2,080,800*
Line 7: Gift tax paid or payable	0
Line 8: Gross estate tax	2,080,800
Line 11: Allowable unified credit	(1,730,800)
Line 16: Net estate tax	350,000

* *See* Exhibit A for the relevant tax brackets.

The above example is a very simple computation of the estate tax liability. Although TRA 2010 applies during the year of death, there is no concern about clawback because the exclusion amount in the year of death exceeds the exclusion amount available at the time A's gift was made.

Clawback concerns arise when the exclusion amount in the year of death is less than the exclusion used during life. At first blush, it might seem that if prior gifts are added back to the total estate to determine the tax base and gross estate tax due, and if the unified credit available at death is used to offset the gross estate tax, a taxpayer may have lost any additional exclusion amount that was available during life.

If the above example is modified by assuming no change has occurred in the tax brackets and that taxpayer A instead makes $5 million of gifts in 2011 and dies in 2014 with an estate valued at $1 million when the exclusion amount is scheduled to be $1 million, the computation of B's tax liability might be calculated as follows:

Line 3(c): Taxable estate	$1,000,000
Line 4: Adjusted taxable gifts	5,000,000
Line 5: Sum	6,000,000
Line 6: Tentative tax	2,080,800
Line 7: Gift tax paid or payable	0
Line 8: Gross estate tax	2,080,800
Line 11: Allowable unified credit	330,800
Line 16: Net estate tax	1,750,000

This example illustrates the possible tax consequences if clawback does occur, but it is not necessarily the correct result based on relevant statutes.

Statutory Analysis

The statute causing the greatest concern is IRC § 2001, which provides the method by which the estate tax is calculated. A comparison of IRC § 2001(b) before and after TRA 2010, as well as new IRC § 2001(g) added by TRA 2010 is shown in Exhibit B.

The issue of clawback arises for some because of the changes made to IRC § 2001(b)(2) and (g).[13] IRC § 2001(b)(2) calls for the tentative tax to be offset by the amount of gift tax paid or payable with respect to lifetime gifts. The previous § 2001(b)(2) stated that the tax rates in effect at death[14] are used to determine the offset amount. New § 2001(b)(2) states that the rates in effect at death are used to determine both the offset amount and the unified credit amount. The Joint Committee on Taxation implied that this change did not necessarily create a new process for calculating the gift tax offset, but rather was intended as a clarification.[15]

In a letter to Congress, the American Bar Association (ABA) Tax and Real Property, Trust and Estate Law Sections explained the cause for concern. Although IRC § 2001(g) explains that the tax rates in effect at the decedent's death are used to calculate the applicable credit amount, the statute is unclear as to whether the exclusion amount in effect at the date of the gift or the date of death should be used in calculating the credit amount.[16] The ABA sections note that the instructions to Line 7 of Form 706 (in which gift taxes paid or payable are used to offset the estate tax liability in whole or in part) indicate that the exclusion amount available at the time of gift is used; however, the letter goes on to note that these instructions were drafted before the enactment of TRA 2010, and probably did not contemplate that the exclusion amount available at death would be lower than the exclusion amount available during life.

At least one well-known authority has indicated the date of death exclusion amount should be used, ignoring the higher exclusion available during life and resulting in a recapture of transfer taxes.[17] This problem may be further compounded by the fact that § 901 of EGTRRA, which also is applicable to TRA 2010,[18] states:

> The Internal Revenue Code of 1986 . . . shall be applied and administered to years, estates, gifts, and transfers [after Decem-

ber 31, 2012] as if the provisions and amendments described . . . had never been enacted.

There Will Not be an Estate Tax Clawback

Several factors support a conclusion that there will not be an estate tax issue. Perhaps most important, the mechanics of IRC § 2001(b) would prevent clawback from occurring. A look back at the second example presented above and further analysis will show the flaws in the earlier calculation. The focus is on line 7, the offset for gift taxes previously paid or payable. In the second example, A made lifetime gifts of $5 million in 2011, and dies in 2014 when the exclusion amount is $1 million. The calculation above really should look as follows, even if the exclusion amounts at death apply:

Line 3(c): Taxable estate	$1,000,000
Line 4: Adjusted taxable gifts	5,000,000
Line 5: Sum	6,000,000
Line 6: Tentative tax	2,080,800
Line 7: Gift tax paid or payable	1,400,000
Line 8: Gross estate tax	680,800
Line 11: Allowable unified credit	330,800
Line 16: Net estate tax	350,000

Line 7 has been recalculated. This is because IRC § 2001(b)(2) instructs us that the gift tax offset is the gift tax that "would have been payable." This needs to be distinguished from the gift tax amount actually paid. The worksheet for line 7 accompanying the instructions to Form 706 (*see* Appendix) calculates the proper gift tax offset, but makes no distinction between gift taxes previously paid, or gift taxes that were payable with respect to prior gifts. Compare this example to the first example and the amount of estate tax due at death is unchanged. This makes sense because in both situations, the exclusion amount is $1 million at the time of one transfer and $5 million at the time of the other. Assuming no change in tax brackets, it should make no difference whether the exclusion decreases or increases between the two transfers of wealth. Identical tax liabilities are expected.

This conclusion also is supported by the following facts: (1) there is nothing in the legislative history of TRA 2010 to indicate clawback was intended; (2) there would have been virtually no point to increasing the exclusion amount for gift tax purposes, only to take it back through recapture at death (other than perhaps the ability to remove the appreciation in value of lifetime gifts); and (3) doing so would be a radical departure from the transfer tax regimes that have existed at least since 1935 (in terms of subjecting *inter vivos* gifts previously and effectively "exempt" from taxation to tax at death).

Conclusion

The confusion in this area can be traced to the gift tax offset, reported on line 7 of Form 706 and allowed by IRC § 2001(b)(2). Attorneys who believe the offset should exist only for gift taxes actually paid probably should wait for additional guidance from either Congress (perhaps in the form of a technical amendment to the statute) or the IRS before plunging ahead with clients to take advantage of the current $5 million exclusion and corresponding unified credit before it expires. Others (including this author) will move forward with confidence that gifts using the existing exclusion amount will not be subject to estate tax in subsequent years as a result of the sunset of TRA 2010 and EGTRRA.

Notes

1. Pub.L. 111-312, 124 Stat. 3296 (Dec. 17, 2010).
2. Pub.L. 107-16, 115 Stat. 38 (June 7, 2001).
3. Pub.L. 108-27, 117 Stat. 752 (May 28, 2003).
4. EGTRRA § 501 (codified at IRC § 2210). Unless otherwise noted, all statutory provisions cited are to the Internal Revenue Code of 1986, as amended (IRC) and regulatory provisions are to the Treasury Regulations (Treas. Reg.) promulgated under the IRC.
5. 2001 Tax Legislation, Law Explanation and Analysis: Economic Growth and Tax Relief Reconciliation Act of 2001 (CCH) ¶ 305 (2001). The unified credit also was scheduled to be adjusted for inflation, but for purposes of this article, the exclusion amounts, unadjusted for inflation, are used for convenience.
6. *Id.* at ¶ 308.
7. *Id.* at ¶ 312.
8. *Id.* at ¶ 308.
9. EGTRRA § 901.
10. TRA 2010 § 302.
11. Treas. Reg. § 20.2001-1(c).
12. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (JCS-33-76) 525-28 (Dec. 29, 1976). The net effect of adding back *inter vivos* gifts is that the same amount of tax is payable, whether wealth is transferred during life or at death.
13. TRA 2010 § 304.
14. Such rates are stated in IRC § 2001(c).
15. Joint Committee on Taxation, General Explanation of the Tax Legislation Enacted in the 111th Congress (JCS-2-11) n.1577 (March 2011). It appears that the changes had the opposite affect from clarification.
16. American Bar Association Sections of Taxation and Real Property, Trust and Estate Law, Letter to Max Baucus, Chairman of the Senate Committee on Finance *et al.* (April 4, 2012), available at www.americanbar.org/content/dam/aba/administrative/taxation/040512letter.authcheckdam.pdf.
17. Stephens *et al.*, *Federal Estate and Gift Taxation Supplement* ¶ 2.02 [1] n.88 (8th ed. 2002).
18. TRA 2010 § 304. ■

Exhibit A
2011 Estate and Gift Tax Rates

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A
$0	$10,000	$0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	—	155,800	35%

Exhibit B

IRC § 2001(b) before TRA 2010	IRC § 2001(b) and new 2001(g) after TRA 2010 (*emphasis added*)
(b) Computation of Tax—The tax imposed by this section shall be the amount equal to the excess (if any) of -	**(b) Computation of Tax**—The tax imposed by this section shall be the amount equal to the excess (if any) of -
(1) a tentative tax computed under subsection (c) on the sum of -	(1) a tentative tax computed under subsection (c) on the sum of -
(A) the amount of the taxable estate, and	(A) the amount of the taxable estate, and
(B) the amount of the adjusted taxable gifts, over	(B) the amount of the adjusted taxable gifts, over
(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the provisions of subsection (c) (as in effect at the decedent's death) had been applicable at the time of such gifts.	(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, *if the modifications described in subsection (g) had been applicable at the time of such gifts.*
For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.	For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.
	(g) Modifications of Gift Tax Payable to Reflect Different Rates—For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute -
	(1) the tax imposed by chapter 12 with respect to such gifts, and
	(2) the credit allowed against such tax under section 2505, including in computing -
	(A) the applicable credit amount under section 2505(a)(1), and
	(B) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).

Form **706**
(Rev. August 2011)
Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2010, and before January 1, 2012.

OMB No. 1545-0015

Part 1—Decedent and Executor

1a	Decedent's first name and middle initial (and maiden name, if any)	**1b** Decedent's last name		**2 Decedent's social security no.**
3a	County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death	**3b** Year domicile established	**4** Date of birth	**5** Date of death
		6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP code) and phone no.		
6a	Name of executor (see instructions)			
6c	Executor's social security number (see instructions)			Phone no.
7a	Name and location of court where will was probated or estate administered			**7b** Case number
8	If decedent died testate, check here ▶ ☐ and attach a certified copy of the will.	**9** If you extended the time to file this Form 706, check here ▶ ☐		
10	If Schedule R-1 is attached, check here ▶ ☐			

Part 2—Tax Computation

1	Total gross estate less exclusion (from Part 5—Recapitulation, item 12)			**1**	
2	Tentative total allowable deductions (from Part 5—Recapitulation, item 22)			**2**	
3a	Tentative taxable estate (before state death tax deduction) (subtract line 2 from line 1)			**3a**	
b	State death tax deduction			**3b**	
c	Taxable estate (subtract line 3b from line 3a)			**3c**	
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))			**4**	
5	Add lines 3c and 4			**5**	
6	Tentative tax on the amount on line 5 from Table A in the instructions			**6**	
7	Total gift tax paid or payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)			**7**	
8	Gross estate tax (subtract line 7 from line 6)			**8**	
9	Maximum unified credit (applicable credit amount) against estate tax (see instructions)	**9**			
10	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See instructions.)	**10**			
11	Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)			**11**	
12	Subtract line 11 from line 8 (but do not enter less than zero)			**12**	
13	Credit for foreign death taxes (from Schedule P). (Attach Form(s) 706-CE.)	**13**			
14	Credit for tax on prior transfers (from Schedule Q)	**14**			
15	Total credits (add lines 13 and 14)			**15**	
16	Net estate tax (subtract line 15 from line 12)			**16**	
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)			**17**	
18	Total transfer taxes (add lines 16 and 17)			**18**	
19	Prior payments. Explain in an attached statement			**19**	
20	Balance due (or overpayment) (subtract line 19 from line 18)			**20**	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 20548R Form **706** (Rev. 8-2011)

Line 7 Worksheet (Unified Credit Allowable for Prior Periods) *Keep for Your Records*

Line 7 Worksheet – Tax on Gifts Made After 1976											
(a) Period	(b) Taxable Gifts for the Current Period	(c) Total Taxable Gifts for Prior Periods[1]	(d) Cumulative Taxable Gifts Including Current Period. *(Col. (b) + Col. (c))*	(e) Tax Based on 2011 Rates on Gifts from Prior Periods *(Col. (c))*[2]	(f) Tax Based on 2011 Rates on Cumulative Gifts Including Current Period *(Col. (d))*	(g) Tax on Gifts for Current Period *(Col. (f) – Col. (e))*	(h) Maximum Unified Credit Available for Current Period (based on 2011 rates)[3]	(i) Unified Credit Allowable in Prior Periods[4]	(j) Available Credit in Current Period *(Col. (h) – Col. (i))*	(k) Credit Allowable *(Lesser of Col. (g) and Col. (j))*	(l) Tax Payable for Current Period *(Col. (g) – Col. (k))*
Pre-1977											
2011	*5,000,000*	—	*5,000,000*	—	*1,730,800*	*1,730,800*	*330,800*	—	*330,800*	*330,800*	*1,400,000*
1. Total gift taxes payable on gifts made after 1976 (add all amounts in column (l)).										1.	*1,400,000*
2. Gift taxes paid by the decedent on gifts that qualify for "special treatment." Enter the amount from Worksheet TG, line 2, column e.										2.	—
3. Subtract line 2 from 1.										3.	*1,400,000*
4. Gift tax paid by decedent's spouse on split gift included on Schedule G. Enter amount from Worksheet TG, line 2, column (f).										4.	—
5. Add lines 3 and 4. Enter here and on Part 2—Tax Computation, line 7.										5.	*1,400,000*

1. Column (c): Enter amount from column (d) of the ***previous*** row.
2. Column (e): Enter amount from column (f) of the ***previous*** row.
3. Column (h): Enter amount from the Table of Unified Credits. (For each row in column (h), subtract 20 percent of any amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977.)
4. Column (i): Enter the sum of column (i) and column (k) from the ***previous*** row.

You need not file these worksheets with your return but should keep them for your records. *Worksheet TG—Taxable Gifts Reconciliation* allows you to reconcile the decedent's lifetime taxable gifts to figure totals that will be used for the Line 4 Worksheet and the Line 7 Worksheet.

You must have all of the decedent's gift tax returns (Form 709) before you complete *Worksheet TG—Taxable Gifts Reconciliation*. The amounts you will enter on *Worksheet TG* can usually be derived from the filed returns that were subject to tax. However, if any of the returns were audited by the IRS, you should use the amounts that were finally determined as a result of the audits.

In addition, you must make a reasonable inquiry as to the existence of any gifts in excess of the annual exclusion made by the decedent (or on behalf of the decedent under a power of attorney) for which no Forms 709 were filed. Include the value of such gifts in column b of *Worksheet TG*. The annual exclusion per donee for 1977 through 1981 was $3,000, $10,000 for 1981 through 2001, $11,000 for 2002 through 2005, and $12,000 for 2006 through 2008. For 2009, 2010, and 2011, the annual exclusion for gifts of present interest is $13,000 per donee.

How to complete line 7 worksheet
Column (a). Beginning with the earliest year in which taxable gifts were made, enter the quarter/year of the prior gift(s).
Column (b). Enter all taxable gifts. Enter all pre-1977 gifts on the pre-1977 row.
Column (c). Enter the amount from column (d) of the ***previous*** row.
Column (d). Enter the sum of column (b) and column (c) from the current row.
Column (e). Enter the amount from column (f) of the ***previous*** row.
Column (f). Enter the tax based on the amount in column (d) of the current row from *Table A — Unified Rate Schedule* above.
Column (g). Subtract the amount in column (e) from the amount in column (f) for the current row.
Column (h). Enter the amount from the *Table of Unified Credits (as recalculated using 2010 rates).*
Note. The entries in each row of column (h) must be reduced by 20 percent of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (but no more than $6,000).
Column (i). Enter the sum of column (i) and column (k) from the ***previous*** row.
Column (j). Subtract the amount in column (i) from the amount in column (h).
Column (k). Enter the lesser of column (g) and column (j) for the current row.
Column (l). Subtract the amount in column (k) from the amount in column (g) to determine any tax due. Enter result in column (l).
Repeat for each year in which taxable gifts were made.

For examples of how to use the Line 7 Worksheet, see the examples in the 2010 Instructions for Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, schedule B, column C (Unified Credit Allowable for Prior Periods). Add a column to the right of column (k) to determine the tax payable for the current period (column (g) minus column (k)).