When the Claws Come Out: Reviewing 'Anti-Clawback' Provisions in Light of Additional Proposed Regulations

BY CAROLINE E. HECHT

Most practitioners are familiar with the Tax Cuts and Jobs Act of 2017 ("TCJA") and in particular, its amendment to section 2010(c)(3) of the Internal Revenue Code. The amendment provides that for persons who die or make gifts after December 31, 2017, and before January 1, 2026, the basic exclusion amount ("BEA") and the Generation-Skipping Transfer ("GST") Tax Exemption is increased from $5 million to $10 million, adjusted for inflation. However, after January 1, 2026 (unless section 2010(c)(3) is further amended prior to that date), the BEA/GST Exemption will drop back down to $5 million, adjusted for inflation (the current estimate is that this amount will be approximately $6.8 million).

The TCJA amendment has provided a significant estate tax planning opportunity for high-net-worth individuals. As of January 1, 2023, individuals can transfer $12,700,000, during their lifetime, upon their death, or a combination of both. In addition, married couples can gift a combined amount of $25,400,000. It is also not a "use it or lose it" scenario – a surviving spouse can capture their deceased spouse's unused exclusion amount by filing a federal estate tax return (a concept known as "portability") and then apply that exemption at their death.

Many high-net-worth individuals have taken advantage of these unprecedented higher exemption amounts by making large lifetime gifts. But this created a dilemma for the IRS - what happens if an individual makes lifetime gifts in an amount that falls within the BEA during their lifetime, but exceeds the BEA that is available upon their death? Can the IRS "clawback" the gift? Or what if a decedent gifted all of their assets during life, leaving an insolvent estate – who is responsible for the estate tax due if the BEA at death is lower than that which was available during the decedent's life?

The IRS' answer to these quandaries was 26 CFR 20.2010-1, adopted on November 26, 2019, and colloquially referred to as the "anti-clawback regulation." This special rule provides that a decedent's estate is not taxed on completed gifts that were made as a result of the increased BEA. Technically speaking, if the total credits used on a decedent's gift tax are greater than the applicable credit amount used to compute the estate tax, then the credit used to compute the estate tax is deemed to be the total credits that were used in computing the decedent's gift tax.

However, we recently learned that the "claws" remain – and had only been slightly trimmed. On April 26, 2022, the U.S. Treasury issued new proposed regulations, informally as the "anti-abuse exceptions" or "anti-clawback rule exceptions." The intent was to limit potential abuses of the 2019 anti-clawback regulation as it relates to retained-interest transfers (transfers in which the donor continues to have title, possession, use, benefit, or control of the transferred property). In other words, the IRS seeks to prevent a taxpayer from using certain estate planning techniques to try to lock in the higher BEA and still have access to the gifted assets until their death. Effective the earlier of (i) January 1, 2026 under current law or (ii) April 27, 2022 if a law is enacted reducing the BEA prior to January 1, 2026, certain transfers will not apply under the anti-clawback regulation. Those transfers will instead be subject to the BEA in effect on the decedent's date of death, rather than the BEA in effect at the time of the gift. The proposal includes four non-exclusive categories of transfers:

"(c)(3) Exception to the special rule—

(i) Transfers to which the special rule does not apply. Except as provided in paragraph (c)(3)(ii) of this section, the special rule of paragraph (c) of this section does not apply to transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b), including without limitation the following transfers:

(A) Transfers includible in the gross estate pursuant to section 2035, 2036, 2037, 2038, or 2042, regardless of whether all or any part of the transfer was deductible pursuant to section 2522 or 2523;

(B) Transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death;

(C) Transfers described in §25.2701-5(a)(4) or §25.2702-6(a)(1) of this chapter; and

(D) Transfers that would have been described in paragraph (c)(3)(i)(A), (B), or (C) of this section but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person."[1]

Examples of some exempted transfers based on the above would include:

- Gifts made within three years of the decedent's death (section 2035)
- Transfers with a retained life estate (section 2036)
- Certain transfers taking effect at death (section 2037)
- Revocable transfers (section 2038)
- Freeze partnerships under section 2701
- Grantor Retained Annuity Trusts, Grantor Retained Unitusts, and

- Qualified Personal Residence Trusts (section 2702)
- Certain life insurance proceeds (section 2042)

The proposed regulations also provide some exceptions to the exception. Namely, the anti-clawback rule exception will not apply when the gift is *di minimus*, such as when the gift is 5% or less than the total amount of the transfer or when the taxpayer gives up the retained interests within the 18 months prior to his or her death (in which case those retained interests will still be included in the decedent's taxable estate).

In light of the above, some strategies practitioners should consider include:

- Advising clients with estates in excess of the BEA to think about making gifts before January 1, 2026 (and in evaluating the types of assets available to gift, consider income tax basis, whether any discounting may apply, etc.).
- Encouraging clients to file an estate tax return to claim a deceased spouse's unused exemption.
  - Note: Revenue Procedure 2022-32 extends late portability automatic extension relief from two years to five years. For those clients who do not wish to file a return (be it due to the cost to prepare the return, time needed to collect documents, etc.), the attorney should have the client sign a waiver confirming that the client understands their right to file a return and declines to do so.
- For clients who wish to do planning involving retained interests, preparing an explanatory letter regarding the implications of the transfer at death based on current law.

Final Note: As of the writing of this article, Regulation 20.2010-1(c)(3) has not yet been adopted, but proposed regulations are generally binding on the IRS until they become final. Once finalized, the regulations then become binding on taxpayers.■

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1. Prop. Regs. Secs. 2010-1(c)(3)(i)(A) through (D).

A Summary of the Trusts & Estates Section Council's Dec. 9, 2022, Business Meeting

BY JENNIFER BUNKER SKERSTON

Publications

The Illinois Bar Journal published our two "Top 5" lists for trust and estates developments in 2022 and developments to watch for in 2023.[9] The article was combined with those from other section councils in the Illinois Bar Journal. The contribution of the publication subcommittee included discussion of the following:

Top Five Trusts and Estates Developments in 2022

1. Illinois Electronic Wills and Remote Witnesses Act, updated Illinois Notary Public Act, and proposed secretary of state rules
2. Late portability election relief
3. Changes to the Real Property Transfer on Death Instrument Act
4. Revisions to the Illinois Residential Real Property Disclosure Act
5. Proposal for the breadth of the "anti-clawback" rule to be limited

Top Five Trusts and Estates Developments to Watch for in 2023

1. Tenancy by the entirety and trust ownership
2. Proposed federal regulations for the SECURE Act
3. Estate tax deduction for payment of certain administration expenses and claims
4. Sunset of the Tax Cuts and Jobs Act and maximizing exemptions
5. Trailer bill for the Illinois Residential Real Property Disclosure Act

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Future programs will focus on helping attorneys become "practice ready" and be done as part of the "Successful Estate Planner Series" to be held on May 2, 9, and 23, 2023.

The Council will also be participating in a webinar designed to teach mediators basic concepts of the estate administration process and a webinar concerning the Illinois Supportive Decision-Making Agreement Act on April 4, 2023.

Legislation

The subcommittee on trust ownership of real estate held in tenancy by the entirety reported that they are working on researching the issue.

Senate Bill 2664 was passed and Illinois Secretary of State Rules of Remote Notarization will come into effect approximately 90 days after it issues a second notice for the rules' implementation. The Notary Public Rulemaking Record was circulated by email prior to the meeting. The Secretary of State has changed the rules to no longer require law firms to maintain notary journals if they keep copies of notarized documents in their file.

ISBA Legislative Proposal 3-7 was discussed concerning the Uniform Voidable Transactions Act. The subcommittee recently participated in a Zoom call