# GIFT NOW, PAY LATER?

**An Analysis of the Potential Estate Tax "Clawback"**

There is an unprecedented opportunity for individuals to transfer wealth through the end of 2012, given the generous $5 million gift exemption. However, many people are hesitant to forge ahead with making these large gifts for fear of what has been termed a possible "clawback", which would seek to subject previously made exempt gifts to future estate tax, if the gift exemption drops below the current $5 million level after December 31, 2012.

Under a "unified" gift and estate tax regime, post-1976 "adjusted taxable gifts" are added back to a decedent's taxable estate in order to compute the estate tax on the total amount of lifetime transfers. Any gift tax that was previously paid is backed out of the combined tax computation to arrive at the amount of estate tax due at death. Why do we add back prior adjusted taxable gifts? The purpose of doing so was to push the taxable estate into the tax bracket it would have been in if the gifts had been included as part of the estate. The intent of adding back prior adjusted gifts was to not subject prior gifts to additional tax upon death.

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, ("The 2010 Act"), the unified credit allocated to gifts made in prior periods is required to be redetermined, based on the tax rate in effect at the date of the decedent's death, rather than the rate in effect at the date of the gift. So, chances are that if someone died in 2010 or 2011 and had previously made taxable gifts, the tax computed on those gifts would be recomputed at the *current* rate of 35%, instead of the rate in effect when the gift was originally made, which could have been as high as 55%.

Since the provisions of the 2010 Act sunset after 2012, what happens if someone dies in 2013, assuming the exemption drops back down to $1 million? There is a concern that those prior taxable gifts that were made in 2011 and 2012 in excess of $1 million would be "clawed back" into their estates and taxed at the then higher rate of 55% (remember, the donor *thought* they were either paying zero gift tax or a rate of only 35%). The unified credit allowed on those prior gifts would **not** be adjusted for the new rate in effect at death, but, instead, would be based on the unified credit in effect at the time the gift was made. So, the result you have is a higher estate tax computed with no change in the allowable credit for the prior transfer. Simply stated, you would owe **additional** estate tax on those prior transfers.

A variation on this clawback issue could exist where a surviving spouse made lifetime gifts using the "deceased spouses unused exclusion amount" (DSUEA), also known as the "portability amount". If that surviving spouse remarries someone with a lower unused exclusion amount, and *that* second spouse dies before 2013, the surviving spouse is *now* limited to the DSUEA of **the most recent spouse**. The result, again, is that the surviving spouse will owe additional estate tax on those prior gifts.

Planners, like us, assume for the most part, that Congress did not intend for gifts made during 2011 and 2012 to be subject to additional estate tax in 2013 and thereafter.
We're hoping that Congress corrects this before the end of 2012, but, in reality, we *are* dealing with Congress. We are not optimistic about change coming soon.

Since we don't know if this will be resolved by January 1, 2013, what should our clients, do? Should they **not** make large gifts and miss an opportunity to reduce the size of their estates? Or are there ways for our clients to *still* make these large gifts now and protect themselves from this potential future "clawback"?

Following is some useful advice for those considering taking advantage of the current increased gift exemption:

- If your estate's beneficiaries are different from those who will have received the 2011 or 2012 gifts, make sure you discuss the potential risk with those beneficiaries.
    - Consider entering into an agreement with these gift donees whereby they agree to reimburse the estate for their share of estate tax, in the event of a clawback.
- There is still a benefit to making a gift now. You will still remove future appreciation from your taxable estate. The ability to "freeze" the value of an asset and remove future appreciation is still valuable. If the asset has short-term appreciation potential, the possibility of a clawback should definitely not deter the transfer.
- Techniques such as sales to intentionally defective grantor trusts (IDGTs), grantor retained annuity trusts (GRATs), and irrevocable life insurance trusts (ILITs) can still provide great leverage, use smaller exemption amounts and remove assets from the estate with much higher future values as compared to the amount of the original gift.
- Even if a donor fails to make gifts in 2011 or 2012 due to concerns over a potential clawback, those foregone gifts would still be included and taxed in their gross estate at death. Therefore, it is arguable that one is no worse off by making the gift. If the clawback ends up being a non-issue, then the donor will have successfully removed assets from their gross estate.

Although many estate planners agree that the potential for a clawback is low, with uncertainty, there is always risk. The best we can do, as planners, is to inform our clients of the issue and its potential risk. Ultimately, the decision to make any gift rests in the hands of the donor.