Global Wealth Management
Switzerland

Client Alert

November 2019

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IRS Issues Final Regulations Protecting Current Large Gifts from Future Taxation

The US Internal Revenue Service ("IRS") issued final regulations that ensure US citizens and domiciliaries who make gifts of up to their available transfer tax exclusion amount ($11.58 million in 2020) between 2018 and 2025 will receive the full benefit of the gift and estate tax exemption without risk of "clawback" if the exclusion amount is lowered by future legislation. This guidance is a relief for many individual taxpayers contemplating the use of the increased exclusion amount, although the US estate and gift tax landscape remains subject to change due to potential political developments over the coming years.

Background – 2018 US Tax Changes

The Tax Cuts and Jobs Act ("TCJA") increased the baseline for gift and estate tax exclusion amounts[1] from $5 million to $10 million, which is adjusted annually for inflation effective January 1, 2017. The inflation-adjusted exclusion amount was $11.4 million in 2019 and will be $11.58 million in 2020. This exemption allows taxpayers to transfer up to this amount (or double the amount for a married couple) during life, or at death, without triggering gift tax or estate tax. Absent legislative intervention, the federal exclusion amount is scheduled to revert to $5 million (adjusted for inflation) on January 1, 2026. Depending upon the political climate in the United States, there is also the possibility that the exclusion amount could be further reduced to much lower levels, such as pre-2010 exclusion amounts of $3.5 million or even lower.

It is important to note that the exclusion amount applies only to US citizens and US domiciliaries for estate and gift tax purposes. Absent an applicable estate and gift tax treaty, there is generally no available exemption for lifetime transfers by non-US domiciliaries. In addition, a reduced estate tax exemption of only $60,000 applies to non-US domiciliaries.[2]

Clawback Concerns

Based upon the applicable tax computation, uncertainty existed as to whether gifts that were originally exempted from gift tax because of the increased exclusion would be clawed back into the taxpayer's estate if the taxpayer passed away in a later year when the exclusion amount had been reduced.

The IRS released final regulations on November 22, 2019, addressing such concerns and largely adopted the measures found in earlier proposed regulations released in November 2018. The final regulations permit US citizens or US

[1] The US federal estate and gift taxes are unified under the US transfer tax system, with an applicable maximum tax rate of 40% and available exclusion of a $10 million baseline amount, subject to annual adjustment for inflation. The adjusted exclusion amounts were $11.18 million (2018) and $11.4 million (2019) and will rise to $11.58 million (2020).

[2] Non-US domiciliaries are generally taxed only on their US-situs assets (e.g., US real estate, stock of US corporations, etc.). Non-US domiciliaries should confirm whether an estate and gift tax treaty is in force that modifies the definition of US-situs assets for estate and gift tax purposes.

domiciliaries to apply the federal exclusion amount in effect at the time the gift is made, or at the decedent's death, whichever is greater. The final regulations reassure taxpayers that, if they utilize the increased exclusion amount but pass away in a year when the exemption is reduced, the amounts sheltered by the increased exclusion amount when the transfer was made would not be clawed back into the decedent's estate for estate tax purposes.

In addition, the IRS confirmed that for purposes of calculating the portion of the exclusion amount used by a taxpayer, any amounts transferred would first be applied against the original exclusion amount (for example, against the lower amount of $5 million, adjusted for inflation), as opposed to the amount of the current exclusion amount over such future lower amount. As a result, the increased available exemption under the TCJA is essentially a *use it or lose it* proposition available under current law through December 31, 2025.

As an example, assume taxpayer made cumulative taxable gifts of $4 million in 2019, all of which were sheltered from gift tax on the date the gifts were made. Assume further that taxpayer dies in 2026 with an estate of $3 million, and the exclusion amount on taxpayer's death is $5 million. For purposes of the ordering rules, the $4 million in lifetime gifts first reduce the $5 million base exclusion amount, as opposed to reducing the $11.4 million exclusion available at the time the gift was made (i.e., the $4 million gift does not come off the top of the bonus exclusion amount). As a result, the taxpayer would have an available exclusion of $1 million remaining at his death, and his estate would be subject a 40% estate tax on $2 million ($3 million estate - $1 available exemption). In order to utilize part of the bonus exclusion, taxpayer would have had to make gifts in excess of $5 million before the exemption was reduced.

Time to Act

Taxpayers that intend to make large gifts should consider doing so soon (potentially in advance of the upcoming presidential elections), if they have not done so already, due to the use it or lose it nature of the increased exemption and particularly in light of the political uncertainty in the United States between now and 2026.

Non-US domiciliaries with US-situs assets, specifically US real estate, seeking to take advantage of an applicable estate and gift tax treaty should also consider the potential impact of current and future estate tax exclusion amounts available to them.

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