Presentation to the
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"Portability and Clawbacks: Tale of Two Code Sections"

I. Introduction. Sections 2001 and 2010 are interrelated sections of the Internal Revenue Code that play a large role in determining the amount of the estate tax that is to be paid in connection with the death of a decedent. Section 2001 imposes an estate tax and § 2010 provides a unified credit against that tax. Both of these sections have been expanded with important new provisions in the last three years which have given rise to new and unfamiliar terms such as "portability" and "clawbacks." Not only are these provisions new, their future is also quite uncertain due to the scheduled sunset of many key tax provisions in less than eight months from now. Given that this year—before it sunsets--marks 200 years since the birth of the author, Charles Dickens, it seemed appropriate to borrow from one of his novels for the title used above.

II. Section 2001—A Tax is Imposed. The "clawback" issue arises because of the somewhat unusual computation method found in § 2001. Therefore, it is important to carefully review the statutory language in order to fully understand the nature of the clawback. Although the clawback is normally thought of in connection with the loss of a decedent's basic estate tax exclusion, the issue also arises in the context of portability, as will be discussed below. The basic formula for calculating the tax imposed by § 2001 is as follows: the tax imposed equals a tentative tax less a hypothetical gift tax, both of which are based on estate tax rates in effect at the time of death.

A. The Tentative Tax. This is computed on the sum of the taxable estate and adjusted taxable gifts—i.e., a "gross up"--using estate tax rates in effect under § 2001(c). The purpose of the gross up is to ensure that the highest applicable marginal rates will apply.

B. The Hypothetical Gift Tax. Based on the subtraction methodology of § 2001, this is a "good" tax—the bigger the better. In thinking about this, we need to enter an "alternate universe" in which taxes are good and exemptions are bad. Therefore, in the case of a $5,000,000 gift covered by exemption, if the estate tax laws later sunset and the estate tax exemption returns to $1,000,000, in calculating the hypothetical gift tax we would prefer to have the "benefit" of the lower exemption at death rather than the higher exemption that was available when the gift was actually made. However, as written, the literal language of the statute appears to require the use of the actual exemption in effect for the year of the gift.

C. Modification Under New Subsection 2001(g). New subsection 2001(g) went into effect in 2010. The purpose of this subsection is to calculate the Hypothetical Gift Tax using the estate tax rates in effect at the time of the decedent's death, not the gift tax rates in effect when the gifts were made. Because § 2001 adds gifts (i.e., in the Tentative Tax) and subtracts them (i.e., in the Hypothetical Gift Tax) using the same tax rates, other than increasing the marginal rates, the section appears to create a wash with respect to the gross up for taxable gifts. However, as discussed below, this is not necessarily true with respect to the application of credits and exemptions.

D. The **Unified** Credit. It is significant that § 2001 calculates the tax to be imposed but does not identify the estate tax to be paid. This requires the application of available credits, of which the § 2010 unified credit against the estate tax is generally the most important. Interestingly, § 2001 does not direct the taxpayer to apply any estate tax credits. Surprisingly, under the statutory scheme, the unified credit against the estate tax is not directly reduced by the lifetime use of the unified credit against the gift tax. Instead, the lifetime use of the gift tax unified credit directly reduces the amount of the Hypothetical Gift Tax. This means that the Tentative Tax is grossed up for the full amount of adjusted taxable gifts, but only the portion above the gift tax credit amount (i.e., the portion representing the Hypothetical Gift Tax) is subtracted out. In other words, the tax computation formula under § 2001 increases the tax imposed by including the exempt portion of lifetime gifts in the tax base. The unified nature of the gift and estate tax credits comes from turning to § 2010 to find the estate tax credit that will offset the tax imposed under § 2001. By including the exempt portion of gifts in the tax base under § 2001, there is an indirect offset of the estate tax unified credit.

E. The "Clawback". The foregoing system works just fine as long as the estate tax exemption equals or exceeds the gift tax exemption. However, if the gift tax exemption exceeds the estate tax exemption, things don't work out so well. This is because the increase in the tax imposed under § 2001, which comes from including in the Tentative Tax base the amount of gift tax exemption used during lifetime, may not be fully offset by the estate tax unified credit. It is this discrepancy which creates the "clawback" of gifts covered by exemption when they were made for which there is insufficient estate tax unified credit to offset the increase in the tax imposed at death. The result is to subject these excess gifts to the estate tax even though they were covered by the lifetime exemption. To summarize, the higher the gift tax credit to be applied at death, the lower the Hypothetical Gift Tax to be subtracted from the Tentative Tax, and the higher the tax to be imposed under § 2001.

As noted above, subsection 2001(g) provides that certain modifications are to be made in calculating the Hypothetical Gift Tax. These changes involve substituting the current estate tax rates for the lifetime gift tax rates. However, the problem with subsection 2001(g) is not so much with what it says but with what it doesn't say. Although at least one commentator feels that the language of § 2001 allows for the use of a modified gift tax credit or exemption, a close reading of the statute does not support this conclusion. The specific language of § 2001(b)(2) is as follows: "the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent . . . if the modifications described in subsection (g) had been applicable at the time of such gifts." Because the modifications in (g) say nothing about the amount of gift tax credit to be used (other than identifying the rate to be used in calculating that credit), it seems clear that the gift tax which "would have been payable under chapter 12" must be based upon the gift tax credit available at the time of the gift. This approach is also supported by the instructions to the estate tax return, Form 706, for 2011 and in prior years. Notwithstanding the express language of § 2001, from a statutory construction standpoint, an argument that this result was not intended by Congress is that the gift and estate tax credits are supposed to be unified, and the clawback creates disunity between the two.

F. Why it Matters. The maximum exposure from the clawback depends upon tax rates and future changes in the gift and estate tax exemptions. For example, if a $5,120,000 gift is made in 2012 using the full gift tax exemption, and if the estate tax exemption returns to $3,500,000 with a 45% rate at the time of death, the tax exposure would be $729,000 (i.e., $5,120,000 - $3,500,000 x .45). If the $5,120,000 gift is doubled through the use of portability (discussed below), then the exposure is doubled to $1,458,000. However, if exempt gifts of $10,240,000 were made in 2012 using full portability, and if the estate tax laws (including portability) sunset in 2013 and the estate tax exemption returns to $1 million with a top rate of 55%, the maximum exposure would be $5,082,000 ($10,240,000 - $1,000,000 x .55). As an extreme example, if the estate were left entirely to charity or a surviving spouse, the estate tax paid pursuant to the clawback would reduce the marital or charitable deduction otherwise available, and the resulting interrelated calculation would create an estate tax owing of $11,293,333 (assuming that the estate is sufficiently large). In the event of a clawback, an important question will be tax apportionment—which beneficiaries are going to be responsible for paying the additional tax? Another issue that may arise is if the estate has insufficient funds to pay the tax, whether the donees could be held liable for the unpaid tax. Because this would be an attempt to collect an estate tax from donees whose liability would normally be determined in a gift tax context, traditional transferee liability under § 6324 seems unlikely to apply in this case.

G. Possible Solutions. Although the IRS could deal with the clawback issue administratively, the best solution would be to resolve the issue through legislation. For example, if § 2001(g) were expanded to provide that for purposes of calculating the Hypothetical Gift Tax, the gift tax credit to be applied for each year in which gifts were made is the lesser of the estate tax unified credit generally available at death or the gift tax credit actually used for that year, the clawback issue should disappear because the resulting increase in the Hypothetical Gift Tax would exactly offset the increase in the Tentative Tax. This solution is essentially the same as the one offered in proposed legislation in the House of Representatives last year. The proposed legislation would modify § 2001(g) to provide that for purposes of calculating the Hypothetical Gift Tax, the gift tax credit generally deemed available to taxpayers under § 2505(a)(1) for each year that gifts were made could not exceed the applicable credit amount available to the decedent's estate. Another option would be to increase the estate tax unified credit provided under § 2010 by the amount of gift tax credit that would otherwise be lost through the clawback.

It has been suggested that § 2001 actually requires the use of the unified credit available at death rather than the credit available when the gift was made. However, if the credit at death exceeded the credit when the gift was made, this interpretation could result in what one commentator refers to as a "reverse clawback." This is because all or part of any gift taxes actually paid would not be taken into account in calculating the Hypothetical Gift Tax, resulting in a corresponding increase in the estate tax to be paid (see S. Akers, 2012 Heckerling Musings, p. 13). This illustrates why for purposes of calculating the Hypothetical Gift Tax, an imbalance may result regardless of which exemption is highest. For that reason, the "lesser of" approach described above appears to be the best way to fix the problem.

III. Section 2010—The Unified Credit. The title of § 2010 is “Unified Credit Against Estate Tax.” However, the actual language of this code provision does not refer to a “unified credit,” but instead provides for the calculation of the “applicable credit amount” (this credit is found with a number of other estate tax credits in Chapter 11, Subchapter A, Part II). In addition to these terms, we often hear about exemptions, exclusions, and the applicable exclusion amount. Effective for gifts and deaths after 2010, we now have two new terms: “basic exclusion amount” and “deceased spousal unused exclusion amount” (“DSUEA”). These are found in subsection (c), which contains approximately one-half a page of new code provisions, effective beginning in 2011.

A. Applicable Credit Amount. As provided in § 2010(c), the applicable credit amount is determined by applying the estate tax rates to the “applicable exclusion amount.”

B. Applicable Exclusion Amount. Drilling down further into § 2010, subsection (c) also provides that the applicable exclusion amount is the sum of the “basic exclusion amount” and the “deceased spousal unused exclusion amount.”

C. Basic Exclusion Amount. For 2011, the basic exclusion amount was $5,000,000, and based on an index for inflation, for 2012, the amount is $5,120,000. Based on a 35% rate, the basic exclusion could be worth as much as $1,792,000. For a husband and wife, that amounts to $3,584,000 of tax savings. However, if the new provisions of § 2010(c) sunset as scheduled at the end of this year, the amount for 2013 and beyond will only be $1,000,000 per person, unless changed by future legislation.

D. Deceased Spousal Unused Exclusion Amount. The deceased spousal unused exclusion amount (“DSUEA”) is the lesser of the following two amounts: (1) the basic exclusion amount of the surviving spouse; and (2) the excess of (a) the basic exclusion amount of the “last deceased spouse,” over (b) the tentative tax base amount of such deceased spouse. The DSUEA has given risen to a new estate planning term known as “portability,” in which the unused exemption of a deceased spouse can be used by the surviving spouse.

E. Problems with Portability. Although simple in concept, there are a number of problems that have been identified in connection with the calculation of DSUEA. Whether these “problems” were intended by the drafters of § 2010(c) or were oversights may be a matter of opinion. Fixing them may require technical corrections or actual substantive changes to the code.

1. No Aggregation of DSUEA. As noted above, portability requires the identification of the unused exclusion of the "last deceased spouse." A possible problem with this approach is that a disincentive to marry is created for a surviving spouse who is considering remarrying a new spouse with less exclusion than the deceased spouse. Although a number of legislative proposals on portability allowed for a surviving spouse to aggregate the DSUEA of multiple deceased spouses (subject to the cap of the survivor's basic exclusion amount), the word "last" was inserted into the statute as finally enacted, with the result that the DSUEA of previous spouses is lost, and a potential "marriage penalty" may occur.

2. Lack of Privity. As noted above, the calculation of DSUEA relies upon the basic exclusion amount of the last deceased spouse. Although the deceased spouse's applicable exclusion amount consists of that spouse's basic exclusion amount and DSUEA, using only the basic exclusion amount of the deceased spouse eliminates that spouse's DSUEA from the calculation of the surviving spouse's applicable exclusion amount. This statutory failure to provide a carryover of unused DSUEA from prior spouses is referred to as a lack of "privity." The Joint Committee on Taxation issued an "errata" suggesting that it may be necessary to change "basic exclusion amount" to "applicable exclusion amount" in order to achieve the statutory intent.

3. The Estate Tax Return Trap. Section 2010(c)(5) provides that in order to obtain portability, the executor of the estate of a deceased spouse must file an estate tax return upon which an election is made to use portability. In Notice 2011-82, the IRS indicated that by virtue of filing the return, the executor will be deemed to have made the election unless a contrary intent is manifest as part of the return. Although there are projected to be about 8,000 estates per year that exceed the current filing threshold of approximately $5,000,000, this filing requirement could force up to 1,000,000 estates per year to file an estate tax return (see November 2, 2011 ACTEC Report, "Eight Recommendations to Improve Implementation of Existing Tax Laws," p.12). ACTEC recommends that as an alternative to filing an estate tax return, estates be allowed to elect portability by providing the required information on the decedent's final 1040.

4. The Portability Clawback. A surviving spouse may use the DSUEA of a deceased spouse by making gifts during the survivor's lifetime. If the survivor later remarries a spouse with less DSUEA who also predeceases the survivor, the "last deceased spouse" rule will result in a lower DSUEA for purposes of the survivor's estate tax unified credit under § 2010. This will create a "portability clawback" which is similar to the normal clawback situation previously discussed. In the first case, the clawback results from less exemption available at death because of a legislative reduction in the basic exclusion amount. In the second case, the clawback results from a remarriage and the operation of the portability rules. Because the circumstances of these two clawbacks are very different, the legislative solutions, if any, may also be very different.

5. Adjusted Taxable Gifts Issue. As noted above, the DSUEA is limited to the excess of the last deceased spouse's basic exclusion amount over such spouse's tentative tax base amount under § 2001 (also subject to the additional limitation of the surviving spouse's basic exclusion amount). Because the amount of adjusted taxable gifts is included in the tentative tax base amount, the higher the adjusted taxable gifts amount, the less DSUEA that will be available. Although this system may work just fine in most cases, if the gift tax exemption was fully used and substantial gift taxes were paid in one year, but additional estate tax exemption was available in the year of death, the formula will nonetheless reduce the DSUEA otherwise available by the full amount of adjusted taxable gifts, even though a portion of those gifts triggered the payment of gift taxes and did not use up any gift tax exemption. A more logical approach would be to modify the tentative tax base amount in such a case to only include adjusted taxable gifts to the extent they were actually covered by gift tax exemption.

IV. Conclusion: Sunset, Repeal, or Something In Between. At the present time, there is a great deal of uncertainty with respect to the future of the federal estate tax laws. On the one hand, many important provisions are scheduled to sunset at the end of this year, which would result in a return to the much less favorable provisions of the past. On the other hand, there continue to be proposals to repeal the estate tax. However, if the experience of the temporary estate tax repeal in 2010 in conjunction with the end-of-the-year, retroactive reinstatement of the tax (subject to an election out into a different tax system) teaches us anything, it is to expect the unexpected. Into this framework of confusion, the possibly fleeting concepts of portability and clawback are a perfect fit. Just as it is difficult to rely on the federal estate and gift tax laws in general because of their transitory nature, it is hard to know whether clawbacks and portability are permanent features of our tax code or temporary visitors who will disappear from the stage almost as soon as they arrived. The only thing certain is that time will tell--and we probably won't know anything more until it does.

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Chapter 1: It's a dark and stormy night. You are sitting all alone in your study when suddenly there is a knock at the door. As you open the door, a man dressed in a dark suit and tall hat pushes past you, into the house. He seems quite agitated. You reluctantly invite him to sit down, but he declines. He claims to be the trustee and executor of your recently deceased uncle's estate—your mother's brother. Your own parents have been deceased for many years and they never mentioned the fact that your mother had a brother. The stranger pulls a document from his satchel and quickly signs it in your presence. It is a deed conveying title of your uncle's mansion to you as his sole heir and beneficiary. Then the mysterious visitor leaves as quickly as he came, never to be seen again.

Chapter 2: Six months later, there is another knock at the door. Another man is standing there, with a grim expression on his face. He is the groundskeeper of your uncle's property, which you still have not seen. He regrets to inform you that the mansion has burned to the ground. Even worse, you learn that there was no insurance on the property.

Chapter 3: Several months later, and about a year since your uncle's death, there is another knock at the door. This time a woman is standing there. She claims to be from the government but she is not here to help. Instead, she hands you a letter stating that you owe $1,750,000 in estate taxes plus interest and penalties. When you protest, saying that you never even saw the property and that it is now worthless, she informs you that it doesn't matter whether you ever saw it, that the property was worth $10,000,000 when your uncle died, and that you are a transferee who is personally liable for the unpaid estate tax.

Chapter 4: Knowing that you can never pay the amount owing, you begin to search for ways to defend yourself. One day while searching the county records for information, you discover a marriage license for your uncle and his housekeeper, whom he had secretly married late in life. Your search also uncovers a death certificate revealing that this woman died shortly before your uncle, leaving everything she owned to him. To your surprise, you also learn of a new tax law called "portability," which allows a surviving spouse to use the exemption of a deceased spouse.

Chapter 5: You next find yourself in court, defending against the claim for unpaid estate taxes. When you introduce the doctrine of portability, the government responds that your uncle was not married. At this time, you present the court with the marriage license and death certificate. The government then argues that portability can only be obtained by making an election on a timely filed estate tax return, and that the time for such a return has passed. In response, you demonstrate that the government has allowed an automatic six month extension for the initial portability returns, making fifteen months total, that the time expires tomorrow, and that you have just placed in certified mail an estate tax return for your deceased uncle's wife. You then hand the judge the mailing receipt.

Chapter 6: The court is finally ready to make its decision, which is that, because of portability, your uncle died with an applicable exclusion of $10,000,000, exactly the amount needed to cover his estate. Although the government tries to argue that a clawback should somehow apply, the court rules that enough is enough, and issues a final judgment in your favor.

Chapter 7: A few months later, there is another knock at your door. A young woman stands there holding a large envelope containing many of your uncle's personal papers. She says that she worked as a secretary in your uncle's house and that she was able to rescue these papers at the time of the fire. In the envelope, you discover an insurance policy covering your uncle's house. With the proceeds, you are able to marry the secretary, rebuild the mansion, and live there happily ever after. The End.