The Estate-and-Gift-Tax Exemption:

Breaking down the upcoming sunset

By Michael Raczkowski, J.D., CFP®
Head of Advanced Planning and Underwriting

The federal estate-and-gift-tax exemption is sunsetting on Jan. 1, 2026 – there's still a golden opportunity to address your estate planning. However, there are a lot of moving parts that need to be considered, such as the mix of assets you have, your income need, your family situation, and your planning objectives.

All these need to be considered when creating your plan.

Tax Cuts & Jobs Act of 2017 (TCJA)

The ticking clock on the sunset

The ***Tax Cuts & Jobs Act of 2017 (TCJA)*** included many tax provisions, but the most relevant for estate planning was the temporary doubling of the estate-and-gift-tax exemption to $10 M (indexed to inflation). Today, because of the indexing, the exemption is currently $13,610,000.

> This enhanced figure is scheduled to sunset to $5 M (indexed to inflation) on Dec. 31, 2025. The projected exemption in 2026 will likely be between $7.25 to $7.5 M per person.

The sunset will happen unless Congress proactively passes legislation to extend it and the President signs it into law. Allowing the sunset of the entire TCJA is an immediate, nearly $4 T tax increase over ten years,[1] without anyone in Congress making a politically risky vote to increase taxes.

The Congressional Budget Office already projects interest on the debt will exceed defense spending **this year.**

Many candidates currently running for office are promising to extend all or most of the TCJA, but that may be unrealistic given the deteriorating fiscal situation. The TCJA was passed almost $15 T of debt ago,[2] in a world of record-low interest rates.[3]

Continues >

[1] Build Your Own Tax Extensions | Committee for a Responsible Federal Budget (crfb.org)
[2] Historical Debt Outstanding | U.S. Treasury Fiscal Data
[3] Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis (DGS10) | FRED | St. Louis Fed (stlouisfed.org)

The Congressional Budget Office[4] projects that current laws and programs will result in a $22 T deficit over the next 10 years or so. Making matters worse, the Social Security Trust Fund will be exhausted in nine years[5] (which would automatically cut benefits by more than 20%), causing more pressure on the budget.

It seems unlikely, against that background, that tax planning in the future will be as favorable for the taxpayer as today's planning conditions.

The clawback and the sunset's incentive

After the passage of the TCJA, estate-planning practitioners immediately focused on a question of clawback, whether clients like you who made large gifts during the limited TCJA window would be subject to a penalty after the sunset.

The IRS later stated there would be no penalty.[6] Specifically, the IRS wrote final regulations to provide a special rule that allows the estate to compute its estate-tax credit using the higher of the credit applicable to gifts made during life, or the exclusion applicable on the date of death.

The IRS' guidance means you may make large gifts, while the exemption is temporarily doubled, without concern that the service will later disallow the gift or bring the value of the gift back into the taxable estate.[7]

Clawback definition: A clawback, in this context, refers to a retrieval or recovery of tax allowances by additional forms of taxation.[8]

The unintended incentive

Based upon the clawback rule described above, TCJA created an unexpected incentive for high-net-worth families to give more than the exemption is expected to be reduced to after the sunset.

EXAMPLE 1

Assume the exemption reduces to around $7.25 M per person in 2026. If a hypothetical taxpayer worth $20 M makes a large gift of $5 M to an irrevocable trust in 2024, then when they pass away after 2026, their estate can calculate the estate-tax credit based on the higher of the credit applied to the gift, or the exemption at death.

In this hypothetical, because the taxpayer gave $5 M, the exemption at death is projected to be higher than the credit applied to that gift.

As a result, the estate uses the higher of the exemption at death or the credit applied to the gift, and the executor realizes the post-2026 exemption remaining for that taxpayer would be reduced by the $5 M gift, leaving $2.25 M in remaining exemption for that taxpayer.

Without factoring in growth, that taxpayer would now have a taxable estate of $12.75 M ($20 M, minus the $5 M gift, minus the remaining $2.25 M exemption after the sunset). The resulting estate-tax bill would be approximately $5,100,000 (40% of $12.75 M).

[4] Budget and Economic Data | Congressional Budget Office (cbo.gov)
[5] https://www.cbo.gov/system/files/2024-06/51136-2024-06-Trust-Fund.xlsx
[6] Federal Register :: Estate and Gift Taxes; Difference in the Basic Exclusion Amount
[7] Taxpayers need to always be mindful that large gifts, if made within 3 years of the death of the taxpayer, are included in the taxable estate. 26 USC § 2035(a).
[8] Black's Law Dictionary, 2nd. Pocket Ed.

EXAMPLE 2

If the same taxpayer as in example 1 gave $10 M in 2020, and dies in 2026, the IRS would permit the estate to calculate the estate-tax credit for the prior gift based upon the credit applied at the time of the gift, which is much higher than the expected exemption.

That taxpayer took advantage and used the higher exemption before it went away. Since the taxpayer had given away more than the prevailing 2026 exemption, the estate would have $0 remaining exemption. The resulting estate tax would be about $4 M (40% of $10 M).

Just by making gifts before the sunset, the taxpayers could realize substantial tax savings. If the gifts were then magnified with life insurance in the trust, the results could be much more substantial, often multiplying the gift several times over.[9]

The Blindside Hit

Targets who don't see it coming

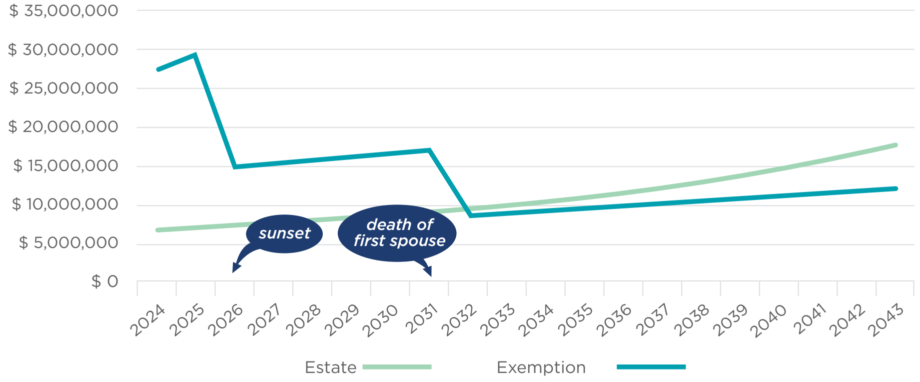
One occurrence, which may be common after the sunset, would be for taxpayers who never thought they were exposed to federal estate taxes to suddenly be significantly exposed.

For example, a couple who had a net worth of $6 M and averaged a 6% rate of return would see that, over 20 years, turn into $18 M. Twenty years ago, they felt very comfortable about their position, and were young enough they didn't feel that they needed to plan for estate taxes.

Because of their comfort, this couple didn't plan to fund a credit-shelter trust, nor did they elect portability, and so upon the passing of the first spouse, their exemption was wasted.

Following the sunset, the survivor would suddenly be on a trajectory where their hard-earned capital is going to be exposed to estate taxes, as their estate's growth outpaces the annual increases in the unified credit.

The graphic illustrates a joint exemption ($27.2 M today) until the sunset. Then it shows the first client death in 2031 and the continued growth of the estate for the survivor.



[9] Life insurance availability and results would be subject to the good health and age of the investor, and claims paying ability of the underlying insurance carrier selected.

The gift-split instinct

Most married taxpayers, husband and wife, file joint tax returns. Often, when it comes to gifting, their instinct is to gift split. In wealth-transfer planning, this means that a couple makes a large gift and reports it on their gift-tax return as one-half coming from the husband, and one-half coming from the wife, using an equal amount of each person's unified credit.

i However, with the looming sunset, this instinct may not be the best approach. Unless they're going to completely maximize their pre-sunset gifting.

EXAMPLE 3

Jack and Diane, a married couple worth $25 M, make a $10 M gift to an irrevocable trust to buy life insurance. They have two options: gift-split or solo gift.

If they gift-split on their gift-tax return, $5 M counts against Jack's exemption, and $5 M counts against Diane's. Fast forward to 2026, and if Jack or Diane died, they would have a remaining exemption of $7.25 M, minus the $5 M previously gifted (about $2.25 M each). By gift splitting an amount less than the full $13,610,000 available exemption, their combined remaining exemption would be about $4.5 M.

If Jack alone made the gift, and passed away in 2026 or later, he would have no remaining exemption (having used more than the available exemption for the $10 M gift), but Diane would have her entire exemption remaining – leaving about $7.25 M available (nearly $3 M more for the family). The estate-tax savings on an additional $3 M exemption would be about $1.2 M.

The portability play

Deceased Spouse's Unused Exemption (DSUE)

You wouldn't leave $5,444,000 on the table, would you? That amount equals the 40% estate tax that would be due on a $13,610,000 bequest.

That amount is also often left on the table because portability is often not elected when the first spouse passes away and an estate-tax return is not required. Portability of the ***deceased spouse's unused exemption (DSUE)*** allows a spouse to carry forward their late spouse's remaining, unused estate-tax exemption.

Portability is often used today in the same way that planning was once used to fund Credit Shelter Trusts upon the passing of the first spouse in the past. For a non-taxable estate, the IRS has permitted up to five years after death for a surviving spouse to elect portability by filing an estate-tax return for the deceased spouse.[10]

i **Portability definition:** A provision in the tax code which permits a surviving spouse to carry forward their deceased spouse's unused estate-tax exemption.

[10] **Revenue Procedure 2022-32 (irs.gov)**

Portability considerations

You may think, "An estate-tax return could be expensive to file. Why do I need it?"

This may be the case if the family is well below the estate-tax exemption. Let's explain why portability is important, particularly for families worth more than $5 M.

1. No guarantee the current estate-tax system remains unchanged. The exemption may revert to a lower number, or the tax rate could increase.

2. DSUE will not grow with inflation but is locked in at the exemption based upon the year the spouse died.

3. Only one DSUE can be held at a time – for the last deceased spouse. If the surviving spouse is likely to get remarried, plan with advisors on how best to use the DSUE from the first spouse.

4. The surviving spouse, when gifting during lifetime, uses the DSUE first, before their own exemption.

5. More work is required by the tax advisors to track and report the DSUE.

Another consideration for portability, which may be used in arguing against portability planning – there's a possibility that a future Congress, looking for revenue, changes the rules.

Portability planning may still be worth it, as the combined revenue lost by electing portability is rather small in the grand scheme. Congress needs trillions of dollars of revenue to support the budget. At best, the repeal of portability would likely raise very little revenue, probably in the low billions. The relatively few elections of portability are therefore potentially a de minimis target, considering the revenue needs of the federal budget.

De minimis definition: Lacking significance or importance, so minor as to be disregarded compare substantial.

Power of portability

EXAMPLE 4

George and Hazel have been married for many years. Through some success with their business, they now find themselves with a $30 M estate, which they'd like to leave to their children.

George passes away in 2022 (when the exemption was $12,060,000), leaving his entire estate to Hazel. Since there's an unlimited spousal exemption, and George and Hazel's initial plan was a pour-over will leaving everything to the surviving spouse, there was no need to file an estate-tax return. This advice had been given because the couple wanted simple planning.

Now, imagine the tax bill when Hazel dies in the future if she elects portability, compared to the bill if she doesn't make that election.

Option	Year of Death	Estate Value (5% growth)	Estate Exemption (3% inflation)	Taxes due	Net to heirs
No portability	2024	$30 M	$13,610,000	$6,556,000	$23,444,000
Portability	2024	$30 M	$27,220,000	$1,112,000	$28,888,000
No portability	2031	$42,200,000	$8,620,000	$13,437,000	$28,775,808
Portability	2031	$42,200,000	$20,680,000	$8,613,000	$33,587,000

What is the potential gain from filing an estate-tax return and electing portability? **Millions.**

Imagine Hazel used some of that DSUE and made a gift to her trust with the trustee applying for life insurance on her. The trustee could leverage that gift with life insurance, multiplying the gift into a substantially larger, tax-free legacy using life insurance in the trust.

Catch the GST of It

Generation-Skipping Transfer (GST) tax

The resurgence of the generation-skipping transfer tax

With the reliable and steady increase in the estate-and-gift-tax exemption since the start of this century, many practitioners overlooked the potential resurgence of the ***generation-skipping transfer (GST) tax***. All of which may put a damper on multigenerational wealth-transfer plans after the sunset.

The concept of a GST tax isn't new. The first version in the U.S. dates to 1976, when it aimed to capture lost tax revenue on wealth passed directly to grandchildren – effectively preventing estate-tax avoidance through skipping a generation.

The initial version of GST presented many administrative challenges. A revised GST tax was enacted in 1986 as a result. This version offers some exemptions and is designed to work in conjunction with the estate-and-gift-tax system by applying a 40% GST tax to transfers to skip persons (e.g., grandchildren).

It should be noted that transfers are interpreted broadly. They can include:

1. Gifts
2. Trust distributions
3. Life-insurance proceeds
    a. Where they aren't owned by a trust that already has a GST-exemption allocated to it to shield those assets

Why GST may be back en vogue

Some people may often make plans with trusts that are designed to run for generations. Planning will often involve pouring over assets from the taxable estate to the trust, upon death. And where most estates are more than sufficiently protected via the high estate-and-gift-tax exemption today (gift and GST exemptions), the sunset may change that.

EXAMPLE 5

Picture an investor with an estate above the federal estate-tax exemption. They've used their gifting and GST allocation to form a trust to provide for their children and grandchildren. As the investor ages, they realize their children are more than adequately provided for and would like to leave some bequests directly to their grandchildren.

The GST makes this a very inefficient transfer. In fact, the combined impact of the 40% estate tax with a 40% GST on top of it makes the effective tax rate well over half of the bequest (without including any state estate or inheritance taxes).

1 Testamentary targeted bequest to grandchild **$1,000,000**	2 Start with **$2,333,333**	3 Estate taxes on transfer **$933,333**
4 Left before GST **$1,400,000**	5 GST taxes **$400,000**	6 Effective tax rate on transfer **57%**

Imagine this alternative: An investor allocates a portion of their GST exemption to a trust holding a life insurance policy. The policy grows over time, tax deferred. Upon death, the trust receives a substantial death benefit, all shielded from GST because of the allocation on the gifts. This allows for a much larger inheritance to flow, tax-free, to grandchildren and future generations.

Life insurance acts as a magnifying glass, amplifying the power of a GST allocation for trust assets. By combining these tools, you can work with your financial professional to craft highly effective multigenerational wealth-transfer strategies for you.

Conclusion

With the estate-and-gift-tax exemption set to decrease after Dec. 31, 2025 – now's the time to act. Using the current, higher-exemption levels offers significant opportunities for tax savings and effective estate planning. Strategic actions today can help mitigate future tax burdens and ensure a more efficient transfer of wealth for you and your loved ones.

Contact your financial advisor for more retirement planning information today.

The material presented is not intended to be used as tax or legal advice; therefore it is important to coordinate with your tax or legal advisor regarding your specific situation.