A Crucial Window for Estate Planning: Preparing for 2026

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Individuals and families face a looming deadline to revisit their estate plans. In 2017, the Tax Cuts and Jobs Act significantly increased the lifetime estate and gift tax exemption amounts, currently $13.61 million for individuals and $27.22 million for couples. However, this increase is set to expire after 2025 and, absent new legislation before then, would revert to approximately $7 million for individuals and $14 million for couples, subject to inflation adjustments.

This pending reduction in exemption amounts creates a "use it or lose it" scenario for those with taxable estates as failing to capitalize on the current exemption could result in a substantial financial impact. Given the federal estate tax rate of 40% and an expected exemption reduction of $7 million, this reversion would result in tax liability of as much as $2.8 million per individual or $5.6 million for a couple transferring their estate to heirs.

THE NO CLAW-BACK RULE AND THE BOTTOM-UP APPROACH

The IRS has clarified that benefits utilized under the current exemption will not be subject to future reduction or "claw-back." This means that proactive estate planning can lock in a permanent tax advantage, making now an opportune time to act.

When utilizing the exemption, a "bottom-up" approach is applied. For example, if $6 million of the $13.61 million exemption is used towards gifts today, $7.61 million would remain. In 2026, if the exemption limit is slashed to $7 million, the $6 million used will not be recalculated against the reduced exemption. Consequently, after the $6 million gift is made, an individual would have only $1 million remaining to shield assets from estate and gift tax.

ESTATE PLANNING FOR THE MID-AFFLUENT

Contrary to common belief, the benefits of estate planning are not the exclusive province of the ultra-wealthy. The mid-affluent — individuals and couples poised for significant asset growth — should also consider their future tax exposure. A mid-affluent couple with a $10 million estate today could see their assets grow well beyond the future exemption thresholds due to compounding investment returns. Historically, assets such as those tracked by the S&P 500 have seen an average annual return of 7.3% over the past 30 years. Such a rate of return will double an estate's value every decade. Thus, estate planning is imperative for those who may not currently exceed the exemption but may in the future.

Sports fans have no doubt heard the famous quote often attributed to hockey legend Wayne Gretzky, "Skate to where the puck is going to be, not where it has been". The same philosophy applies to estate planning; do not plan based on where the estate stands today; create a plan for where the estate *will likely be* in the future.

STRATEGIC ESTATE PLANNING FOR THE AFFLUENT

For those in the higher wealth brackets, specifically with estates ranging over $20 million, estate planning becomes even more critical as we approach 2026. The scheduled reduction of the estate and gift tax exemption underscores the need for meticulous planning, particularly for those whose assets far exceed the current $27.22 million exemption for couples.

A nuanced approach for a couple with $30 million in wealth involves one spouse fully utilizing their $13.61 million exemption by transferring assets either directly to beneficiaries or into trusts. This maximizes the current exemption of one spouse, ensuring that a significant portion of the estate is protected from future estate tax. The second spouse retains their exemption, which, even after the anticipated reduction, offers another layer of tax shelter. The second spouse also has the option of using a portion of their exemption, thereby removing future appreciation from their estate. This strategy balances the benefits of current tax law with the need for financial flexibility and security.

CORE ESTATE TAX PLANNING TECHNIQUES

Regardless of estate value, there are numerous techniques and account structures available to help minimize estate tax consequences. Following is a summary of the most common among these.

Lifetime and Annual Gifting

As essential tools in the estate planner's toolkit, these strategies facilitate the transfer of wealth to the next generation while minimizing the estate's tax exposure. Lifetime gifting removes assets from the estate, potentially shielding them from estate taxes on future appreciation. Concurrently, annual gifting leverages the IRS's exclusion amounts, currently $18,000 per recipient ($36,000 per couple) to systematically reduce the estate's taxable value. Beyond the annual exclusion gifts, direct payments of tuition or medical expenses have no gift tax limitation at all. Consequently, annual gifting thus offers a methodical approach to estate reduction that can significantly impact over time.

Estate Planning with Irrevocable Trusts

A cornerstone of estate tax planning, irrevocable trusts serve multiple purposes, from reducing the taxable estate to providing for heirs in a tax-efficient manner. Trusts such as Spousal Lifetime Access Trust (SLATs), Grantor Retained Annuity Trust (GRATs), and Intentionally Defective Grantor Trust (IDGTs) offer structured ways to transfer wealth, each with its unique benefits and considerations. For example, SLATs allow spouses to access trust assets, if necessary, while GRATs are excellent tools for transferring asset growth out of the estate. IDGTs are particularly effective for transferring business interests or real estate by freezing the value of the transferred asset at the time of the transfer, thus removing future appreciation from the estate. Trusts such as Qualified Personal Residence Trust (QPRTs), Charitable Remainder Trust (CRTs), Charitable Lead Trust (CLTs), Dynasty Trusts, and Irrevocable Life Insurance Trusts (ILITs) also can provide opportunities to reduce estate and gift tax exposure.

Spousal Lifetime Access Trust

A SLAT offers a strategic avenue for one spouse to support the other while also achieving estate tax savings. By establishing a SLAT, assets are transferred into an irrevocable trust for the benefit of the spouse and potentially other family members. This move effectively removes the assets from the grantor's estate, mitigating estate tax exposure. The beneficiary spouse can access the trust's income and, in certain situations, the principal for needs such as health, education, maintenance, or support (HEMS), without compromising the tax benefits. The grantor also has the option to pay the tax burden on the grantor trust, allowing the trust to grow tax-free and further reducing their future taxable estate. This trust allows for significant asset protection and growth outside the estate, enhancing future financial security for heirs.

Grantor Retained Annuity Trust

The GRAT strategy involves the grantor transferring assets to a trust, retaining the right to receive annuity payments for a predetermined period, typically two to ten years. At the end of the trust term, any remaining assets pass to the designated beneficiaries, often to family members or heirs.

A GRAT is particularly effective in low-interest-rate environments or when assets are expected to appreciate substantially. The key advantage here is the potential for asset appreciation to exceed the IRS's assumed rate (the Section 7520 rate), allowing the excess to pass to beneficiaries free of additional taxes. However, it's also crucial to note that if the grantor passes away during the trust term, the remaining assets might be included in their estate, potentially negating some of the GRAT's benefits.

Legislation has unsuccessfully targeted GRATs for several years, including the bill, "Getting Rid of Abusive Trusts", introduced by Senators Wyden and King on March 24, 2024, which would tax property transfers between the trust and the grantor of the trust. Proposed legislation such as this only adds to urgency to plan. Previous legislation has targeted the "zeroed-out" GRAT, otherwise known as a Walton GRAT. This is a GRAT in which the value of the gift to the beneficiaries is reduced to zero. Put more simply, a Walton GRAT allows a grantor to transfer appreciation of value tax free to beneficiaries at the end of the trust term.

Intentionally Defective Grantor Trust

The IDGT is a very effective tool for transferring wealth, especially useful for appreciating assets like family businesses or real estate. By designating a trust as "intentionally defective," the grantor separates the income tax responsibility from the estate and gift tax implications. This allows the assets within the trust to grow tax-free because of the grantor's payment of the income taxes, which further reduces the estate size indirectly.

Transferring business or real estate assets to an IDGT in exchange for a promissory note allows the assets to grow outside the grantor's estate while the trust repays the note with the business's income. This method effectively moves appreciable assets out of the estate without immediate tax consequences.

Another advantage of IDGTs, as well as other irrevocable gift trusts, is the ability to utilize a "swap power", enabling a grantor to swap assets of equivalent value between their personal estate and the trust. By swapping non-appreciated assets to the trust for appreciated assets, the grantor can manage the trust's holdings actively to ensure they receive a step-up in basis upon the grantor's death, minimizing capital gains taxes for heirs.

Qualified Personal Residence Trust

A QPRT enables the transfer of a primary or secondary residence into a trust, significantly reducing the gift tax consequences by discounting the value of the residence based on the term of the trust and the grantor's retained interest. At the end of the trust term, the ownership transfers to the trust's beneficiaries outright or in further trust.

This strategy not only lowers the estate's taxable value by removing the residence and its future appreciation, but also allows the grantor to continue living in the home for a specified period, typically 10 to 20 years. Should the grantor outlive the term, they can remain in the home by paying rent to the trust's beneficiaries, further reducing the size of the estate by removing additional assets from the estate's tax calculation. However, should the grantor pass away within the trust term, the tax benefits could be reversed, negating the tax benefits of the trust.

Charitable Remainder Trust

A CRT is an excellent vehicle for supporting charitable causes while providing for the grantor or other named beneficiaries. By transferring assets into a CRT, the grantor secures an income stream for a term of years (not to exceed 20 years) or for life, with the remainder interest designated to charity at the end of the trust term or at the death of the last beneficiary. The CRT offers immediate income tax deductions based on the present value of the remainder interest, and potential savings on capital gains taxes, making it an attractive option for those with appreciated assets.

There are two types of CRTs, the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT). The CRAT provides beneficiaries with a fixed annual income based on a predetermined percentage, for example 7%, of the initial fair market value of the assets. A CRUT provides beneficiaries with a variable annual income based on a predetermined percentage of the trust's assets which are revalued annually.

In more advanced planning, CRTs can be structured to benefit multiple generations, extending beyond the grantor's lifetime to provide for children and even grandchildren, all while ensuring that a portion of the trust's value ultimately supports charitable causes. The maximum term is dependent on the present value of the remainder interest going to charity which must be at least 10%. In some circumstances this multigenerational payout is used by planners as an alternative to the inherited stretch individual retirement account (IRA) where inherited IRAs were paid out over a beneficiary's life expectancy. After the Secure Act, the payout term has been generally limited to a 10-year payout period for most inherited IRAs, and therefore the stretch CRT can be sometimes used as an alternative.

Charitable Lead Trust

Conversely, a CLT focuses on providing immediate support to charitable organizations through annual payments from the trust for a specified period or a lifetime, with the remaining assets eventually passing to non-charitable beneficiaries.

The grantor transfers assets into an irrevocable trust, receiving a charitable or estate tax deduction for the calculated present value of the charitable payments. At the end of the trust term, the remaining assets in the trust are typically distributed to non-charitable beneficiaries, such as family members or heirs. The present value of transfer of the remaining assets to the beneficiaries at the end of the trust term is a taxable gift which the lifetime exemption can offset. Facilitating the transfer of assets to non-charitable beneficiaries with reduced estate or gift tax consequences makes a CRT a powerful tool for legacy planning.

Dynasty Trusts

A Dynasty Trust, also known as a Generation Skipping Tax (GST) Trust, is designed for the long-term preservation of assets across multiple generations, avoiding 40% estate and GST taxes with each generational transfer. The grantor establishes an irrevocable trust and transfers assets into it, removing them from their taxable estate and leveraging the grantor's $13.61 million 2024 exemption (the GST exemption amount is the same as the estate and gift tax exemption). By electing to use the $13.61 million GST exemption on the gift, the assets avoid estate taxes that would otherwise be incurred when the assets pass to each future generation. Special rules apply to the inclusion ratios and applicable fraction formulas, depending on the type of trust receiving the GST, so care and planning are required when setting up the trust.

The trust can provide income and support to the grantor's children during their lifetime, with the remaining assets passing to the grandchildren or other skip beneficiaries upon the children's death. The grantor can impose certain restrictions, such as limiting access to the funds until a beneficiary graduates from college. Beyond tax benefits, GST Trusts provide a shield for assets against potential future liabilities such as divorce settlements among beneficiaries, ensuring that the wealth remains within the family lineage.

Dynasty Trusts can extend for centuries, depending on state laws. In Florida or Wyoming for example, a Dynasty Trust can endure up to 1,000 years. In Illinois, the trust can last 360 years. By leveraging the grantor's GST exemption, significant assets can be moved out of the estate, reducing overall estate tax liability, offering a durable solution for generational wealth transfer.

Irrevocable Life Insurance Trusts

An ILIT serves as a crucial tool for estate liquidity and preserving family wealth. By owning a life insurance policy within an irrevocable trust, the proceeds from the policy are not included in the estate, thus not subject to estate taxes. This ensures beneficiaries receive the full amount of the life insurance benefit tax-free, providing essential liquidity for estate obligations without diminishing the estate's value.

Typically, ILITs are funded by purchasing new policies, which avoids the three-year look-back period associated with the transfer of existing policies. For couples, second-to-die policies within an ILIT offer lower premiums and/or higher coverage given a couple's longer joint life expectancy. Premiums can be paid through gifts to the trust, typically classified as "present interests" to qualify for the annual $18,000 gift tax exclusion by using a Crummy tax provision.

Financing life insurance policy premiums is a very effective method of paying for a large upfront or five-to-ten-year series of premium payments. A loan from a bank or premium financing company allows the policy owner to borrow the cash necessary to pay the insurance premium. By borrowing, the grantor does not have to liquidate assets, avoiding an unfavorable taxable capital gains event. It also leaves appreciating assets in the portfolio available for other, higher yielding investments. The loan is repaid either before death out of cash values of the life insurance, or out of the life insurance proceeds upon death, leaving the interest paid on the debt as the only cost of setting up the ILIT.

Family Limited Partnerships (FLPs)

The types of trusts discussed above are just a few of the planning options available to protect assets and minimize estate tax liabilities in advance of 2026. For taxable estates, additional planning options include Family Limited Partnerships which facilitate the seamless transfer of business interests to the next generation, ensuring continuity and protection of the family enterprise while minimizing estate tax exposure.

By transferring ownership interests in closely held family businesses or investments to FLPs, individuals can leverage minority ownership and non-voting valuation discounts as high as 30-35%, effectively reducing the taxable value of their estates even further. FLPs are used to facilitate family business succession planning and asset protection, allowing for wealth transfer among families.

Consider a parent transferring a $20 million interest in a family business to their child through a FLP. By applying a 35% minority discount, the transfer is valued at $13 million for gift tax purposes, staying under the current $13.61 million exemption threshold, transferring wealth tax-efficiently.

ADDITIONAL EXPIRING TAX PROVISIONS

The Tax Cuts and Jobs Act brought about over 20 significant changes to the tax landscape. Like the increased estate and gift tax exemption limits, many of these other favorable tax changes are also set to expire at the end of 2025. Key provisions poised to sunset include lowered marginal tax rates, expanded tax brackets, and the 20% Qualified Business Income deduction for pass-through entities, among others.

PROACTIVE PLANNING IN UNCERTAINTY

The future of TCJA provisions remains uncertain, heavily influenced by the political landscape. Given this uncertainty, proactive and strategic estate planning is imperative. Planning strategies may include optimized timing of income and deductions, retirement contributions, Roth conversions, loss harvesting, charitable giving, and perhaps even a reexamination of business structures, recognizing that the 21% C corporation tax rate was made permanent by the Act. Integrating lifetime gifting, trusts, and FLPs into your estate plan can also offer robust protection against shifting tax policies and can help mitigate the impact of expiring tax provisions and potentially higher tax rates post-2025.

Working closely with financial advisors, tax professionals, and estate attorneys ensures that these strategies align with broader financial goals, maximizing the benefit to heirs while minimizing tax liabilities and securing and preserving a legacy for generations to come.

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