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Beyond the Numbers...



Plan Ahead for Changes to the Lifetime Gift & Estate Tax Exclusion



The current lifetime gift and estate tax exemption is at a historic high, allowing individuals to give away up to \$13.61 million and married couples up to \$27.22 million without incurring federal gift or estate taxes. But, these generous provisions are set to expire at the end of 2025.

In 2026, the exemption will revert to \$5.49 million for individuals and \$10.98 million for married couples, adjusted for inflation from 2017. Most projections show the 2026 exemption will likely fall within the range of \$6-7 million per person after inflation adjustments. This reduction will significantly increase the number of estates subject to the federal estate tax.

With the window closing on the current exclusion threshold, now is the time to reassess and optimize your plans to take full advantage of these higher limits. In this document, we'll walk you through some of your options, with strategic considerations to help you determine which path is best for you.

How will the changes affect taxpayers?

As of 2024, you can gift up to \$18,000 annually to any individual without the gift counting against your lifetime exemption. However, if you gift an individual more than \$18,000, the excess amount will count toward your lifetime exemption. Then, upon death, assets in your estate exceeding your remaining lifetime exemption will be subject to a federal estate tax ranging from 18 to 40%.

In addition to the federal estate tax, you have to consider state taxes. Many states tie their estate tax exclusion to the federal limits, so taxpayers affected by the reduction of the federal exemption amount could also face that same issue on a state level.



Preparing for the lower exemption limits

As the deadline approaches, proactive planning is key. While you have several options, most moves revolve around reducing the value of your estate, maximizing the current lifetime exemption, and protecting your assets with specialized trusts.

Reduce the value of your estate

You can preemptively reduce the value of your estate before the exemption levels drop through donations, accelerated gifting, and discounting strategies. The idea here is pretty simple - you're just transferring assets out of your estate while the higher exclusion threshold is still in effect. But there's a little more to consider.

Donations

By making charitable donations, you can reduce the value of your estate and benefit from charitable deductions. You can donate assets directly to charities of your choosing or through a charitable giving vehicle like a donor-advised fund, private foundation, or charitable trust. This method makes the most sense for those with philanthropic goals who want to offset income taxes and don't plan to leave the entirety of their estate to loved ones.

Accelerated gifting

By making lifetime gifts, you can reduce the value of your estate while the exemption levels are high and provide immediate financial support to your beneficiaries. However, certain gifts, like business interests, may increase the recipient's personal tax burden due to higher income or capital gains. You may also be giving up control over the assets, which could impact your financial security if your circumstances change.

Consider accelerated gifting if you plan to leave a significant portion of your estate to these individuals anyway, and there is minimal risk of them mismanaging the gifted assets. Just be sure to discuss your gifting plan with your beneficiaries and a professional advisor to ensure the gifts align with both your estate planning goals and the financial needs and capabilities of the beneficiaries.



Discounting

You can also use discounting strategies to transfer wealth at reduced values. These strategies involve restructuring assets into Family Limited Partnerships, LLCs, or fractional interests in real estate. Then, beneficiaries leverage valuation discounts based on a lack of control and marketability, allowing for a greater amount of assets to be transferred without exceeding the exemption limits. These entities may also offer an extra layer of protection against creditors and legal challenges.

But, these strategies involve complex valuation issues and tend to be closely scrutinized by the IRS. You would need expert advice to ensure compliance with tax laws, and there is always a risk that changes in tax laws could affect the viability of current discounting strategies. These methods are most suitable for those with substantial assets in businesses or real estate. Effective management will also require cooperation among the beneficiaries sharing fractional interests.

Protect your assets with specialized trusts

You can also use specialized trusts to minimize future tax exposure. Depending on the type of trust used, you may also maintain some control over the management and distribution of your assets.

While there are many types of trusts, Spousal Lifetime Access Trusts, or SLATs, are popular among couples who want to take advantage of the current exemption levels. A SLAT is funded while both spouses are alive. It allows the donor spouse to use their gift tax exemption to fund a trust from which the non-donor spouse can benefit during their lifetime. This gives the beneficiary spouse access to trust assets but removes those assets from the donor's taxable estate immediately.

It's important to note that SLATs are irrevocable - once established, their terms cannot be changed, and the donating spouse loses control over these assets. Any changes in marital status could cause problems. That said, SLATs are best suited for couples in stable marriages, especially where one spouse may not need immediate access to all of their assets.



Beyond SLATs, you can also set up irrevocable trusts for your children. These trusts can specify when and how children access their inheritance, adding a layer of control over the distribution according to your family's needs and goals. For instance, you can distribute assets to children when they reach certain ages or milestones or stipulate that funds will only be disbursed for specific purposes like purchasing a home.

Dynasty trusts are another form of irrevocable trust that may protect your assets for generations to come. These trusts are designed to minimize tax liabilities and provide financial support well beyond the lifespan of the initial contributor. By transferring assets up to the current exemption limit into the trust, the initial transfer is tax-free. Future taxes on the trust's assets are mostly limited to income taxes, but even these taxes can be minimized depending on the specifics of the trust.

Consider life insurance

Regardless of the other methods you implement, consider securing a life insurance policy. Life insurance can supplement other strategies, ensuring that your heirs have the funds to cover estate expenses even if you exhaust the lifetime exemption. Also, life insurance proceeds are generally tax-free. These policies are particularly beneficial if you anticipate estate taxes and have assets that are not liquid or might depreciate if forced into a quick sale.

Creating a life insurance trust can further enhance this strategy. While life insurance proceeds may be tax-free, they tend to be included in the policy owner's estate. An irrevocable life insurance trust can keep the policy out of your estate.

When selecting a life insurance policy, consider your options carefully. Proceeds from life insurance can ensure your heirs receive a predetermined amount, but premiums can be substantial, especially for older individuals with health issues.

Many policies offer features that are customizable, but a key consideration is whether to choose whole life or term life insurance. Whole life is coupled with a savings component that builds cash value, but it's also more expensive. Term life has lower premiums, but there's no cash value accumulation, and coverage ends when the term expires, which could be problematic if not timed correctly.



Prepare for the future now

The impending reduction of the gift and estate tax exclusion requires proactive planning. Waiting until 2025 to start planning could severely limit your options because many of the strategies we've discussed take time to implement. Also, be aware that the IRS may claw back transfers under certain circumstances, applying the lower exclusion amount at death rather than the higher limit at the time of transfer. While the rules surrounding clawbacks are complex, the bottom line is that time is of the essence. The earlier you act, the better.



Final Thoughts

This document highlights just some of the many different estate planning strategies. Each financial situation is unique, and the success of any strategy depends on individual circumstances and current laws. If you would like detailed information and tailored advice, please contact our office to speak with one of our expert advisors.



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