THE ESTATE PLANNER

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Preparing for 2026

Four ways to build flexibility into your estate plan

January 1, 2026, is a significant date for estate planning. On that day, the federal gift and estate tax exemption amount set by the Tax Cuts and Jobs Act will sunset. Currently, the inflation-adjusted exemption stands at $12.92 million ($25.84 million for married couples). But in 2026, it's scheduled to drop to only $5 million ($10 million for married couples). Based on current estimates, those figures are expected to be adjusted for inflation to $6.08 million and $12.16 million, respectively.

If your estate exceeds, or is expected to exceed, 2026 exemption levels, consider implementing planning techniques today that can help you reduce or avoid gift and estate tax down the road. For example, an individual with an $8 million estate could avoid roughly $800,000 in federal estate tax by transferring assets to his or her heirs before the exemption is reduced.

However, what if you're not currently ready to give significant amounts of wealth to the next generation? Perhaps you want to hold on to your assets in case your circumstances change in the future. Fortunately, there are techniques you can use to take advantage of the current exemption amount while retaining some flexibility to access your wealth should a need arise. Here are four of them.

1. SLATs

If you're married, a spousal lifetime access trust (SLAT) can be an effective tool for removing wealth from your estate while retaining access to it. A SLAT is an irrevocable trust, established for the benefit of your children or other heirs, which permits the trustee to make distributions to your spouse if needed, indirectly benefiting you as well.

So long as you don't serve as trustee, the assets will be excluded from your estate and, if the trust is designed properly, from your spouse's estate as well. For this technique to work, you must fund the trust with your separate property, not marital or community property.

Watch out for reciprocal trusts

Couples who establish spousal lifetime access trusts (SLATs) for each other must plan carefully to avoid the reciprocal trust doctrine. Under the doctrine, the IRS may argue that the two trusts are interrelated and leave the spouses in essentially the same economic position they would've been in had they named themselves as life beneficiary of their own trusts. If that's the case, the arrangement may be unwound and the tax benefits erased.

To avoid this outcome, the trusts' terms should be varied so that they're not substantially identical. For example, you might appoint different trustees, establish the trusts in different states, fund the trusts at different times, designate different beneficiaries, or provide for different withdrawal rights or powers of appointment.

Keep in mind that if your spouse dies, you'll lose the safety net provided by a SLAT. To reduce that risk, many couples create two SLATs and name each other as beneficiaries. If you employ this strategy, be sure to plan the arrangement carefully to avoid running afoul of the "reciprocal trust doctrine." (See "Watch out for reciprocal trusts" above.)

2. SPATs

A special power of appointment trust (SPAT) is an irrevocable trust in which you grant a special power of appointment to a spouse or trusted friend. This person has the power to direct the trustee to make distributions to you.

Not only are the trust assets removed from your estate (and shielded from gift taxes by the current exemption), but so long as you are neither a trustee nor a beneficiary, the assets will enjoy protection against creditors' claims.

3. DAPTs

A domestic asset protection trust (DAPT) is another tool that allows you to remove wealth from your estate, taking advantage of the current gift tax exemption, while preserving indirect access to your assets in the future. A DAPT is an irrevocable trust established in a state with a DAPT law, which protects trust assets from creditors even though you're a beneficiary of the trust. An independent trustee has the power to make discretionary distributions to you should a need arise.

DAPTs aren't risk-free, however. Their ability to shield assets from creditors hasn't been fully tested in the courts, particularly for trusts established in a state with a DAPT law by a resident of a non-DAPT state.

One way to reduce this risk is to create a "hybrid DAPT." This strategy involves setting up a trust where you're not initially named as a beneficiary, thereby assuring protection from your creditors. However, if you need access to the assets in the future, a trusted person (such as a trust protector) has the power to add you as a beneficiary, converting the trust into a DAPT.

4. QPRTs

A qualified personal residence trust (QPRT) allows you to transfer your home to a trust for the benefit of your children or other loved ones, while retaining the right to live in the home during the trust term. At the end of the term, title to the home is transferred to your beneficiaries, but you can arrange to continue living there in exchange for fair market rent.

Keep in mind that for this technique to work, you must survive the trust term. Otherwise, the home's value will be included in your taxable estate.

The best of both worlds

The techniques described above are just a few examples of strategies you can use to enjoy the best of both worlds: Taking full advantage of the current exemption amount before it expires, without giving up access to your hard-earned wealth.

Bear in mind that Congress may act before the sunset date of January 1, 2026. Indeed, it may vote on legislation to make certain provisions of the Tax Cuts and Jobs Act permanent. Your estate planning advisor can keep you apprised of any new tax laws that can affect your estate plan. ■

Can you undo an irrevocable life insurance trust?

For years, people have been setting up irrevocable life insurance trusts (ILITs) to avoid estate tax on the death benefits paid out under their life insurance policies. But what if you have an ILIT that you no longer need? Does its irrevocable nature mean you're stuck with it forever? Not necessarily.

You may have options for pulling a life insurance policy out of an ILIT or even unwinding the ILIT entirely. Whether these options will work depends on the terms of the trust and applicable state law.

An ILIT in action

An ILIT shields life insurance proceeds from estate tax because the trust, rather than the insured, owns the policy. Note, however, that under the "three-year rule," if you transfer an existing policy to an ILIT and then die within three years, the proceeds remain taxable. That's why it's preferable to have the ILIT purchase a new policy, if possible, rather than transferring an existing policy to the trust.

The key to removing the policy from your taxable estate is to relinquish all "incidents of ownership." That means, for example, that you can't retain the power to change beneficiaries; assign, surrender or cancel the policy; borrow against the policy's cash value; or pledge the policy as security for a loan (although the trustee may have the power to do these things).

Undoing an ILIT

Generally, there are two reasons you might want to undo an ILIT: 1) you no longer need life insurance, or 2) you still need life insurance but your estate isn't large enough to trigger estate tax, and you'd like to eliminate the restrictions and expense associated with the ILIT structure. Although your ability to undo an ILIT depends on the circumstances, potential options include:

Allowing the insurance to lapse. This may be a viable option if the ILIT holds a term life insurance policy that you no longer need (and no other assets). You simply stop making contributions to the trust to cover premium payments. Technically, the ILIT continues to exist, but once the policy lapses it owns no assets. It's possible to allow a permanent life insurance policy to lapse, but other options may be preferable, especially if the policy has a significant cash value.

Swapping the policy for cash or other assets. Many ILITs permit the grantor to retrieve a policy from an ILIT by substituting cash or other assets of equivalent value. If allowed, you may then be able to gain access to a policy's cash value by swapping it for illiquid assets of equivalent value.

Surrendering or selling the policy. If your ILIT holds a permanent insurance policy, the trust might surrender it, which will preserve its cash value but avoid the need to continue paying premiums. Alternatively, if you're eligible, the trust could sell the policy in a life settlement transaction.

Distributing the trust assets. Some ILITs give the trustee the discretion to distribute trust funds (including the policy's cash value, other trust assets or possibly the policy itself) to your beneficiaries, such as your spouse or children. Typically, these distributions are limited to funds needed for "health, education, maintenance and support."

Going to court. If the ILIT's terms don't permit the trustee to unwind the trust, it may be possible to obtain a court order to terminate it. For example, state law may permit a court to modify or terminate an ILIT if unanticipated circumstances require changes to achieve the trust's purposes or if the grantor and all beneficiaries consent.

An ILIT shields life insurance proceeds from estate tax because the trust, rather than the insured, owns the policy.

These are some, but by no means all, of the strategies that may be available to unwind an ILIT.

Seek professional help

If you have an ILIT that you no longer need, consult your advisor to discuss your options. And keep in mind that some solutions may have tax implications for you or your beneficiaries, so be sure to discuss those with your advisor as well.

QTIP trust

The right trust for your blended family

If you're currently in a second marriage and have older children from your first marriage, this trust should be of interest to you: a qualified terminable interest property (QTIP) trust. It can provide future security for both your surviving spouse and your children from a prior marriage. Plus, it can provide flexibility to your estate plan. Let's take a closer look at the ins and outs of a QTIP trust.

How does a QTIP trust work?

Generally, a QTIP trust is created by the wealthier spouse, although sometimes both spouses will establish a corresponding trust. When the grantor dies, the surviving spouse assumes a "life estate" in the trust's assets. A life estate provides the surviving spouse with the right to receive income from the trust, but he or she doesn't have ownership rights. This means that the surviving spouse can't sell or transfer the assets. Upon the death of the surviving spouse, the assets are passed to the final beneficiaries, who are typically the children from the grantor's first marriage.

Accordingly, you must designate the beneficiaries of the QTIP trust, as well as the trustee to manage the assets. This could be your spouse, adult child, close friend, or, as is often the case, a third-party professional.

A side benefit of establishing a QTIP trust is that it may alleviate family tensions. Your current spouse can relax, realizing that he or she will be taken care of. At the same time, your children from a prior marriage know that they won't be "cut out of the estate" by a stepparent who might turn against them or remarry.

Of course, a QTIP trust can't provide ironclad protection against family conflicts that may arise after you are gone. For instance, the parties may differ over the allocation of assets from an investment viewpoint. This is one of the reasons why it's often a good idea to appoint an independent professional trustee.

What are the estate tax consequences?

A QTIP trust is designed to combine the estate tax benefits of the unlimited marital deduction and the gift and estate tax exemption. When you create the trust and provide a life estate to your spouse, the assets are sheltered from tax after your death by the unlimited marital deduction.

After your spouse passes away, assets in the QTIP trust are subject to federal estate tax. However, the gift and estate tax exemption will likely shelter most estates from this tax liability.

What if estate tax laws change?

A QTIP trust can provide added flexibility to your estate plan. For example, at the time of your death your family's situation or the estate tax laws may have changed. The

executor of your will can choose to not implement a QTIP trust if that makes the most sense. Otherwise, the executor makes a QTIP trust election on a federal estate tax return. (It's also possible to make a partial QTIP election — that is, a QTIP election on just a portion of the estate.)

To be effective, the election must be made on a timely filed estate tax return. After the election is made, it's irrevocable.

The right technique for your plan?

A QTIP trust may be the right estate planning vehicle if you're remarried and have older children from your first marriage. Using this trust type can provide you peace of mind that your current spouse will be taken care of after your death, and that the trust's assets will eventually be passed on to your children after your spouse passes away.

ESTATE PLANNING RED FLAG

You're not sure whether your trust deposits are fully insured

Recent bank failures have increased concerns about the availability of Federal Deposit Insurance Corporation (FDIC) coverage for bank accounts held in trust. The rules regarding insurance of trust accounts are complex, and new rules will take effect on April 1, 2024.

Currently, the extent of FDIC coverage depends on several factors, including whether the trust is revocable or irrevocable, the number of beneficiaries and whether they're primary or contingent, and the relative amounts the beneficiaries will receive.

The new rules will simplify the calculation. Each grantor's trust deposits at an insured institution will be insured up to $250,000 x the number of primary beneficiaries (other than the grantors), up to a maximum of five beneficiaries.

Suppose, for example, that Harry and Sally have a $5 million joint trust account at an FDIC-insured bank, naming their five children as primary beneficiaries and their eight grandchildren as contingent beneficiaries. Under the new rules, each grantor will enjoy up to $1.25 million in coverage ($250,000 x five primary beneficiaries) for a total of $2.5 million, leaving $2.5 million uninsured. Harry and Sally could insure the total amount by splitting it between two trust accounts at different institutions.

Note that a full discussion of the current and new rules is beyond the scope of this article, but it's important for trust depositors to review their insurance coverage under both sets of rules to determine their level of protection. After the new rules take effect, coverage may increase, decrease or stay the same, depending on the circumstances.

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