

ESTATE TAX EXEMPTION SUNSET AND FORM 706

The 2017 Tax Cuts and Jobs Act (TCJA) brought significant changes to income tax and estate tax planning for individuals. If congress does not act, many of the provisions of TCJA will sunset on January 1, 2026. The focus of this article is on the federal estate tax implications of a potential sunset.

Use It or Lose It Prior to 2011

Congress gradually increased the personal estate tax exemption from \$650,000 in 2001 to \$3.5 million in 2009. For deceased spouses, that exemption had to be used at death or it would be lost (i.e. the surviving spouse could not add it to their own exemption). As a result, bypass trusts were a staple in estate plans for couples.

As an example, imagine Tom and Mary; a married couple in 2001 with a net worth of \$1.3 million. Assume that \$650,000 was in Mary's name and \$650,000 was in Tom's name. Tom passed away, leaving his \$650,000 to Mary. Because Tom received an unlimited spousal estate tax exemption for assets left to a spouse, his taxable estate was \$0 and his entire \$650,000 estate tax exemption would have been lost. If Mary subsequently passed away with a net worth of \$1.3 million, she would only get to use her own \$650,000 exemption, while the remaining \$650,000 would have been taxed at a top rate of 55%.

An easy way to avoid this was to have half of the assets in the name of a living trust for each spouse. Upon Tom's passing, his trust would fund a bypass trust for \$650,000, utilizing his full estate tax exemption. That bypass trust could be used to support Mary but would remain outside of her taxable estate. If Mary passed away with a collective net

worth of \$1.3 million, only the \$650,000 in her living trust would be in her taxable estate and no estate tax would be owed. Very basic levels of trust planning could be used to avoid hundreds of thousands of dollars in estate taxes.

Portability Made Permanent in 2011

Congress increased the estate tax exemption to \$5,000,000 per individual in 2011 and indexed that amount to inflation. Importantly, starting in 2011 surviving spouses were permanently given the option of filing for portability of the deceased spousal unused exemption amount (DSUE). Any unused estate tax exemption from a deceased spouse could now be added to the surviving spouse's own estate tax exemption. This made it much easier to make use of two estate tax exemptions for couples without having to utilize bypass trusts. However, the IRS determined that a surviving spouse would need to file for the portability of the DSUE on an estate tax return (Form 706). This became a critical and often overlooked step.

Federal estate tax returns (Form 706) must be filed for any estate that exceeds the individual estate exemption amount. As a result, fewer estate tax returns have been required as the exemption amount has increased over time. The convenience of not having to file an estate tax return also meant that many surviving spouses overlooked the option of filing a Form 706 for portability of the DSUE.

Federal Estate Tax Exemption Doubled in 2018

The 2017 Tax Cut and Jobs Act (TCJA) doubled the estate tax exemption amount to \$11.18 million in 2018 and once again

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indexed the amount to inflation. As of 2024, the estate tax exemption stands at \$13.61 million per individual. Unless congress acts, the exemption will be halved on January 1, 2026 to roughly \$7 million. In short, we do not know what the federal estate tax law will look like in 2026 and beyond.

Form 706 Could Become Very Valuable

While the personal estate tax exemption is subject to change going forward, any amount of DSUE that is claimed by a surviving spouse on Form 706 is permanently locked in.

Consider Tom and Mary in 2024 and they've managed to build a net worth of \$10 million. There is \$5 million in Tom's name and \$5 million in Mary's name. Tom passes away, leaving his \$5 million to Mary. Because Tom gets an unlimited spousal exemption for estate tax purposes, he used none of his \$13.61 million exemption. Mary now has \$10 million in her name, which subsequently grows to \$15 million. The estate tax exemption falls to \$7 million because congress fails to act before January 1, 2026. Since Tom did not have a taxable estate, an estate tax return (Form 706) was not required. As a result, Mary does not get portability of Tom's unused exemption (\$13.61 million). Mary passes away with a net worth of \$15 million and an exemption of \$7 million. Her estate will owe taxes of up to 40% on the \$8 million excess.

If Form 706 had been filed for Tom's estate to elect portability of Tom's unused exemption, Mary would have been able to add Tom's \$13.61 million unused exemption to her \$7 million for a total of \$20.61 million of federal estate tax protection (greater than her \$15 million net worth).

Her heirs would save more than \$3 million in taxes because of a single tax form.

706 Filing Deadline Extended

Historically, Form 706 was due nine months after the date of death with the potential for a six-month extension. Effective July 8, 2022, the IRS allows certain estates to elect late portability relief up to five years after the decedent's death. Relief is generally granted if the executor of the estate was not otherwise required to file an estate tax return (i.e. if the 706 is being filed purely for portability election).

Other Considerations

There are many ways to manage potential estate tax implications and every plan is different. Making lifetime gifts to family members and charitable giving are relatively easy ways to reduce one's taxable estate. For those who are looking to make use of their current \$13.61 million exemption before January 1, 2026, there are more complex estate planning strategies that can be considered. More complex plans will involve coordination with a client's tax and legal counsel. Additional layers of planning are involved for those who live in a state with a state-level estate and/or inheritance tax. In short, January 1, 2026 is an important date to keep in mind for federal estate planning purposes and there is a strong case to be made for filing a Form 706 after the death of a spouse, even if it is not required.

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