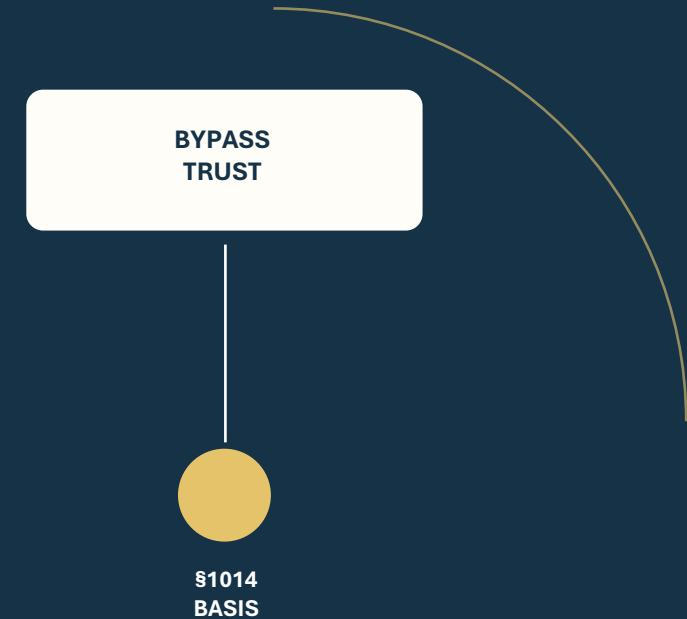


Bypass Trusts in a High-Exemption World

Planning for Basis Not Estate Tax

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Voyager Spacecraft

Extraordinary designs can outlive the assumptions on which they were built.



Voyager 1: launched in 1977; still communicating from interstellar space

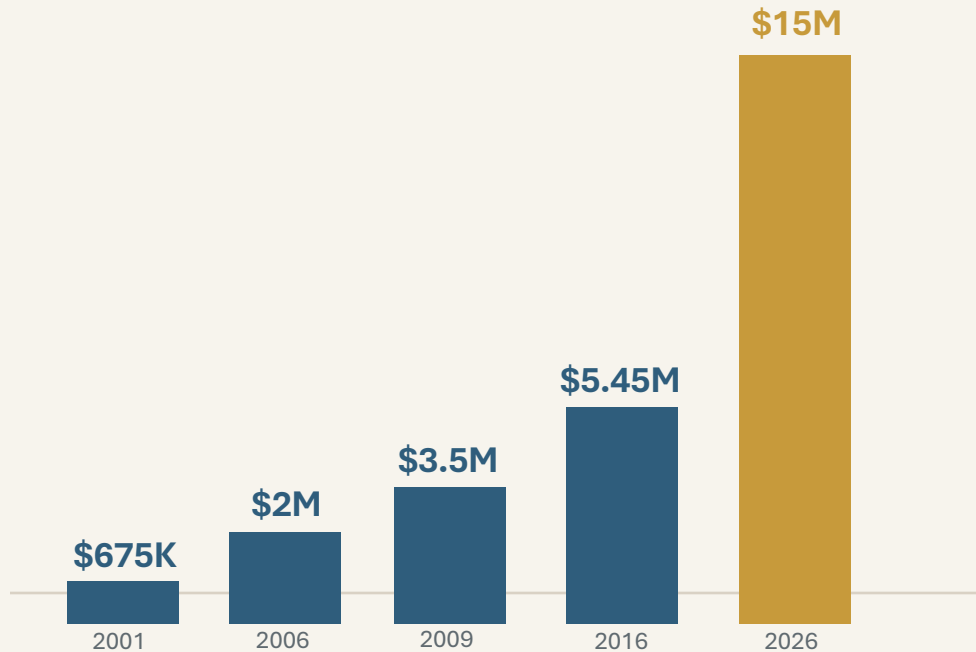
Voyager

In 1977, NASA launched the twin Voyager spacecraft on a mission originally designed to study Jupiter, Saturn, Saturn's rings, and the larger moons of those planets. No one reasonably expected that nearly half a century later, the same spacecraft would still be communicating with Earth from interstellar space.

The spacecraft have remained useful because engineers have repeatedly revisited old assumptions, conserved dwindling power, reprogrammed aging systems, and improvised solutions for problems no one could have fully anticipated in 1977.

The Tax World Moved

Federal transfer-tax pressure fell for many families; basis pressure rose.



Federal portability

Available for estates of decedents dying after December 31, 2010, if timely elected on Form 706; applies to federal estate and gift tax, but not GST exemption or state estate tax.

New Jersey

No estate tax for deaths on or after January 1, 2018; inheritance tax still requires a beneficiary-class check.

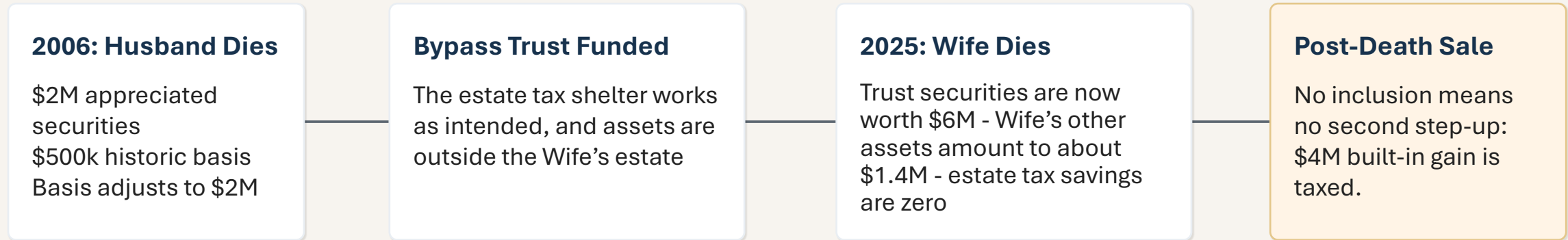
New York caution

Separate estate tax, no state portability, and a cliff make formula planning essential.

Same trust, different tax risk

The bypass trust basis trap

A plan that solved a 2005 estate tax problem can create a 2025 income tax problem.



Core problem The trust did exactly what it was designed to do —
Changes in exemptions and basis economics made the exclusion costly.

What the basis trap costs

Assumes sale after Mom's death, 15% federal LTCG bracket each, no 3.8% NIIT, Adam is a NJ resident, Beth is a FL resident.

Embedded gain

\$6.0M

Sale value after Wife's death

– \$2.0M

Trust basis from Husband's death

\$4.0M gain

No estate inclusion

Adam (NJ)

\$515k

\$300k federal
\$215k NJ

Beth (FL)

\$300k

\$300k federal
\$0 FL income tax

Estate inclusion / step-up

Basis resets to \$6M

Immediate sale produces little or no gain.

\$0

federal / NJ / FL income tax on the sale

The kids paid an \$815,000 income tax bill to save ZERO in estate taxes

Federal Law Creates the Pathway

What actions can we take now to trigger a 1014 basis adjustment

§ 1014

Basis adjustment for property acquired from a decedent.

**Estate inclusion
opens the basis door**

§ 2041

General power of appointment causes gross-estate inclusion.

Section 1014(b)(9) is the bridge from inclusion to basis.

Section 1014: estate inclusion is the basis doorway

What does “acquired from a decedent” really mean

1014(a): the basis rule

Property “acquired from a decedent” generally takes a basis equal to fair market value at death.

The adjustment can be a step-up or a step-down. IRD is excluded.

1014(b)(9): the gateway

Property acquired through the exercise **or non-exercise** of a power of appointment if such property is required to be included in determining the value of the decedent’s gross estate.

Bypass-trust implication

If the beneficiary possesses a power of appointment such that mere possession would trigger the underlying assets to be includible for estate tax purposes, then those underlying assets are treated under section 1014(a) as having been acquired from a decedent, entitling them to basis adjustment.

Section 2041: General Powers of Appointment are the inclusion lever

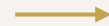
Does the beneficiary hold a power that brings the trust property into his or her gross estate

2041(a)(2): estate inclusion

Property is included if the decedent possessed a general power of appointment at death.

Mere possession can be enough; exercise is not required.

I.R.C. § 2041(a)(2); Treas. Reg. § 20.2041-1(b)(1)

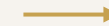


What makes a power “general”?

A power exercisable in favor of the decedent, the decedent’s estate, or the creditors of either.

Substance controls over labels.

I.R.C. § 2041(b)(1); Treas. Reg. § 20.2041-1(c)(2)



Key limits / drafting guardrails

A power limited by an ascertainable standard for health, education, support, or maintenance is not general.

Joint-consent rules and releases require separate review.

I.R.C. § 2041(b)(1)(A), (C); Treas. Reg. § 20.2041-1(c)(2), -3

Planning Point: A formula testamentary general power can target select assets and be limited to the amount that fits within the unused exemption

State law does the plumbing

Federal law tells us what creates inclusion; state law tells us whether we can install it.

New Jersey

- **NJ UTC consent modification:** modify noncharitable irrevocable trust with trustee + all beneficiaries if not inconsistent with a material purpose.
- **Court modification:** unanticipated circumstances / ineffective administration; reformation for mistake; construction to probable intent.
- **Tax-objective modification:** court may modify terms to achieve settlor's tax objectives; retroactive effect possible.
- **Decanting by common law / discretionary power:** case law permits exercise of appointment power in further trust; use cautiously to add a formula testamentary GPOA.
- **Useful cases:** *Wiedenmayer v. Johnson*, 106 N.J. Super. 161 (App. Div. 1969).

New York

- **EPTL 10-6.6 decanting:** authorized trustee may appoint principal to an appointed trust; with unlimited discretion, may grant a beneficiary a power of appointment if that beneficiary could receive principal outright.
- **EPTL 10-6.6(c):** If the original trust is strictly limited to a HEMS standard, the trustee's power is technically "limited" under EPTL 10-6.6(c)
- **Power-of-appointment rules:** EPTL Article 10 governs exercise and over-/under-exercise; decanting exercise is treated as special POA. EPTL § 10-10.1 often prevents an overly casual conclusion that a spouse-trustee can simply distribute selected assets to herself.
- **Surrogate's Court / equitable reformation:** use for mistake, construction, and tax-driven reformation when supported by intent and record.
- **Useful authority:** N.Y. Surr. Ct. Proc. Act (SCPA) § 2106; SCPA § 1420 and whether asking the court to "construe" the trust as having always intended to maximize the family's net-after-tax wealth is a viable alternative.

Does a State Court Action Always Work?

Use caution when asking the court to do something to which only the IRS would object

Bosch

Comm'r v. Estate of Bosch, 387 U.S. 456 (1967)

A lower state-court decree does not bind the IRS in a federal tax controversy when the United States was not a party. Federal authorities give “proper regard” to state rulings; the state high court controls.

Rev. Rul. 73-142

Rev. Rul. 73-142, 1973-1 C.B. 405

The Service respected a final, unappealed pre-death state-court decree eliminating a retained removal power, even though the decree conflicted with prior state high-court law. Timing and finality mattered. Narrow ruling limited to the facts.

Rapp

Estate of Rapp v. Comm'r, 140 F.3d 1211 (9th Cir. 1998)

A post-death probate order could not salvage the desired QTIP tax result. The Ninth Circuit distinguished *Rev. Rul. 73-142* because the order came after death and lacked meaningful support under state law.

Practice Point: A probate court decision may be ignored when determining federal tax consequences, even when that order is final, if the decision is contrary to state law.

PLR 202206008: a trust modification that worked

A modern roadmap for pairing GST-sensitive modification with calibrated estate inclusion for basis planning.

Facts / posture

Pre-Sept. 25, 1985 GST-grandfathered trust; no post-creation additions.

Court-approved settlement resolved beneficiary litigation.

Trustee authorized to grant child a testamentary GPOA over a Defined Portion.

GST ruling

Catch-all safe harbor applied.

No shift of beneficial interests to lower-generation beneficiaries.

No extension of vesting period; GST-grandfathered status preserved.

Estate inclusion result

Only property subject to child's testamentary GPOA was includible.

Inclusion arose under § 2041(a)(2).

The ruling did not address § 1014. If the subject property is included under § 2041 and otherwise satisfies § 1014(b)(9), the statutory basis-adjustment consequence should follow.

PLR 202301001: a trust decanting that worked

A second modern ruling showing how testamentary GPOAs can create estate inclusion without destroying grandfathered GST status.

Transaction posture

Pre-Sept. 25, 1985 GST-exempt trust.

Decanted under state statute with court authorization (subject to receiving a favorable private letter ruling.

The new trust kept the same distribution standard and termination provision, though it added many bells and whistles.



Multi-Step Approach

Step 1: Situs shift to state with favorable decanting statute.

Step 2: Create Trust B and Decant (subject to a favorable PLR).

Step 3: Maintain same class of beneficiaries and same vesting period for favorable GST ruling.



Result

New robust trust created to achieve more than just tax savings.

Each sole lifetime beneficiary received a testamentary GPOA.

Property subject to each power includible under § 2041(a)(2).

Trust B 100% GST Exempt

Powers to Invade: check whether the trust already creates § 2041 inclusion argument

Before modifying or decanting, test whether the spouse's existing fiduciary / invasion powers are already broad enough to be a GPOA.

Estate of Jones v. Commissioner

New Jersey testamentary trust for surviving spouse.

Spouse was both life beneficiary and co-trustee with a bank.

Trustees could invade principal for emergencies or situations affecting spouse's "care, maintenance, health, welfare and well-being."

Issue: whether that co-trustee/invasion power was limited by an ascertainable HEMS standard.

See also *Peoples Trust Co. of Bergen Cty. v. United States*, 412 F.2d 1156 (3d Cir. 1969)

Holding + takeaway

Holding

"Welfare" and "well-being" exceeded health, education, support, and maintenance.

Corporate co-trustee did not save the power. Not an adverse party.

Result: spouse held a general power over corpus for federal estate-tax purposes.

Takeaway

Co-trustee cases can already contain the estate-inclusion plumbing needed for basis planning, but it's a double-edged sword requiring careful attention.

Practice Point

A state savings clause such as N.J.S.A. § 3B:11-4.1 may nevertheless apply to restrict an overbroad power to invade principal, limiting the utility of *Jones* and *Peoples Trust*. It's still necessary to review the terms of the trust closely before a decision to modify is made.

New Jersey Court Action

Modification path for adding or confirming inclusion-causing powers in a legacy bypass trust.

§ 3B:31-11	Nonjudicial settlement	Interested persons may enter a binding nonjudicial settlement agreement if it does not violate a material purpose and contains only terms the court could approve. Useful to build consensus and record tax-sensitive settlement terms.
§ 3B:31-27	Modification by consent	Court may modify a noncharitable irrevocable trust with beneficiary consent; even without unanimous consent, court may approve if nonconsenting beneficiaries are adequately protected.
§ 3B:31-28	Unanticipated circumstances	Court may modify administrative or dispositive terms because of unanticipated circumstances, or where continuation would be impracticable, wasteful, or impair administration. Strong fit for high-exemption / low-basis mismatch.
§ 3B:31-33	Tax objectives	Court may modify a trust to achieve the settlor's tax objectives and may give the modification retroactive effect. Best statutory hook for calibrated GPOA / basis planning.
§ 3B:31-34	Combination and division	Trustee or court can combine or divide trusts. Use before modifying. Isolate low-basis appreciated assets and avoid forcing high-basis or loss assets into the same inclusion decision.

How Much Inclusion Do You Want?

The best answer is often selective, not total.

What is the least amount of inclusion that solves the tax problem?

Full inclusion

Use only when headroom is clear and non-tax concerns are manageable.

Asset-specific inclusion

Apply the power to identified appreciated assets.

Formula inclusion

Include the largest tax-neutral amount, with buffers.

Division-first strategy

Separate an includible share from a protected/excluded share.

Selecting the Right GPOA Clause

The right clause depends on the particular facts, and no single clause should be used automatically.

Match the clause to the tax headroom, the asset mix, and the time available to implement.

1. Broad Testamentary GPOA over Appreciated Non-IRD Assets

2. Automatic Asset-Priority Formula GPOA
Default

3. Schedule A Priority-List GPOA

See Handout for example of each

Practice point: The purpose of any clause is to give the spouse a GPOA over a defined portion of the trust.

Professional Risk and Liability Concerns

No duty to predict future law — but in New Jersey, failing to flag a fixable tax problem now...can cause trouble.

New Jersey: controlling standard

Christakos v. Boyadjis, 262 N.J. 447 (2026), adopted the narrow Restatement § 51 framework for attorney duties to nonclients: invited reliance under § 51(2), or a client's clear intent that the lawyer's services benefit the nonclient under § 51(3).

Rejected the broad California (*Lucas v. Hamm*) balancing test.

Estate of Albanese v. Lolio (App. Div. 2007): allowed the executrix/client and estate to pursue tax-advice claims but found no corresponding duty to the other beneficiaries merely because the advice affected their inheritances.

Pivnick v. Beck still allows a beneficiary claim only where drafting defeats the client's intent.

The estate's route in

Schneider v. Finmann (N.Y. 2010): the personal representative may sue for negligent tax planning — the estate “stands in the shoes” of the decedent.

Stevens v. Wheeler (1st Dep't 2023) applied it; **but strict privity still bars beneficiary suits.**

Caution — Sec. Bank & Trust v. Larkin (Minn. 2018): a \$1.65M GSTT claim failed because the harm accrued only at death.

The modern bypass-trust risk

No hindsight: a trust drafted in 2003 is not negligent because the law later changed.

Risk arises now: when you review, restate, fund, or administer the trust — or the client asks if the plan is current — and miss the trapped gain.

Controls: identify the basis issue, weigh current tax utility, warn the fiduciary/client, and document the decision to act or not act.

Practice point: Be proactive. When a legacy bypass trust crosses your desk, screen for the basis trap, present the options, and paper the file — silence on a known, fixable problem is where exposure lives.

Sources: *Christakos v. Boyadjis*, 262 N.J. 447, 348 A.3d 966 (2026); *Estate of Albanese v. Lolio*, 393 N.J. Super. 355 (App. Div. 2007); *Pivnick v. Beck*, 165 N.J. 670 (2000); *Estate of Schneider v. Finmann*, 15 N.Y.3d 306 (2010); *Stevens v. Wheeler*, 216 A.D.3d 537 (2023); *Sec. Bank & Trust Co. v. Larkin*, 916 N.W.2d 491 (Minn. 2018).

The Emergency Option: Making an Outright Distribution

A blunt instrument may be justified when the basis opportunity will otherwise be lost.

When it may fit

- Time is short and death is foreseeable.
- The instrument already authorizes discretionary principal distributions to the spouse.
- Asset protection and long-term trust control are secondary to preserving the basis opportunity.

What it can solve

- Moves appreciated assets from the bypass trust into the spouse's name before death.
- Should allow a § 1014 basis adjustment when those assets are included in the spouse's estate under § 2033.
- Faster than modification, decanting, or a contested court application when timing is an issue.

What it costs

- Sacrifices spendthrift and creditor protection. GST exemption can be lost.
- May expose assets to creditors and impact how assets would have been inherited by the next generation.
- Can complicate post-distribution planning if the spouse dies before clean-up steps are completed.

Practice point: do not make outright distribution the default. But in the right emergency, a legally available blunt instrument is better than losing a large basis opportunity while waiting for a perfect plan.

Screening legacy bypass trusts

Ten questions to separate “basis opportunity” cases from cases where inclusion would create new risk.

Trust, tax, and asset inventory

- 1 What is the governing law and situs of the trust?
- 2 What is the spouse’s projected federal gross estate if no change is made?
- 3 If state estate tax is in play, what is the projected taxable estate in that state?
- 4 Does the trust already create inclusion under existing distribution or removal powers?
- 5 What assets inside the trust carry the largest unrealized gains?

Constraints, actors, and timing

- 6 Which assets are IRD or would suffer a basis step down?
- 7 Is the trust GST-exempt, grandfathered, or otherwise sensitive to modification?
- 8 Who are the trustees, and who can actually act under state law?
- 9 Is family consent available, or must the plan work without it?
- 10 Is there enough time for formal modification or decanting, or is this an emergency case?

Practice point: Document the screening process and any recommendations made. See the sample letter to clients in the materials.

Legacy Bypass Trusts Should Be Reviewed Proactively

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Questions

Reference Appendix: Selected Authorities

Federal statutes

I.R.C. §§ 1014(a), 1014(b)(9), 1014(c), 1014(e), 1014(f), 2033, 2041(a)(2), 2041(b)(1), 6035, 691, 2010(c), 2631.

Regulations

Treas. Reg. §§ 1.1014-1, 1.1014-2, 20.2041-1; 26 C.F.R. § 20.2010-2(a).

IRS rulings / guidance

Rev. Rul. 2023-2, 2023-16 I.R.B. 658; Rev. Rul. 73-142, 1973-1 C.B. 405; Rev. Rul. 95-58, 1995-2 C.B. 191; Notice 2011-101, 2011-52 I.R.B. 932; CCA 202352018 (Dec. 29, 2023).

Private letter rulings

Priv. Ltr. Rul. 202206008; Priv. Ltr. Rul. 202301001; Priv. Ltr. Rul. 201634016; See I.R.C. § 6110(k)(3).

Cases

Comm'r v. Estate of Bosch, 387 U.S. 456 (1967)
 Estate of Rapp v. Comm'r, 140 F.3d 1211 (9th Cir. 1998)
 Estate of Jones v. Comm'r, 56 T.C. 35 (1971)
 Peoples Trust Co. of Bergen Cty. v. United States, 412 F.2d 1156 (3d Cir. 1969)
 Estate of Vissering v. Comm'r, 990 F.2d 578 (10th Cir. 1993)
 Estate of Schneider v. Finmann, 15 N.Y.3d 306, 933 N.E.2d 718, 907 N.Y.S.2d 119 (2010))

New Jersey authorities

N.J.S.A. 3B:31-11, -27, -28, -33, -34; N.J.S.A. § 3B:11-4.1
 Wiedenmayer v. Johnson, 106 N.J. Super. 161 (App. Div. 1969), aff'd sub nom. Wiedenmayer v. Villanueva, 55 N.J. 81 (1969)
 Christakos v. Boyadjis, 262 N.J. 447, 348 A.3d 966 (2026)
 Estate of Albanese v. Lolio, 393 N.J. Super. 355, 923 A.2d 325 (App. Div. 2007)
 Pivnick v. Beck, 165 N.J. 670, 762 A.2d 653 (2000)

Current tax data

IRS, What's New - Estate and Gift Tax; N.J. Div. of Tax'n, Inheritance and Estate Tax; N.Y. State Dep't of Tax'n & Fin., Estate Tax.