

## Exercising a Grantor Trust 'Swap' Power

**Take-Away:** Exchanging assets of equivalent value with a *grantor* trust is a great way to obtain a step-up in income tax basis after the grantor's exercise of the retained power. That said, the exercise of that power of substitution may run squarely into the trustee's fiduciary duty to protect trust assets for the benefit of the trust beneficiaries.

**Background:** *Grantor* trust status covered under IRC 671-679. Trust income is taxable under a *grantor* trust to its grantor/settlor, or another person who is deemed to be the substantial owner of the trust, and thus the primary taxpayer. The grantor retains administrative powers over the trust when the *grantor* trust status is recognized. One of those powers that creates *grantor* trust status is the power to control beneficial ownership, under IRC 674. IRC 674(a) provides the general rule for the power to control beneficial enjoyment that the grantor will be recognized as the owner of any trust portion concerning the trust corpus or the trust income's beneficial enjoyment. As a result, the grantor is liable for taxes from a retained power of disposition used by either the grantor or a *nonadverse* party without any *adverse* party's consent or approval.

**IRC 645(4)(C):** The power to substitute assets is covered under this section of the Tax Code. Under the statute, the existence of a power that is exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, to "*reacquire the trust corpus by substituting other property of an equivalent value*" will cause the entire trust to be treated as owned by the grantor, even if the power is never exercised. [Treasury Regulation 1.671-3(b)(3); 1.675.1(b)(4) (iii).] This is described in the Tax Code as a "*power of administration*" over the trust. If only the grantor holds this power, and the grantor dies, then the trust will cease to be classified as a *grantor* trust. It should be noted that the power to reacquire trust assets does not need to be expressly stated in the trust instrument. For example, a grantor who retained a lien on property that was transferred to a trust was found to have held a power to reacquire the trust assets by substituting assets of equal value. [*Barber v. United States*, 251 F.2d 436 (5<sup>th</sup> Circuit 1948).]

**Gift and Estate Tax Exposure:** A concern often raised by the grantor is whether the retention of this power to substitute trust assets could cause estate tax inclusion under either IRC 2036 or IRC 2038. While the power to substitute assets held by the grantor could potentially affect the amount of income that the trust generates, the substitution power,

standing alone, does *not* amount to a power to “designate the person who shall possess or enjoy the property or the income therefrom” [i.e., IRC 2036] or to “alter, amend, revoke, or terminate” the trust. [IRC 2038.] Accordingly, neither IRC 2036 nor IRC 2038 should apply to a retained power held by the grantor to substitute assets held in the trust. [*Estate of Anders Jordahl*, 65 *Tax Court* 92 (1975; Revenue Ruling 2008-22.)]

**Life Insurance:** In addition, if the trust held life insurance on the grantor’s life, the grantor’s retained power to substitute trust assets would *not* be considered as a grantor-retained incidence of ownership over the life insurance policies held in the trust that would otherwise cause estate tax inclusion of the life insurance proceeds on the grantor-insured’s death. [Revenue Ruling 2011-28.]

**Release of the Power:** If the grantor holds the power to substitute assets, the grantor can terminate the power by releasing it. However, if the grantor releases this power [or any other retained power] over the trust within three years of the grantor’s death, and that power would have caused the property to be included in the grantor’s gross estate [IRC 2036, 2037, 2038, 2042] if the power had been retained by the grantor on the grantor’s death, the value of the property over which the power was released will be included in the grantor’s gross estate. However, due to the Revenue Ruling mentioned earlier, the retention by the grantor of a power to substitute assets with other assets having equivalent value will probably *not* cause the trust to be included in the grantor’s gross estate if the grantor held the power until the grantor’s death. In short, the release of the power by the grantor within three years of death should not cause estate tax inclusion under IRC 2035.

**Tax Basis Planning:** These days, a grantor’s retained power to substitute assets of equivalent value with the trust can explain the popularity for *grantor* trusts. Securing a *stepped-up* income tax basis on the grantor’s death benefits his/her family’s income tax planning. The advantage of the grantor’s substitution power is its flexibility to exchange low basis assets held by the *grantor* trust with higher basis assets owned by the grantor individually, without requiring recognition of any gain or loss. [Revenue Ruling 85-13.] Consequently, if the grantor holds low-income tax basis assets returned to the grantor in the exchange with the trust at the time of the grantor’s death, the grantor’s estate will receive a fair market value basis adjustment at that time. [IRC 1014.]

**Key Factor:** A key factor to the utility of this retained power is the importance of the trustee's fiduciary duty (to the trust beneficiaries, not to the trust's grantor) to determine the equivalency of value with respect to the substituted property. While the grantor retains the *right* to substitute assets, the trustee nonetheless has to responsibility to trust beneficiaries to determine that what the trust receives is equal in value to what is to be exchanged with the grantor. The exercise of that *right* in the face of the trustee's fiduciary duty can create an impasse, leading to court involvement. The exercise of the grantor's *right of substitution* is easier than it sounds if recent court cases are any indication, especially when the grantor offers a promissory note to the trustee in exchange for appreciating trust assets. A quick summary follows-

The grantor offered in substitution a 9-year interest-only \$9.5 million promissory note with a balloon payment of principal with interest on the note at 1.27%. The trustee objected to the proposed substitution, claiming that the proposed note terms were not of equivalent value. The Court of Appeals supported the trustee's refusal to accept the promissory, but it concluded that the proposed note was a loan from the trustee, and the trust instrument had expressly prohibited loans from the trust to the grantor. *In re Condiott (Colorado Court of Appeals, No. 14CA0969, 2015)*.

The grantor proposed to substitute a promissory note in the amount of \$58.29 million to the trustee in exchange for limited partnership interests that had previously been sold by the grantor to the trust. The trustee refused to accept the proposed promissory note, which was unsecured, prompting the trustee to conclude that the proposed interest rate did not reflect the additional risk the trust would take-on after the substitution. The trustee was also concerned that just before the proposed asset substitution, the limited partnership had negotiated a highly favorable sale to a pharmaceutical company, thus adding to the trustee's concern that the proposed note terms would not have reflected the price that would have been paid to the trust had it sold its limited partnership interests. *Schinazi v. Eden 792 S.E.2d 94 (Georgia Court of Appeals, 2016.)*

Two separate 30% interests in an LLC were transferred to a trust. The grantor then proposed to substitute for the two LLC interests in exchange for his promissory note. The trustee expressed the concern that the interest rate in the grantor's proposed note would not provide the same risk, or rate of return, as the LLC interests. The Michigan Court of Appeals

found that the trustee's refusal to accept the proposed notes in exchange for the two LLC interests was reasonable, noting:

*“Nothing in the language of the substitution clause requires the trustee to accept any tender of property as substitution for trust assets; rather, the substitution clause prohibits the trustee from declining to comply with the [grantor's] substitution of equivalent value property. A necessary precondition to that substitution is that equivalent value be established....Once [the grantor] has tendered property of equivalent value, the trustee lacks the discretion to deny the substitution. The trustee, however, still possessed the power and the duty to determine whether the attempted substitution complied with the requirements of the substitution clause.” In re Dino Rigoni Intentional Grantor Trust, Michigan Court of Appeals, WL 4255417, 2015.)*

The grantor proposed to substitute assets with the trust. The trustee resisted that proposed exchange, based on the timing of the trustee's duty to accept the proposed exchange of assets. The trustee felt that its fiduciary duty was to ensure that the substituted assets are of equivalent value and was, in effect, a condition precedent to the grantor's exercise of his right to make the substitution. The court disagreed with the trustee's position, noting:

*“This interpretation contradicts the plain language of the Swap Power, which allows the grantor, ‘during his lifetime’ and ‘acting alone in his individual and not in any fiduciary capacity’ to reacquire trust assets by substituting other property of equivalent value and in doing so, ‘neither the consent of the trustee nor the consent of any other person shall be required...A plain language reading of the substitution provision compels the conclusion that the grantor had the unilateral right of substituting assets. The trustee's fiduciary duty to determine whether the substitution of assets was equivalent did not abridge, delay, or block the grantor's right of substitution.” Manatt v. Manatt, 2018 WL 3154-461 (S.D. Iowa, 2018.)*

The grantor, the owner of the New Orleans Saints and Pelicans, attempted to substitute self-adjusting valuation promissory notes in exchange for hard-to-value nonvoting interests in those professional teams that he had previously transferred to the trust. The trustee refused to accept the proposed promissory notes, feeling that the value to be exchanged had to be simultaneous with the transfer of the business interests from the trust, in effect

objecting to the post-exchange valuation adjustment provisions in those notes. The court disagreed with the trustee's position. The court concluded that the trustee did not have the power to prevent the proposed exchange, concluding that if, with hindsight, the values were not equivalent, the trustee always had the remedy to sue the grantor for additional value, much like an award in a property condemnation situation. The court also noted that under Revenue Ruling 2008-22, the burden of proof as to the value of the proposed substituted asset falls on the trustee, which means that it is the trustee's responsibility to prove that the asset proposed to be substituted to the trust corpus is not of equivalent value. *Benson v. Rosenthal*, 2016 WL 2855456, E.D. Louisiana.)

**Observations:** The challenge is to ascertain equivalent values, which will be easy if cash is exchanged for marketable securities. Offering a promissory note in exchange for a stock portfolio is probably workable substitution, unless the terms of the promissory note are not consistent with fair market terms, which forces the trustee to refuse to accept the note in exchange for trust assets. If hard-to-value assets are the subject of the proposed exchange, problems immediately arise, along with delays, due to the trustee's responsibility to determine equivalent values. Other random thoughts that come to mind when dealing with a 'swap power' that might be exercised to gain a future basis adjustment include:

- While the mere presence of the swap power is sufficient to make the trust a *grantor* trust, the trust instrument should contain provisions that contemplate the grantor will exercise the power of substitution.
- The grantor's durable power of attorney should expressly give the grantor's agent under the power of attorney the authority to exercise the grantor's retained right of substitution, so there will be no questions or delays if the power is exercised when the grantor is either incapacitated or on his/her deathbed.
- For creditor protection purposes, the right to exchange assets of equivalent value retained by the grantor should be non-assignable, so that only the grantor, or his/her agent acting under the grantor's durable power of attorney, can exercise the retained power.

- The trust instrument needs to identify an established procedure to certify the equivalent value of the proposed substituted asset and how that certification is to be obtained, perhaps even including a timeline in which to determine that equivalency.
- While IRC 675(4)(C) does not expressly provide for this, the trust instrument should equate 'equivalent value' with 'fair market value' as the 'floor' for value used for the exchange. This, then, provides a common standard that appraisers can follow, both as to the assets going out of the trust and the assets, or the promissory note, going into the trust as the exchanged asset.
- Since the asset exchange may have to be immediately implemented, e.g., the grantor is on his/her deathbed, the trust instrument should expressly address if promissory notes constitute 'property of equivalent value', and if so, what terms will be considered necessary for those promissory notes, e.g., collateral security, self-adjusting principal (see the *Bensen* case), how post-transfer appraisals are obtained, the need for interest rates greater than the applicable federal rate (AFR), etc.
- If the exercise of the 'swap power' results in a delay in the exchange of property interest, the trust instrument should address when the risk of loss passes from the trustee to the grantor.
- If the proposed exchange is intended to take immediate effect, the trustee should be protected from claims filed by the trust beneficiaries for breach of trust for not protecting trust assets or claims for the dissipation of trust assets.

**Conclusion:** *Grantor* trusts with 'swap powers' are an excellent way to achieve a basis adjustment to assets that might be inherited from the grantor on his/her death. Often overlooked, though, are the mechanics of the exchange of assets, how they are to be valued, how equivalency is determined, and the timing of the asset exchange between the grantor and the *grantor* trust. The court cases that have looked at the exercise of a power of substitution provide some direction, but they also indicate what can happen if the grantor

and the trustee have not actually contemplated, in advance, the grantor exercising the retained power, and how disputes can easily arise.

If you would like to read additional missives, [click here](#).