IRS confirms large gifts now won’t hurt post-2025 estates

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The IRS has issued final regulations that should provide comfort to taxpayers interested in making large gifts under the current gift and estate tax regime. The final regulations generally adopt, with some revisions, proposed regulations that the IRS released in November 2018. This is welcome news for those taxpayers who make large gifts using their increased exemption now but die in a year when the exemption is lower. The final regulations make clear that gifts made with the increased exemption amount used before the taxpayer's death won't be "clawed back" into the taxpayer's estate.

The need for clarification

The Tax Cuts and Jobs Act ("TCJA") temporarily doubled the gift and estate tax exemption from $5 million to $10 million for gifts made or estates of decedents dying after Dec. 31, 2017 and before Jan.1, 2026. The exemption is adjusted annually for inflation ($11.40 million for 2019 and $11.58 million for 2020). After 2025, though, the exemption is scheduled to drop back to pre-2018 levels.

With the estate tax a flat 40%, the higher threshold for tax-free transfers of wealth would seem to be great news, but some taxpayers became worried about a so-called “clawback” if they die after 2025. Specifically, they wondered if they would lose the tax benefit of the higher exemption amount if they didn’t die before the exemption returned to the lower amount.

The concern was that a taxpayer would make gifts during his or her lifetime based on the higher exemption, only to have their credit calculated based on the amount in effect at the time of death. To address this fear, the final regulations provide a special rule for such circumstances that allows the estate to compute its estate tax credit using the higher of the exemption amount applicable to gifts made during life or the amount applicable on the date of death.

Examples

Let's say you made $9 million in taxable gifts in 2019, while the exemption amount of $11.40 million is in effect. But you die after 2025, when the exemption drops to $6.8 million ($5 million adjusted for inflation).

Under the final regulations, the credit applied to compute the estate tax is based on the $9 million of the $11.4 million exemption used to compute the gift tax credit. In other words, your estate won’t have to pay tax on the $2.2 million in gifts that exceeds the exemption amount at death ($9 million less $6.8 million).

If, however, you made taxable gifts of only $4 million, because the total of the amounts allowable as a credit in computing the gift tax ($4 million) is less than the credit based on the $6.8 million exemption amount at death, the special rule doesn't apply and the credit to be applied for purposes of calculating the estate tax is based on the $6.8 million exemption amount at death.

Act now

Even though the TCJA and the final regulations provide a strong tax incentive to transfer assets, it's important to remember that the offer is "use it or lose it." The final regulations apply only to gifts made during the 2018-2025 period, so please contact us now to formalize your gifting strategies.

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