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Federal Estate Tax Exemption Sunset: What You Need to Know

Note: The goal of this newsletter is to provide an illustration of the general estate tax rules and common strategies many families are using to avoid incurring estate taxes. This document is not to be meant as legal or tax advice. We strongly recommend consulting with your estate planning attorney, who will be familiar with your specific situation, relevant federal and state laws, and their implications on your specific estate tax situation, if applicable.

Summary

On January 1, 2026, the federal estate tax exemption (explained below) will sunset from $12,920,000 per person (the current amount in 2023) to about half of this amount, depending on annual inflation increases. This change might have significant implications for your estate planning, tax planning, and overall wealth management strategy.

How Estate Taxes Work

When you pass away, the combined value of all your holdings and assets, liquid and illiquid, becomes known as your gross estate. This gross value is reduced by deductions, including most commonly debts, estate administration expenses, property that passes on your surviving spouse, and property gifted at death to qualified charities[1]. This value (gross estate less deductions) is known as your taxable estate.

Under federal law, taxable estates that are worth more than the current exemption (currently $12,920,000 for a single person or $25,840,000 for a married couple, as of 2023) are subject to federal estate taxes. Estates below these limits are known as “non-taxable estates”, as they are not subject to federal estate tax.

States also set their own estate tax exemption. Here are three common state exemptions we encounter:

- Washington: $2,193,000 per person[2].
- Oregon: $1,000,000 per person[3].
- California: Not applicable. California does not have an estate tax, but does have relatively high probate fees[4].

Both federal and state estate taxes are paid from the assets of your estate before they are distributed to your heirs and/or beneficiaries. The federal estate tax return, Form 706, is due nine months after your death, not including an optional six-month extension.

Four Basic Methods to Reduce Estate Taxes

If your taxable estate is likely to exceed the exemption, which might be cut in half as mentioned, there are four straightforward ways to avoid or reduce this tax. None of these basic methods requires much administrative work, although we recommend discussing them with your advisor and attorney.

Annual Gifting

You can gift up to $17,000 to any person per year, regardless of family status, without incurring gift/estate tax or filling out a gift tax form[5]. Married couples can gift up to $34,000 annually to any single person, using a strategy called "gift splitting." For families with taxable estates, we often see this strategy being used with children, grandchildren, and other relatives. Annual gifting both reduces the value of your taxable estate and allows you to teach younger generations about the value of financial stewardship.

Qualified Transfers

Under current law, any person can make payments on someone else's behalf if made directly to a qualified academic institution or medical care provider. So, as an example, you could pay your granddaughter's tuition directly. These payments both escape gift tax and reduce the value of your taxable estate.

Charitable Contributions

You can make charitable contributions while you are still alive. If you are passionate about a particular cause, donations to qualified charities remove assets from your taxable estate. Many families prefer using Donor Advised Funds (DAFs), which allow you to contribute cash or certain types of property and re-

ceive an immediate income tax deduction (if you itemize on your taxes). Property contributed can grow in your DAF and be granted at your direction over time to qualified charities.

Spend it Down

You can simply spend down your net worth over your lifetime to reach the level of the federal estate tax exemption. Rather than having your estate incur federal estate taxes, you can draw down the value of your estate by increasing your expenses. Your advisor can model scenarios evaluating the feasibility of this approach and recommend comfortable annual spending targets. However, for many families that have attained a net worth greater than the federal exemption, spending it down may feel extravagant.

Four Advanced Methods to Reduce Estate Taxes

If any combination of the four simple methods is insufficient to reduce your estimated estate tax liability to a reasonable level, there are a number of more advanced methods at your disposal.

Again, we strongly recommend consulting with an estate and trust attorney, as they will be most familiar with your specific situation and your state's laws. Below, we will describe four common advanced methods.

Spousal Lifetime Access Trust (SLAT)

A Spousal Lifetime Access Trust is an irrevocable trust[6]. Property that you contribute into most irrevocable trusts lives outside your taxable estate. SLATs allow one spouse (the "donor") to gift property into a trust for the benefit of the other spouse (the "non-donor"). Other relatives can also be named as beneficiaries. Gifts into SLATs are generally not taxable, as the donor is utilizing their lifetime exemption.

SLATs bring another potential benefit in that they are Grantor Trusts. In a Grantor Trust, the donor, not the trust, pays the tax on the income generated within the trust. This further reduces the taxable estate, as the income tax is a legal obligation of the donor, not the trust.

If structured properly, the property contributed into a SLAT, and its potential appreciation, is removed from the donor's estate. These types of vehicles are beneficial for younger and healthier individuals (to allow more time for capital appreciation) and for those in which there is little to no chance of divorce. If a

married couple forms a SLAT and subsequently divorces, the assets are irrevocably "lost" by the donor spouse.

A significant drawback of SLATs is that the property contributed into them does not receive a "step up" in cost basis at death. This requires careful tax and estate planning consideration to evaluate if a SLAT will be beneficial to your family.

Charitable Remainder Trust (CRT)

With Charitable Remainder Trusts, you contribute property into the trust, receive a charitable deduction for the contribution (only for the present value of the remainder interest), avoid capital gains on the asset transfer, and receive an income during your lifetime.

Families typically contribute highly appreciated assets into the CRT. The trustee then sells your highly appreciated assets, does not pay capital gains taxes, and reinvests the proceeds into income producing assets. At this point, you receive a tax deduction for the present value of the charitable remainder interest. Then, for the rest of your life, the trust pays you an income, depending on the structure of the CRT. Charitable Remainder Annuity Trusts (CRATs) pay you a fixed percentage of the trust's *initial* value annually. Charitable Remainder Unitrusts (CRUTs) pay you a fixed percentage of the trust's *latest* value, determined annually[7]. In both cases, when you pass away, the "charitable remainder" is then gifted to the qualified charities you specified in setting up the CRT.

Family LLC

In a Family LLC, the senior family members (typically the parents, a married couple) transfer assets into the LLC in exchange for membership interests, which likely includes controlling shares and non-controlling shares. The original funding of an LLC is generally a tax-free event. The parents start by owning all of the LLC, then sell or gift non-voting interests of the LLC to family members (typically one or more children or trusts established for them).

This type of structure is quite advantageous for families with real estate and closely-held businesses[8]. In essence, the senior family members can retain *control* over property while giving up *ownership* of said

property for estate tax purposes. Typically, the parents end up controlling the real estate and pay enough rent to the LLC to pay household expenses such as property taxes and utilities.

Like all the advanced methods we have described, Family LLCs require careful analysis from your estate planning attorney, tax preparer, and advisor to meet strict compliance rules.

Intentionally Defective Grantor Trust (IDGT)

In an Intentionally Defective Grantor Trust, property is "sold" to the trust in exchange for a promissory note (also known as an installment note)[9]. The note pays enough interest to classify the trust as above-market, but the assets sold are expected to appreciate at a faster rate. If properly structured, this type of structure is an effective estate planning tool that allows you to lower your taxable estate while selling assets at a locked-in value.

The property contributed to an IDGT is often, but not limited to, shares in a private small business. Grantors are usually responsible for paying income taxes generated by assets in the trust. In other words, the trust is "defective" for income tax purposes but "effective" for estate taxes. The beneficiaries of IDGTs are typically children or grandchildren. The other benefit of this transaction is that it allows assets to be bought and sold while not pushing a capital gain onto the parents/sellers.

Putting it All Together

The future of the estate tax exemption sunset will depend on the outcomes of the 2024 U.S. elections. Unified control of the federal government by Republicans might keep the exemption at the higher level of $12,920,000 per person, adjusted upward for inflation. Unified control by Democrats could see the sunset fall back to $6 million to $8 million level, or possibly an even lower level. A divided government might not take any action and therefore let the sunset occur as scheduled.

Regardless of election outcomes, it is very likely that estate planning attorneys will be inundated in 2025 as we come closer to the January 1, 2026 sunset. If you believe this sunset will affect your family's future, we recommend speaking with your advisor and updating your estate plan sooner rather than later.

Together with your attorney and tax preparer, we look forward to ensuring that your legacy transfers in accordance with your vision and values.

Sources:

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