Katten

ADVISORY



Planning Considerations for the Rest of 2025 and Into 2026

2025 Year-End Estate Planning Advisory

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Click here for the 2025 Year-End Estate Planning Table of Contents

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The years 2025-2026 mark an inflection point for estate, gift and generation-skipping transfer (GST) planning following enactment of the One Big Beautiful Bill Act (OBBBA or the Act). The Act permanently increased the federal estate, gift and GST exemption to $15,000,000 per individual (indexed for inflation) beginning January 1, 2026. For 2025, the exemption is $13,990,000 per individual. These amounts are significantly higher than the pre-TCJA baseline and, unlike the TCJA, do not sunset. For most families, this reduces federal transfer tax pressure and refocuses planning on income tax efficiency, basis step-up, trust flexibility and state estate tax coordination. For clients whose wealth approaches or exceeds the new thresholds, this remains a critical window to remove future appreciation from the taxable estate and to structure trusts for income, asset protection and multigenerational objectives. All clients should review dispositive provisions, tax elections and fiduciary structures with counsel as 2025 concludes.

Year-End Checklist for 2025

- Make 2025 annual exclusion gifts of $19,000 per donee ($38,000 for married couples who elect to split gifts).
- Make 2025 IRA contributions and confirm required minimum distributions compliance.
- Establish or fund 529 Plans; consider 5-year frontloading of annual exclusions, coordinated with other 2025 gifts.
- Pay tuition and non-reimbursable medical expenses directly to providers to avoid gift tax treatment.
- Complete 2025 charitable giving, including qualified charitable distributions (QCDs) from IRAs where appropriate.

Review Formula Bequests

- Many wills and revocable trusts use formula clauses that fund a credit shelter (bypass) trust up to the available federal exemption, with the balance passing to a marital trust. With the exemption at $13.99 million in 2025 and $15 million in 2026, legacy formulae can unintentionally overfund a credit shelter trust and underfund (or eliminate) the marital share, which may be inconsistent with the testator's objectives or prudent for the surviving spouse's support. This risk is heightened in blended families and in states with estate taxes decoupled from the federal system. A targeted review should confirm the formula, beneficiary class and state estate tax interaction remain appropriate. Consider modern flexibility mechanisms – such as disclaimer-based plans, QTIPable trusts with elective treatment and carefully drafted powers of appointment – to right-size post-mortem outcomes.

Income Tax Basis Planning

- With federal transfer tax exposure reduced for many, the tradeoff between lifetime gifting and income tax basis becomes central. Low-basis assets held until death generally receive a step-up in basis, eliminating built-in gain for heirs, whereas assets gifted during life retain carryover basis. Revenue Ruling 2023-2 confirms no section 1014 basis adjustment at the grantor's death for assets held in a completed-gift grantor trust unless those assets are includible in the grantor's gross estate. Strategies to secure basis step-up where appropriate include:
  - Prioritizing retention of low-basis assets in the taxable estate while gifting higher-basis or low-growth assets.
  - Using substitution powers or purchases from grantor trusts to "swap in" high-basis assets and "swap out" low-basis assets before death.
  - Where a trust beneficiary has unused estate tax exemption, selectively causing inclusion of low-basis trust assets in that beneficiary's estate via a general power of appointment, a properly structured distribution, or deliberate exercise of a limited power of appointment to trigger the Delaware tax trap, subject to careful asset-by-asset analysis and creditor considerations.
  - These techniques require individualized modeling of basis profiles, expected appreciation, exemption availability and liquidity.

Planning to Utilize Increased Federal Exemptions

- Increased exemptions create opportunities to remove appreciating assets from the estate permanently and to implement flexible, protective structures for long-term succession. While

OBBBA made the higher exemptions permanent, future legislation could alter them; clients with material transfer tax exposure may wish to accelerate strategic transfers.

- In parallel, many families without exposure will benefit more from income tax optimization, state estate tax planning and trust modernization rather than aggressive transfer tax strategies.

Gifting Techniques

- Lifetime gifts are tax-exclusive, remove future appreciation from the estate, and can be combined with valuation discounts and trust structures. However, lifetime gifts forgo a basis step-up at death; the balance between transfer tax savings and capital gains deferral should be analyzed across the asset mix. For clients not expected to owe estate tax, retaining low-basis assets until death is often preferable, subject to cash flow needs and risk tolerance.
- Trust-based approaches include:
  - Spousal Lifetime Access Trusts (SLATs) to create access for a spouse while excluding assets from both estates, ensuring non-reciprocal design between spouses and observing timing rigor to avoid potential step transaction issues.
    - To mitigate the risk of application of the Reciprocal Trust Doctrine, consider differing beneficiary classes, divergent powers of appointment, distinct termination dates and non-identical distribution standards.
    - Where one spouse must first transfer assets to equalize estates before the other funds a SLAT, allow adequate time and substance between steps; using separate tax years for intra-spousal transfers and downstream trust funding is a conservative approach.
    - Consider the impact of the order of deaths and the possibility of divorce. If the beneficiary spouse predeceases the grantor, the grantor may lose indirect access to trust assets. Similarly, if the couple divorces, the beneficiary spouse's interest in the SLAT may be terminated or altered, potentially cutting off access for both parties. Trust documents should address these contingencies to ensure the trust continues to serve its objectives under changing circumstances.
  - Dynasty trusts to which GST exemption is allocated, insulating assets from transfer tax and often providing robust long-term asset protection and governance benefits.

Techniques Leveraging the Higher Exemption

- Sales to grantor trusts and combination gift/sale structures can "freeze" values. Adequate disclosure should be used to commence the statute of limitations; qualified appraisals are essential for nonmarketable assets.

- Forgiving or restructuring intrafamily notes may be attractive, although today's higher interest rates can reduce the appeal of refinancing.
- Allocate additional GST exemption to existing GST non-exempt trusts to improve multigenerational efficiency.
- Balance spouses' estates to maximize both exclusions, with care for transfers to non-US citizen spouses (annual exclusion $190,000 for 2025; $194,000 for 2026) and creditor protection.
- Reassess life insurance needs and ownership structures; consider irrevocable life insurance trusts (ILITs) to keep death benefits outside the taxable estate and to provide liquidity.

Trust Income Tax Planning and Medicare Surtax

- Non-grantor trusts reach the top 37% bracket at just $16,000 of taxable income in 2026 and are exposed to the 3.8% net investment income tax (NIIT) once undistributed net investment income exceeds trust thresholds. Shifting DNI to beneficiaries in lower brackets can materially reduce the family's overall tax burden, and targeted distributions can also mitigate trust-level NIIT where beneficiaries are below the NIIT thresholds. Evaluate distribution standards, beneficiary tax profiles, and potential to include capital gains in DNI where state law and governing instrument permit.
- Beginning in 2026, a 2/37ths itemized deduction reduction applies to trusts and estates with income above the 37% bracket threshold, which can modestly erode the section 642(c) charitable deduction at the trust level. Planning should account for this haircut when designing charitable distributions from non-grantor trusts.

Freeze Planning in the Current Environment

Even with higher exemptions, traditional freezing techniques remain relevant for wealth preservation, creditor protection, income shifting and governance:

- Grantor Retained Annuity Trusts (GRATs) remain effective, though higher section 7520 rates reduce leverage. Properly structured GRATs can be "zeroed-out" to avoid current gift tax; outperformance over the hurdle rate transfers excess value to remainder beneficiaries transfer-tax-free.
- Sales to Intentionally Defective Grantor Trusts (IDGTs) continue to be a cornerstone technique. The grantor status prevents gain recognition on sale and interest payments; appreciation above the applicable federal rate (AFR) accrues outside the estate. As a rule of thumb, seed equity of at least 10% of post-sale trust value is prudent. Pairing closely held entities with voting/nonvoting classes can support valuation discounts for lack of control and marketability when supported by a qualified appraisal.

- Consider swaps or buybacks of low-basis assets from grantor trusts to secure a basis step-up at death. Obtain appraisals for hard-to-value assets to avoid inadvertent gifts and support fiduciary prudence.
- Consider intrafamily loans to fund life insurance premiums in ILITs, capitalize trusts for investment spreads over AFR. Formalize all loans with promissory notes, commercial terms, and consistent administration.

Charitable Planning

- Maintain awareness of the 2026 0.5% annual gross income (AGI) "haircut" on individual charitable deductions and plan bunching strategies accordingly.
- Qualified Charitable Distributions (QCDs) remain a compelling tool for those age 70½ and older to satisfy charitable intent and reduce taxable income outside itemized deduction limitations. For those at least age 73, QCDs also count towards satisfying annual RMDs. For 2025 and 2026, the maximum amount which may be directly transferred from an IRA to a qualified charity as a QCD is $108,000. This is in addition to the new above-the-line charitable deduction of up to $1,000 for single filers or $2,000 for joint filers for 2026.

Review and Reevaluate

- Consider whether legacy techniques (e.g., certain qualified personal residence trusts, family limited partnerships, or split-dollar arrangements) still deliver net benefits.
- Confirm GST allocations and inclusion ratios; for partially exempt trusts, consider whether allocating additional GST exemption or trust modifications would strengthen outcomes.
- Portability remains valuable – particularly when paired with QTIP planning – to preserve a second basis step-up and retain post-mortem optionality. Rev. Proc. 2022-32 provides a simplified method to elect portability up to five years after death in qualifying cases, but it is critical to ensure the filing of a "complete and properly prepared" estate tax return or run the risk of disqualification as illustrated in *Estate of Rowland v. Commissioner*, T.C. Memo. 2025-76 (July 15, 2025).
- Unmarried couples should review foundational documents and beneficiary designations.

2025 Year-End Estate Planning Advisory Table of Contents:

- 2025–2026 Planning Priorities
- The One Big Beautiful Bill Act: Key Year-End Tax Changes for Private Wealth Clients

- Select Updates Impacting Family Business Owners
- Planning Considerations for the Rest of 2025 and Into 2026
- Select Federal Caselaw Updates
- State of the States
- Relevant International Updates

To download a PDF of the entire advisory, click here.

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