SUNSET IN 2026 – PLANNING FOR THE FEDERAL ESTATE TAX EXEMPTION REDUCTIONS

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WINTHROP WEALTH

What is it

The federal tax law passed in 2017 (The Tax Cut and Jobs Act) changed significantly the tax impact on transferring wealth from one generation to the next. When someone with a significant amount of wealth passes away, a tax is paid by the estate to the federal government. There has historically been an exemption to the estate tax before the tax is applied.

At the time of the last revision to the law, 2010, the exemption amount was set to $5 million per person, indexed for inflation. A couple could pass a combined $10 million without any federal estate taxes being incurred. In 2018, when the new law became effective, the exemption was doubled, which brought it to $11,180,000 per person due to prior inflation adjustments. As of 2023, the exemption is $12,920,000 per person.

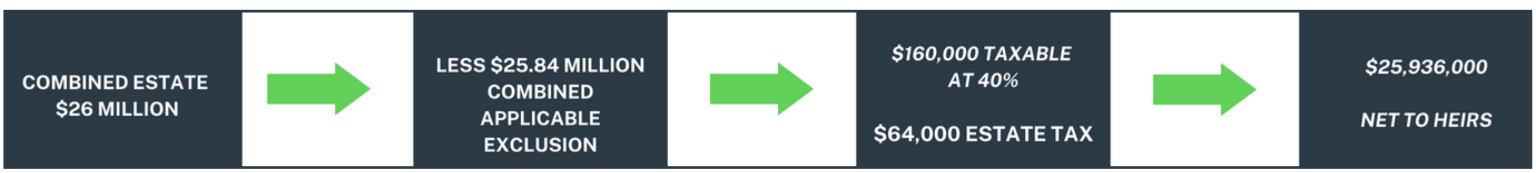
The exemption can be used at death (and combined with a spouse) or can be used during lifetime to make gifts. The result is that a married couple can pass on an estate valued at nearly $26 million today before the 40% estate tax comes into play.
However, the 2017 Tax Cut and Jobs Act contained sunset provisions for several income and estate tax components. On January 1st 2026, the estate tax exemption will revert to the pre-2018 numbers, unless there is a specific action taken by Congress to avoid this. Absent a new action, the exemption will reset to the 2011 rate of $5 million per person, with adjustments for inflation. A reasonable estimate of the reset federal estate exemption amount is approximately $7 million.

Impact

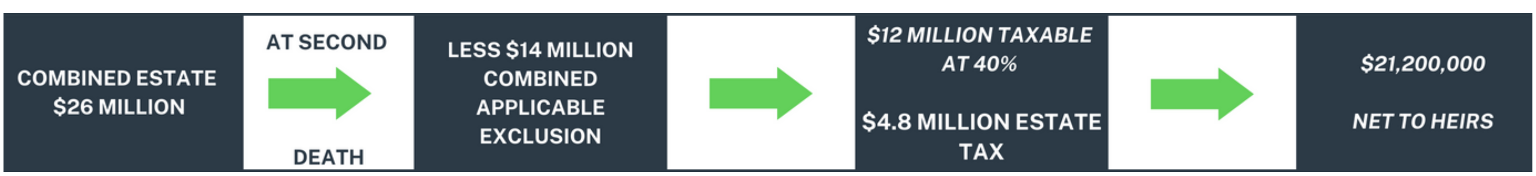
If your net worth today is about $13 million or less, your estate will not be subject to taxes when passed to the next generation – transfers between spouses are tax free under the unlimited marital exemption (special rules apply to spouses who are non-citizens of the United States) In 2026, this same $13 million estate would be subject to a 40% tax on the excess over the exemption, or approximately $2.4 million in taxes.[1,2]

A couple worth $26 million today would be exempt from taxes, but in 2026 would be subject to a tax of roughly $4.8 million.[3]

Simplified estate tax impact for a married couple in 2023:



Simplified estate tax impact for a married couple in 2026:



In summary, without additional legislation by Congress, wealthy individuals and families may be subject to significantly more tax on larger estates.

There are proposals to lower the exemption further as well as to continue it as is into the future. But the reality is that while we simply don't know what Congress will do, we do know what the law is today and that there is a window of opportunity that may very possibly expire – so now is the time to do planning to help reduce the impact to your family.

1. IRC § 2001 https://codes.findlaw.com/us/title-26-internal-revenue-code/26-usc-sect-2001
   2010 https://codes.findlaw.com/us/title-26-internal-revenue-code/26-usc-sect-2010.html
2. $13 million net estate, less $7 million estimated appliable exclusion equals $6 million taxable estate. 40% tax equals $2.4 million.
3. $26 million combined net estate, less $14 million estimated combined applicable exclusion equals $13 million taxable estate. 40% tax is $4.8 million.

Planning options and opportunities

1. ***Consider Utilizing the Increased Exemption Amount Now***

   Take advantage of this window (from now until December 31st 2025) to transfer assets.
   Consider making outright gifts to irrevocable trusts of the exemption amount. This can be liquid or illiquid assets. This will remove the assets – and, most importantly, any future growth in value – from the taxable estate permanently. All or part of the exemption may be used without paying gift taxes and the IRS has ruled that gifts now will not be clawed back to the estate when the exemption goes down.

2. ***Take Advantage of Valuation Discounts***

   Take advantage of techniques such as valuation discounts to increase leverage of the assets being gifted. Typically, we can get valuation discounts on illiquid assets such as minority shares of a closely held business. The valuation discounts apply when the gifted asset is subject to lack of marketability and lack of control. This discount on the gift is potentially advantageous to both the individual gifting and the beneficiary.

3. ***Retain Flexibility in Accessing Your Funds***

   Be aware that flexibility is possible. We can work with you and your estate planning attorney to find methods that help you take advantage of the exemption amounts while retaining flexibility for you and your spouse. One such example is a spousal lifetime access trust which allows one spouse access to funds that were gifted to the trust by the other spouse. Some will also find that selling an asset, such as a business interest, to a trust with a promissory note is effective. While the mechanics of this are complex, the result is the removal of potential future growth from the estate while the option to be paid back from the trust or forgive the note and make a gift before the exemption expires is retained.

4. ***Leverage Insurance to Offset Estate Tax Exposure***

   Create powerful leverage using tools such as life insurance inside a trust. Moving existing insurance into a trust that is outside of the estate is a leveraged gift that reduces estate tax exposure. Adding a new policy to a trust, such as survivorship (second to die) insurance provides a large amount of liquidity for a small amount of premium dollars. This helps offset any remaining estate taxes for literally pennies on the dollar.

Now is the time to take action

Ultimately, it is very important for anyone who has enough wealth to be potentially subject to estate taxes to take advantage of this limited time to review existing plans and to make moves that are possible now to preserve what you've built up over your lifetime. Seek to maximize the value of your assets transferred to your heirs.