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AALU Bulletin No: 11-97

November 9, 2011

Subject: **A Look-back at Clawback: Why 2011 and 2012 Gifts Are Still Good Planning**

Major References: [“Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010,” P.L. 11-312, Title III, \(December 17, 2010\)”](#)

Prior AALU Washington Reports: 11-09; 11-13

MDRT Information Retrieval Index Nos.: 4400.05; 7400.023

**SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO  
THE CONCLUSION OF THIS WASHINGTON REPORT.**

*The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 (“TRA 2010”) has been in effect now for the better part of a year. During that period of time, advisors have been presented with unique planning opportunities arising from the increased - to \$5 million per person - and reunified estate, gift and generation-skipping tax exemptions in TRA 2010. However, some advisors and/or their clients have expressed reservations about the use of the increased exemption in light of the possible “clawback” of prior gifts into the taxable estate of the donor should he or she die after TRA 2010 “sunsets” in 2013.*

*This Washington Report, prepared at the suggestion of AALU’s Business, Insurance and Estate Planning Committee, explains the “clawback” scenario and why it should not be a deterrent to gifting, if properly explained and disclosed.*

1. **What is “Clawback?”/Reasons for Concern.**

Since the 1976 Tax Reform Act (when the estate and gift tax exemptions were first “unified”) the concept of “adjusted taxable gifts” has been used to compute the amount of Federal estate tax due on the taxable estate. In essence, in the unified system, the amount of post-1976 taxable gifts is added to the taxable estate, the estate tax is computed on the total amount. Thereafter, the gift tax previously paid (or deemed to be previously paid, pursuant to a computation in the Worksheets to the Form 706) is backed out of the computation. The purpose of the “adjusted taxable gifts” computation was simply, in light of the progressive tax rates, to put the taxable estate into the right estate tax bracket, not to subject prior gifts to additional tax.

Sections 2001(g), which was added to the Internal Revenue Code as part of TRA 2010, and section 2001(b)(2), as amended, clarify an important aspect of this gift tax computation: in computing the gift tax that is deemed to be previously paid, the rates of tax in effect at the date of the decedent’s death are to be used in lieu of the rates of tax in effect at the date of the gift to compute both the gift tax paid or deemed paid and the credit allowed against such amounts.. These amendments, however, along with the entirety of TRA 2010, are scheduled to sunset after 2012.

A number of commentators have posited that, without section 2001(g), decedents’ estates could have a portion of taxable gifts made in 2011 and 2012 “clawed back” into their estates and taxed. This theory is based in part on the calculations required on the worksheets to Form 706, which has not been updated in this respect since 2009. Using the rates of tax in effect on the date of the gift - as required on the Form 706 - could result in a higher overall tax if the rates increase (and the credit decreases) between the date of the gift and the date of death - as may happen if TRA 2010 sunsets after 2012.

Example 1: Donor makes a taxable gift of \$5,000,000 in 2011, and pays no gift tax on this taxable gift because the gift tax exclusion amount is \$5,000,000. Donor dies in the year 2013 when the exclusion amount has returned to \$1,000,000, and the rate schedule (under § 2001(c)) has a top 55% rate. At death, Donor’s taxable estate is \$1,000,000. If “clawback” applies, the estate tax due is computed as follows:

Taxable estate	\$1,000,000
Adjusted taxable gifts	\$5,000,000
Total	\$6,000,000
Tentative Tax on \$6,000,000	\$2,940,800
<u>Less Credit For Gift Tax “Paid” on \$5 Mil.</u>	<u>(\$1,730,800) [Using credit in effect in 2011]</u>
Tax Due on \$1 Million Estate	\$1,210,000

Note that the tax due in this example is greater than the Donor’s taxable estate (\$1 million) at date of death, which would work a particular hardship on the Donor’s legatees if they happened to be different from the recipients of the gift, as might happen in a second marriage situation.

**However**, as we stated in our prior Washington Reports, the result in Example 1 is far from clear, and many believe that it would not be reached even if the sunset of section 2001(g) is taken into account. (See our Bulletins Nos. 11-09 and 11-13.) If no “clawback” applies, the estate tax in the foregoing example would be computed as follows:

Example 2:

Taxable estate	\$1,000,000
Adjusted taxable gifts	\$5,000,000
Total	\$6,000,000
Tentative Tax on \$6,000,000	\$2,940,800

Less Credit For Gift Tax "Paid" on \$5 Mil.	(\$2,390,800) [Using credit in effect in 2013]
Tax Due on \$1 Million Estate	\$550,000

What is reasonably clear is that Congress did not intend the result in Example 1 - *i.e.*, that gifts made during 2011 and 2012 would be subject to an additional estate tax in 2013 and thereafter. Furthermore, it is possible that some type of administrative or legislative relief will be forthcoming, even assuming that an unintended "glitch" does exist. This relief may be as simple as revising the Form 706.

NOTE: A variation on the clawback issue may exist when gifts are made using the surviving spouse's "deceased spousal unused exclusion" (DSUEA) during the surviving spouse's lifetime. If the surviving spouse remarries a second spouse with less exclusion, and the second spouse dies, the surviving spouse will not have as much DSUEA for estate tax purposes as when the gifts were made. Hence, the exclusion amount for estate tax purposes will be less than for gift tax purposes. If so, additional estate taxes may be due on the surviving spouse's death. This problem is different from the one that theoretically might apply in Example 1, and the answer to it, if one exists in the statute, is unclear at this time.

## 2. Planning Strategies/Reasons for Taking Advantage of Gifting Opportunities.

While acknowledging the possibility of clawback, AALU believes that there remain good reasons to take advantage of the increased exemptions while they are available. Thus, we would advise the following with respect to this issue:

- **Disclosure.** Advisors should, of course, note, in discussions with clients, the possibility of clawback when discussing making large gifts to take advantage of the increased exemptions available in 2011 and 2012. This discussion is particularly important where the beneficiaries of the 2011-2012 gift(s) are likely to be different than the beneficiaries of the decedent's estate, who will be the ones bearing the estate taxes. These clients may want to review their estate tax apportionment clauses and adjust their gifting strategies (such as, where possible, by making "net" gifts to take possible estate taxes into account).
- **Removing Appreciation from the Estate is an Added Benefit.** Even if all or a portion of the gifts made during 2011 and 2012 are clawed back into the donor's estate in later years, the appreciation on those gifts will be permanently out of his or her estate - for multiple generations, if the donor's generation-skipping transfer tax exemption is used. Much of modern estate planning consists of "freeze" techniques that are designed to remove appreciation from the client's estate. The continued ability to accomplish this valuable objective arguably should not be affected by a potential clawback.
- **Leverage.** The ability to "leverage" gifts through sales to trusts, GRATs, gifts of life insurance and other techniques will continue to be available even if an original gift is clawed back. Thus, using the \$5 million exemption for "seed money" can remove the appreciation on up to a total of \$50 million in assets transferred by gift and sale to a grantor trust. Using the exemption to pay life insurance premiums can remove the proceeds of life insurance having a value equal to many times the original gift. Where a grantor trust is used as the vehicle for the gift, additional leverage can come from the donor's payment of the income tax on the assets gifted or sold to the trust.
- **Taxation of Foregone Gifts at Death.** Assuming that a potential donor fails to make any gifts in 2011 and 2012 due to concerns about clawback, the foregone gifts will still be taxed in his or her estate at death. Therefore, one can argue that one is no worse off for making the gift, even if clawback applies. And, if - as many argue - there is no clawback, the donor will have removed considerable amounts of wealth from his/her estate.

- **No Loss of Previously Allocated GST Exemption.** Any GST exemption previously allocated would not be affected by clawback. Therefore, gifts to a trust to which GST exemption was allocated in 2011 and 2012 will remain GST-exempt.
- **Legal Uncertainties.** It is possible that Congress may extend the current level of exemptions for some period of time after the proposed “sunset” in 2013. Even failing an extension of current rates and exemptions, Congress - which must certainly be aware of - albeit not focused on - the issue surrounding clawback by now - may make technical changes to clarify that it does not apply under TRA 2010, and/or Treasury may make corrections to Form 706 to remove the possible unintended consequences that can result from a literal application of the instructions to the form.

In conclusion, AALU does not believe that clawback should be a significant deterrent to gifting, so long as full disclosure is made so that the client can evaluate the respective risks and benefits of the proposed transfer.

Any AALU member who wishes to obtain a copy of *“Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010,” P.L. 11-312, Title III, (December 17, 2010)* may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org) and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at [raglani@aalu.org](mailto:raglani@aalu.org) and include a reference to this *Washington Report*.

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