

## **ARTICLE I**

### **Power to Substitute Property**

I shall act as the Substitutor. During my lifetime, the Substitutor shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675(4)) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to acquire or reacquire any asset or assets forming part of the trust estate of any trust held under this Trust Agreement by substituting other property of an equivalent value, determined as of the date of such substitution. I direct that this power is not assignable, and any attempted assignment will make this power void. Without reducing or eliminating the fiduciary duties imposed on the Trustee hereunder or by applicable law, the Substitutor shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value, and the Trustee shall have a fiduciary obligation to ensure the Substitutor's compliance with the terms of this power by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Revenue Ruling 2008-22. This power to substitute property cannot be exercised in a manner that can shift benefits among the trust beneficiaries. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the Trustee shall have, with respect to any trust which is not being administered as a unitrust or the distributions from which are not limited to discretionary distributions of principal and income (so that the power to reinvest the principal of the trust and the duty of impartiality are not required in order to avoid this power of substitution potentially causing a shift of benefits among trust beneficiaries, all within the meaning of Revenue Ruling 2008-22), the power to reinvest the principal of the trust and the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect. The foregoing grant of a power of reinvestment and imposition of a duty of impartiality are included herein for compliance with Revenue Ruling 2008-22, and whenever such power and duty are not granted and imposed under this Article, the remaining provisions of this Trust Agreement shall determine whether and to what extent such power and duty are granted and imposed. The Substitutor may at any time during my lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Trustee. Any such release made by the Substitutor shall be irrevocable, and shall be binding upon all current and successor Trustees, the current and any successor Substitutor, and all persons interested hereunder, and no person shall thereafter have the power to substitute trust property under this Article to the extent of such release. Any Substitutor may cease to act as Substitutor by delivery of a written and acknowledged notice to the Trustee. If the Substitutor should cease to act for any reason without having fully released the power to substitute property as provided under this Article, and if no successor Substitutor has otherwise been named, the successor Substitutor shall be such individual (other than me or any person who is a related or subordinate party within the meaning of Code Sec. 672(c) with respect to me) as shall be designated by a written and acknowledged instrument executed by the Trustee. If at any time prior to the complete release of the power of substitution there is no Substitutor acting hereunder, the Trustee (but acting in an individual capacity and not in a fiduciary capacity) shall exercise the Substitutor's powers under this Article until the appointment of a successor Substitutor as provided in this Article.

**Comparison of Swap Powers**  
**Five cases involving attempted exercises of swap powers**  
**Suggested Composite Swap Power Clause**

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**Manatt v. Manatt:** 10.14 Power to Exchange Assets. During my lifetime, I, acting alone in my individual and not in any fiduciary capacity, shall have the power, with respect to any trust created under this instrument, to reacquire trust assets by substituting other property having an equivalent value herewith; provided, however, that this substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries as provided in Rev. Rul. 2008–22. Neither the consent of the trustee nor the consent of any other person shall be required. The power described in this paragraph may be exercised by an agent appointed under a durable power of attorney or through any other means, whose actions shall be conclusive and binding.

*In all events, the trustee shall satisfy himself or herself that the properties acquired and substituted pursuant to this paragraph are, in fact, of equivalent value; and, further the trustee shall ensure that this substitution power is exercised in a manner that cannot shift benefits among the trust beneficiaries as such phrase is used in Rev. Rul. 2008–22. By written instrument delivered to the trustee, I (or an agent appointed under a durable power of attorney) may irrevocably release the power under this paragraph 10.14; and on the first to occur of (a) my death, (b) the expiration of the term beginning on September 1, 2012 and ending on August 31, 2027 and (c) the release of my power pursuant to this paragraph 10.14, my power under this paragraph 10.14 shall terminate and have no further legal force or effect under this instrument.*

**Schinazi v. Eden:** *[The grantor] expressly reserve[d] the right, exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, during [his] lifetime to reacquire any part or all of the property of any trust created hereunder by substituting property of equivalent value.*

**Benson v. Rosenthal:** The Swap Power in the 2009 Trusts read as follows:

*Notwithstanding any other provision of this agreement to the contrary, the Grantor hereby reserves the right and authority, exercisable in a nonfiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to reacquire or exchange any property of the Trust created hereunder by substituting other property of an equivalent value; however, if this power of substitution is exercised, the Grantor shall certify in writing that the substituted property is of equivalent value to the property for which it is substituted and the Trustee has a fiduciary obligation independently to verify that the properties acquired and the properties substituted by the Grantor are in fact of equal value. Any dispute regarding the value of the substituted property may be resolved in an appropriate court. This power is intended to create grantor trust status under section 675(4) of the Code.*

The Substitution Provisions in the 2012 Trusts, although less specific, express an identical power, stating: *Notwithstanding any other provision of this agreement to the contrary, the Grantor hereby reserves the right and authority, exercisable in a nonfiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to reacquire or exchange any property of the Trust created hereunder by*

*substituting other property of an equivalent value. This power is intended to create grantor trust status under section 675(4) of the Code.*

***In re Rigoni:*** *As Grantor, I [Dino Rigoni] do hereby retain the power and right, exercisable only for my personal benefit and only in a non-fiduciary capacity, to reacquire trust assets by substituting property of an equivalent value without the approval or consent of the Trustee or any person acting in a fiduciary capacity. The Trustee shall comply with my written expressed intentions concerning the exercise of this power.*

***In re Condiotti:*** *Notwithstanding any other provision of this instrument . . . to the contrary, [the] settlor, acting in a nonfiduciary capacity and without the approval or consent of any person acting in a fiduciary capacity, reserves the power to reacquire the trust corpus by substituting other property of an equivalent value.*

### **Annotated Swap Power Provision<sup>1</sup>**

**L. Paul Hood, Jr.**

#### **Article \_\_**

##### **A. Swap Power.**

1. **General Grant.** Until renounced by the grantor or removed by [INDICATE WHO HAS THE REMOVAL POWER] [INCLUDE IF POWER TO RESTORE GRANTOR TRUST STATUS IS USED unless subsequently restored as provided herein,<sup>2</sup>] the grantor [OR THIRD PARTY WHO HAS THE SWAP POWER] shall have a non-assignable right and power of administration pursuant to Code Section 675(4)(C), exercisable in writing at any time solely in a non-fiduciary capacity without the need for consent or approval by anyone in a fiduciary capacity pursuant to the exercise procedure set forth hereinbelow [OR ANYONE ELSE<sup>3</sup>/BUT SUBJECT TO THE VETO POWER OF [NAME/S], acting in a non-fiduciary capacity,] to cause the Trustees to transfer some or all of the Trust assets of the choosing of the grantor [OR POWERHOLDER][INCLUDE IF THERE ARE EXCLUDED ASSETS that are not Excluded Assets (as defined hereinbelow)] to the grantor in exchange for assets of equivalent value within the meaning of Code Section 675(4)(C) ("Swap Power"). The Swap Power may be exercised by an agent appointed by the grantor/powerholder<sup>4</sup> under a durable power of attorney or through any other means, whose actions shall be conclusive and binding.<sup>5</sup>
2. **Valuation.** For purposes of the Swap Power, the term "equivalent value" shall have the same meaning given that term in Code Section 675(4)(C), which shall not in any case be less than fair market value as finally determined for federal estate and gift tax purposes.<sup>6</sup>
3. **Certification and Delivery.** Without reducing or eliminating the fiduciary duties imposed on the Trustees herein or by applicable law, the grantor [OR THIRD PARTY POWERHOLDER] shall exercise the Swap Power only by certifying in writing that the property proposed to be transferred by the grantor to the Trustees pursuant to the grantor's exercise of the Swap Power and the Trust property for which it is being substituted are of equivalent value (as defined hereinabove) pursuant to the procedure set forth below, and, on the effective date of the transfers, the grantor shall provide the Trustees with the appropriate deeds, assignments or other evidence of property ownership and transfer of the assets to be substituted into the Trust, together with current

written qualified appraisals by a qualified, independent appraiser (all within the meaning of Treas. Reg. Sec. 1.170A-17), even for promissory notes sought to be substituted into the Trust.

4. **Promissory Notes; Valuation; Security Required.** If the grantor seeks to substitute promissory notes for property of the Trust, the promissory notes shall be secured by adequate security equal to at least 110% of the fair market value of the property to be substituted out of the Trust for the promissory note.<sup>7</sup> Said promissory notes shall bear interest at a current market rate (not merely the applicable federal rate)<sup>8</sup> for the risk that an unrelated third party debtor would pay and, if contemporaneous appraisals have not been provided, shall be adjustable by formula to ensure equivalence of value with the value of the property to be substituted out of the Trust as defined hereinabove.<sup>9</sup> [SPELL OUT MINIMUM REQUIREMENTS FOR NOTES-TERM, PAYMENTS BEFORE MATURITY, AND SECURITY]
5. **Effective Date.** The effective date of consummation of the Swap Power exchange shall be as of the date of written certification of substitution, and the risk of loss pre-consummation immediately passes<sup>10</sup> to the grantor and the Trustees, respectively.<sup>11</sup>
6. [USE IF A THIRD PARTY IS THE POWER HOLDER **Successor Holders.** If there is a vacancy in the office of holder of the Swap Power, then [INSERT NAME/S OR A METHOD FOR SELECTING A SUCCESSOR POWER HOLDER] shall immediately be the power holder, effective upon the vacancy creation.

- B. **Assignment Prohibited.** The grantor's Swap Power is not assignable; any attempted assignment by the grantor of the Swap Power shall render the Swap Power absolutely null and void and of no further legal effect.<sup>12</sup>

[C.] **[Excluded Assets.** The term "Excluded Assets" shall mean (a) any shares of the voting stock of any corporation in which the grantor owns, directly or indirectly, including ownership by attribution under Code Section 318, the right to vote stock constituting at least twenty percent (20%) of the total combined voting power of all classes of the said corporation's stock; and (b) all policies of life insurance insuring the grantor's life. INSERT IF WORRIED ABOUT IRC SECS. 2036(b) or 2042]<sup>13</sup>

**D. Exercise Procedure.**

1. **Notice.** The grantor must exercise the Swap Power only in writing by certifying that the property to be transferred by the grantor to the Trustees pursuant to the grantor's exercise of the Swap Power is equivalent value (as defined hereinabove) to the assets sought to be transferred out of the Trust and must deliver said notice of exercise of the Swap Power to each of the Trustees.
2. **Timing.** [Except as provided below, INCLUDE IF 3 IS ADDED] [I]n his written exercise of the Swap Power, the grantor hereby is authorized to determine the occurrence and timing of any such proposed exchange of assets required thereby.
3. **[Delay in Effective Date of Swap.** Unless the grantor and trustee mutually agree otherwise, the effective date of the Swap Power exchange shall occur not less than [NUMBER OF DAYS IN WORDS (NUMBER OF DAYS EXPRESSED AS A NUMBER) days following the date of written notice of the grantor's exercise of the Swap Power.]<sup>14</sup>

**E. Trustees' Duties Regarding Exercise of the Swap Power.**

1. **Fiduciary Duty.** The Trustees shall have the sole and absolute right and fiduciary duty to satisfy themselves that the assets proposed to be transferred to the Trustees as a result of the grantor's exercise of the Swap Power are of equivalent value (as defined hereinabove) to the assets being transferred out of the Trust.
2. **Court Instructions, etc.** In the exercise of the Trustees' fiduciary duty to the beneficiaries to satisfy themselves that the value of the assets being transferred to the Trustees pursuant to the grantor's exercise of the Swap Power are equivalent in value as defined hereinabove, the Trustees may, but are not required, to seek instructions from a proper court or to take any other actions in response to the grantor's exercise of the Swap Power that the Trustees feel are necessary or appropriate to protect the interests of the Trust beneficiaries, including, without limitation, alternative dispute methods such as mediation or arbitration.
3. **Immediacy.** [Except as otherwise provided herein,]<sup>15</sup> [T]he Trustees' duty to satisfy themselves of equivalent value (as defined hereinabove) being exchanged pursuant to the grantor's exercise of the Swap Power shall include neither a veto power over the grantor's exercise of the Swap Power nor any advance consent requirement as a condition of exercise and consummation of the substitution pursuant to the Swap Power.
4. **Equivalent Value Requirement.** The Trustees shall have a fiduciary obligation to ensure the grantor's compliance with the terms of the Swap Power by being satisfied that the properties acquired and substituted are in fact of equivalent values as defined hereinabove.

#### F. Limitations on the Grantor's Exercise of the Swap Power.

1. **No Shift of Benefits.** The grantor's exercise of the Swap Power shall not be exercised in a manner that could in any way shift benefits among the Trust beneficiaries within the meaning of Revenue Ruling 2008-22 and all subsequently issued rulings or caselaw.
2. **Duties and Powers.** Without limiting the foregoing prohibition upon shifting benefits among Trust beneficiaries, the Trustees shall have the power to reinvest the principal of the Trust and [ADD IF IT IS A MARITAL TRUST], except in the case of a Marital Trust,] the duty of impartiality with respect to Trust beneficiaries at all times while the Swap Power is in effect, unless the Trustees shall have absolute discretion in making distributions of principal and income among the Trust beneficiaries so that the power to reinvest the principal of the Trust and the duty of impartiality are not required in order to avoid the Swap Power potentially causing a shift of benefits among Trust beneficiaries, all within the meaning of Revenue Ruling 2008-22 and all subsequently issued rulings or caselaw.
3. **Power to Resist Certain Swap Powers.** The Trustees shall wholly disregard and shall resist any attempt to exercise the Swap Power if the Trustees reasonably believe that such exercise of the Swap Power would shift benefits among the Trust beneficiaries.

#### G. Removal and Recreation of Swap Power.<sup>16</sup>

1. **Cancellation; Re-Grant.** [INDICATE WHO HOLDS THIS POWER HERE] may cancel the Swap Power at any time and for any reason by a writing delivered [USE IF A THIRD PARTY IS THE HOLDER OF THE SWAP POWER to the grantor and] to the Trustees, designating the effective date of cancellation; provided, however, that [INDICATE WHO HOLDS THIS POWER HERE, WHICH SHOULD

NOT BE EITHER THE GRANTOR OR FORMER HOLDER OF THE SWAP POWER OR THE SPOUSES OF EITHER] may re-grant the Swap Power only to the grantor or to the grantor's spouse at any time and for any reason, by a writing delivered to the grantor, with a copy to each Trustee and to each then-living adult beneficiary of the Trust, designating the effective date of the re-grant of the Swap Power. All re-grants of the Swap Power and any attempted exercise of the re-granted Swap Power shall be subject to this Article [INDICATE NUMBER]

2. **Alternate Holders of Cancellation and Re-Grant Powers.** If [INDICATE WHO HOLDS THIS POWER HERE] shall be or become unwilling or unable to serve under this Article, [INDICATE WHO HOLDS THIS POWER HERE] shall hold and exercise the powers of cancellation and re-grant of the Swap Power. If both named persons are unable or unwilling to serve under this article, the grantor shall name as the holder of this power an individual who is neither related nor subservient to the grantor or the grantor's spouse, as defined in Code Section 672(c), who shall immediately succeed the holder of this power upon a vacancy in the office of power holder.

### **Swap Power Private Letter Rulings of Interest**

**PLR 200846001**-approved the exercise of a swap power that determined value of shares exchanged using "mean between highest and lowest quoted selling prices" on day of the swap.

**PLR 200842007**-determined that the exercise of a swap power was not taxable because the trust was a wholly grantor trust under IRC Secs. 675(4)(C) and 677.

**PLR 200514002**-a trust instrument providing that the grantor's swap power did not extend to stock of a controlled corporation was approved.

**PLR 200603040**-concluded that the swap power would not cause estate inclusion under IRC Secs. 2033, 2036(a), 2036(b), 2038, or 2039 because the trust instrument provided that the grantor's swap power could be exercised only in a fiduciary capacity.

**PLR 200434012**-third parties as swap power holders for a stock sale.

**PLRs 9253010; 9419990; 800237023; 9227013; 9413045; 8808018; 200010036; 9642039; 9224029; 9247024; 9037011; 9713017; 9810019; 9713017** (provided for backup swap power holders); **9407014; 200434012; 200010036; 199908002; 9810019; 9713017; 9642039 9247024**-Third party holder of the swap power for a charitable lead trust.

**PLR 201730018**-conversion of non-grantor trust to grantor trust.

**PLRs 201216034 and 200546054**-Primary beneficiary given swap power.

**PLRs 9352017; 9345035; 9248016; 9239015; 9416009; 9352004; 9351005; 200001015; 200001013; 9239015; 9352007; 9525032**-Grantor given swap power over a GRAT, some of which were holding stock in S corporations.

**PLRs 200449029 and 9037011**-Swap power given to trustees.

**PLRs 200845015; 9253010; 9239015; 9418024; 9416009; 9352004; 9227023; 9335028; 8932063; 9227013; 9645013; 9337011; 9351005; 199942017; 200729016; 8801008; 200729005; 9227013; 199908002; 9504024** (provided for release of swap power) **9126015** (beneficiary held swap power and had backup swap power holders)-Swap powers to hold S corporation stock.

**PLR 8930021**-Trust modification to add swap power to make the trust a valid S corporation shareholder.

**PLRs 200729006-16**-Jointly held Swap Powers (ruling is silent as to whether the powers were jointly held or whether each had a separate and independent Swap Power.

**PLR 9525032**-Grantor held swap power and had the right to borrow the trust assets without adequate security to make a GRAT a wholly grantor trust.

**PLR 201730018**-conversion of trust to grantor trust for charitable lead trust.

**PLRs 199927010; 200404009; 9808031**-negating grantor trust status.

**PLR 9548013**-IRS ruled that existence of a swap power made grantor trust holding S corporation stock but does not trigger inclusion under IRC Sec. 2038(a); swap power assignable.

**PLR 9318019**-IRS declined to rule on whether amending GST Tax “grandfathered” trust to give the grantor a swap power would cause loss of GST Tax grandfathered status, or whether it would create estate tax exposure to the grantor.

**200408015**-Culled out life insurance policy from swap power.

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<sup>1</sup> © L. Paul Hood, Jr. 2019. No representations or warranties are made about any aspect of this form.

<sup>2</sup> All grantor trust provisions should have an exit strategy built in to prevent a *Millstein v. Millstein*: 110 N.E.3d 674 (8<sup>th</sup> Dis. App. 2018), 2018-Ohio-1204, 2018 Ohio 2295. situation, because if the grantor cannot get out of grantor trust status, he may well have a claim for professional negligence against the trust scrivener.

<sup>3</sup> See, e.g., *Manatt v. Manatt*, 2018 WL 3154461 (S.D. Iowa May 2, 2018 and *Benson v. Rosenthal*, Civil Action No: 15-782 Section: “H”(2) (E.D. La. Nov. 10, 2016)). This is not required because IRC Sec. 675(4)(C) only prohibits interference by someone acting in a fiduciary capacity and does not prohibit a veto power being given to someone acting purely in a non-fiduciary capacity, and its inclusion limits flexibility, so I do not recommend it. However, some clients may feel more comfortable with its inclusion.

<sup>4</sup> Such a power should be express.

<sup>5</sup> See, e.g., *Benson v. Rosenthal*, Civil Action No: 15-782 Section: “H”(2) (E.D. La. Nov. 10, 2016).

<sup>6</sup> The term “equivalent value” is only used once in the Internal Revenue Code of 1986. The equating of equivalent value and fair market value, with fair market value as finally determined for federal estate and gift tax purposes being the floor of value, in order to prevent a gift. See also PLR 200846001, which used the fair market value rules for determining the price of substituted publicly traded common stock. In *Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer*, 2015 WL 4255417 (unpublished opinion, Court of Appeals of Michigan July 14, 2015), the court agreed with the trustee’s appraiser, who concluded that fair market value was the incorrect standard of value because the trustee was not a willing seller, so fair value was the proper standard of value.

<sup>7</sup> Adequate security is intended to protect the trust and forestall an argument that a gift was made by the exercise of the Swap Power.

<sup>8</sup> *In re Matter of Condiotti*, No. 14CA0969 (Col. App. July 9, 2015 unpublished opinion).

<sup>9</sup> The grantor’s first attempt to exercise the Swap Power actually used defined value notes.

<sup>10</sup> Important for insurance and liability purposes.

<sup>11</sup> *Benson v. Rosenthal*, Civil Action No: 15-782 Section: “H”(2) (E.D. La. Nov. 10, 2016).

<sup>12</sup> *Steve Leimberg’s Asset Protection Planning E-Mail Newsletter* No. 313 (February 3, 2016), Ed Morrow wrote an exhaustive analysis of the possible “dark side” of swap powers. By “dark side,” he meant the potential asset protection and bankruptcy ramifications of the swap power if it was to get into the hands of the **wrong people**, like a creditor or bankruptcy trustee. But see PLR 9548013, where the Swap Power was assignable, which I do not recommend.

<sup>13</sup> See, e.g., PLRs 200514002 and 200408015.

<sup>14</sup> Use if you want to delay the actual substitution.

<sup>15</sup> Add bracketed language if there is a delay in the effectiveness of the consummation of the substitution under the Swap Power.

<sup>16</sup> The whole area of toggling grantor trust status off should be safe and actually is encouraged to be a part of every grantor trust provision. However, the restoration of a swap power is much riskier. I advise extreme caution, and don’t vouchsafe the re-grant power in the hands of the original holder of the Swap Power or his or her spouse. The IRS has been sniffing around the toggle idea and issued Notice 2007-73 to stop a transaction type involving a grantor trust and toggling. It is now a transaction of interest to the IRS, which requires disclosure on tax returns. However, in my opinion, the notice doesn’t cover all attempts to toggle grantor trust status on and off.

# Snap, Crackle, Swap: The Substitution Power in Grantor Trusts

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# Quotes of the Day

- Appearances are deceitful, I know, but so long as they are, there's nothing like having them deceive for us instead of against us.
- George Horace Lorimer, *Letters from a Self-Made Merchant to His Son*
- All appearances are initially classed as real. Any appearance found self-contradictory is (deductively) illusory, and its contradictory is consequently self-evident and (deductively) real.
- Aví Sion, *Logical Philosophy: A Compendium*

# Agenda

- History of the swap power as a grantor trust power
- *Clifford* Regulations
- Analysis of IRC Sec. 675(4) and the corresponding regulations
- The interpretation of “reacquire”
- Tax consequences of holding the swap power; *Jordahl Estate v. Comr.*
- How should the swap power be held and exercised, i.e., in a fiduciary or non-fiduciary capacity

# Agenda

- Rev. Rul. 2008-22 and 2011-28; Rev. Procs. 2007-45 and 2008-45: Comfort to use of the swap power?
- Tax consequences of exercising the swap power
- Who should hold the swap power and who shouldn't
- Toggling the swap power and the consequences of such; Notice 2007-73
- Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes
- Interpretation of “equivalent value”

# Agenda

- The third party as power holder
- Analysis of the proper language for the swap power, **including forms!**
- Duties of the trustee when a swap power is exercised
- Uses of the swap power for basis planning
- Asset protection implications of the swap power
- Swap Power Do's and Don'ts

# Agenda-Lagniappe\*

- Court cases involving attempted exercise of the swap power
- Private Letter Rulings of interest
- \* A little extra; if time permits.

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## A word of thanks...

- I would like to thank my fellow LISI team members, Howard Zaritsky and Ed Morrow, for reviewing my presentation and making helpful corrections and comments.
- However, I am solely responsible for any errors in my materials.



# First, a little history...

- The federal income tax became effective in 1913. The federal estate tax was enacted in 1916, but the federal gift tax wasn't enacted for good until 1932 (originally enacted in 1924 but repealed in 1926).
- The fact that the rules were drafted at different times is why the string provisions of the federal estate tax and the income tax grantor trust provisions were crafted without coordination.
- They were addressing different situations, many on the fly as crafty taxpayers tried novel approaches to split income with persons in lower marginal tax brackets.

# First, a little history...

- When the income tax rates increased **exponentially** to finance World War I, taxpayers resorted to using trusts to split income.
- Initially, taxpayers used **revocable** trusts, but they finally lost a case on revocable trusts, so they switched to **short term reversionary trusts**, which the IRS continued to fight with mixed success.
- The first income tax grantor trust rules appeared in the Revenue Act of 1924. Sec. 219(g) and (h). The swap power wasn't included in the original grantor trust rules. **It is paramount to remember that the grantor trust powers were supposed to be bad, and the “punishment” was that the grantor (or a beneficiary under IRC Sec. 678) was taxed on the trust's income.**

# First, a little history...

- Things continued to fester in this area. In 1940, the Supreme Court decided *Helvering v. Clifford*, a case involving the use of a short term reversionary trust.
- Instead of providing some much needed guidance in a murky area, the U.S. Supreme Court sadly yet predictably chose the path of intellectual sloth and resorted to the favorite test of a lazy court: facts and circumstances.
- This only increased the amount of darkness and litigation in this area as neither taxpayers nor the IRS were really sure of the rules, so many taxpayers simply played the audit lottery.

# First, a little history...

- To its credit, in the aftermath of the really less than satisfying *Clifford* decision, the Treasury Department began work on some regulations intending to give bright line guidance in this area.
- These regulations were promulgated in 1945 and were known as the *Clifford* Regulations. Unfortunately, the courts kept muddying up the waters, so Congress stepped in and enacted subpart E of subchapter J of the Internal Revenue Code of 1954 when it replaced the 1939 code in 1954.
- Congress retained much of the *Clifford* Regulations. However, it made a **significant change to the language** in what would become the swap power in IRC Sec. 675(4)(C).

# The Swap Power: *Clifford* Regulations (1945)

- Sec. 39.22(c) ...and a power to reacquire the trust corpus by substituting other property[, **whether or not**] of an equivalent value. [Emphasis added] Bracketed [] language not included in IRC Sec. 675(4)(C).

# The Swap Power: *Clifford* Regulations (1945)

- Sec. 39.22(e)(1)(iv) ...and a power to reacquire the trust corpus by substituting other property of an **equivalent value**. [Emphasis added]

The Swap Power:  
IRC Sec. 675(4)(C) (1954)

- (C) a power to reacquire the trust corpus by substituting other property of an **equivalent value**. [Emphasis added]

# Comparison of Swap Power Language Between the *Clifford* Regulations and IRC Sec. 675(4)(C)

- Note that the *Clifford* Regulations version covered a swap of assets that were worth **less** than fair market value of the swapped out property.
- Query: Wouldn't the retention of a swap power that was **favorable** to the grantor result in an **incomplete gift** by the grantor since the grantor retained a power to take value back through exercise of the swap power, i.e., the gift didn't become irrevocable?



# Comparison of Swap Power Language Between the *Clifford* Regulations and IRC Sec. 675(4)(C)

- Congress kept the swap power as a tainted grantor trust power, but required that the swap be of “an **equivalent value**,” and this is the **only place in the Internal Revenue Code where this term appears**.
- Query the potential for shenanigans where the swap must be **of equivalent value** such that it was deemed to be a tainted grantor trust power.
- This may have been **a solution in search of a problem**, which ironically has become the go-to defect. Or, given the number of reported decisions in this area, did Congress show that it understood human dynamics of greed very well?

# Comparison of Swap Power Language Between the *Clifford* Regulations and IRC Sec. 675(4)(C)

- Treas. Reg. Sec. 1.671-1(a)(3) provides “If certain administrative powers over the trust exist under which the grantor **can or does benefit** (section 675).” [Emphasis added] Note that the **IRS is still suspicious of administrative powers that it feels that taxpayers can benefit themselves.**
- Query how a grantor benefits if the grantor is forced to substitute property of **equivalent value**, and the trustee of the grantor trust serves as a protection mechanism.
- This is what the Tax Court observed in *Jordahl Est. v. Comr.*
- Yet this language is a vestige of the *Clifford* Regulations because the swap power thereunder permitted bad deals to be foisted upon the trustee.

Analysis of IRC Sec. 675(4)  
and the corresponding regulations: Current language of IRC  
Sec. 675(4) (has never been amended)

- *A power of administration is exercisable in a **nonfiduciary capacity** by **any person without the approval or consent** of any person in a **fiduciary** capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to **reacquire** the trust corpus by substituting other property of an equivalent value. [Emphasis added]*

# Analysis of IRC Sec. 675(4) and the corresponding regulations: Sec. 39.22(e), *Clifford* Regulations

- *(iv) Any One of the following powers of administration over the trust corpus or income is exercisable in a nonfiduciary capacity by the grantor, or any person not having a substantial adverse interest in its exercise, or both : a power to vote or direct the voting of Stock or other Securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property of an **equivalent value**.*  
[Emphasis added]

Analysis of IRC Sec. 675(4)  
and the corresponding regulations: Sec.  
39.22(e), *Clifford* Regulations (1945)

- Differences between current IRC Sec. 675(4)(C) and its counterpart in the *Clifford* Regulations:
- While the swap power may be held by **anyone** and count as a tainted power as to the grantor in current IRC Sec. 675(4)(C), the swap power of the **grantor, or any person not having a substantial adverse interest in its exercise, or both** were the **only** power holders to be tainted with grantor trust status in the *Clifford* Regulations.

Analysis of IRC Sec. 675(4)  
and the corresponding regulations: Sec.  
39.22(e), *Clifford* Regulations (1945)

- Differences between current IRC Sec. 675(4)(C) and its counterpart in the *Clifford* Regulations:
- When the word **reacquire** was used in the *Clifford* Regulations, it made sense because the tainted power was limited to the **grantor or any person not having a substantial adverse interest in its exercise, or both**, and it probably was the grantor who originally contributed the property to the grantor trust.

# Analysis of IRC Sec. 675(4) and the corresponding regulations: Sec. 39.22(e), *Clifford* Regulations (1945)

- Congress picked up the word **reacquire** in IRC Sec. 675(4)(C), but it was unnecessary and wrong, since the tainted administrative powers in IRC Sec. 675(4) may be held by **anyone**, i.e., not limited to the grantor or any person not having a substantial adverse interest in its exercise, or both, like was the case in the *Clifford* Regulations.
- This probably explains why the IRS has always interpreted the word reacquire to mean acquire. Mystery solved. See the discussion of the meaning of reacquire in an upcoming slide.

# Analysis of IRC Sec. 675(4) and the corresponding regulations: Sec. 39.22(c), *Clifford* Regulations (1945)

- Differences between current IRC Sec. 675(4)(C) and its counterpart in the *Clifford* Regulations:
- IRC Sec. 675(4)(C) provides in pertinent part: *A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a **fiduciary** capacity.* [Emphasis added]
- Sec. 39.22(c)-22(e) provides as follows: *Any one of the following powers of administration over the trust corpus or income is exercisable in a nonfiduciary capacity by the grantor, or any person **not having a substantial adverse interest in its exercise**, or both:*
- Note that in the *Clifford* Regulations, the tainted swap power can only be held by the grantor or any person who doesn't have a substantial adverse interest, while the swap power under IRC Sec. 675(4)(C) may be held by **anyone**.



# Tax consequences of holding the swap power; *Jordahl Estate v. Comr.*

- For federal income tax purposes, a trust that has a swap power is a grantor trust **in whole, but only with respect to the portion of the grantor trust over which the swap power applies**. Treas. Reg. Sec. 1.671-3(b)(3). *Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.*
- Therefore, if the grantor trust swap power is expressly **inapplicable** to certain assets, e.g., IRC Sec. 2036(b) voting stock or certain closely-held corporations, unless the scrivener adds another defective trust power, the trust won't be a **wholly** grantor trust for income tax purposes.

# Tax consequences of holding the swap power; *Jordahl Estate v. Comr.*

- In *Jordahl Estate v. Comr.*, the Tax Court decided that the right to buy an asset, exercisable in a **fiduciary** capacity, for its fair market value is not a retained right or interest for purposes of IRC Secs. 2038 or 2042, and the IRS acquiesced in the result of the case. 65 T.C. 92 (1975), acq. 1977-2 C.B. 1.
- Given that the power in *Jordahl Estate* was exercisable in a **fiduciary** capacity, most practitioners believed it to be of limited utility for a non-fiduciary swap power under IRC Sec. 675(4)(C).

# Tax consequences of holding the swap power; *Jordahl Estate v. Comr.*

- The explicit holding of Rev. Rul. 2008-22 is a grantor's nonfiduciary swap power by itself will not cause inclusion under IRC Secs. 2036 or 2038, provided that the trustee has a fiduciary obligation (under the instrument or local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and that the swap power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

# Tax consequences of exercising the swap power

- **Exercise by the grantor:** Should be no tax consequences to either the grantor or the grantor trust. Rev. Rul. 85-13. The grantor would take the grantor trust's basis in the swapped out asset, and the trustee would take a carryover basis in the substituted asset. PLRs 200842007 (no gain recognized on grantor's exchange of equivalent assets when grantor owned entire trust under Sec. 677); 200846001 (no gain recognized on grantor's exchange of equivalent assets when grantor owned entire trust under Section 674(a)).

# Tax consequences of exercising the swap power

- **Caveat from Howard Zaritsky:** A grantor could have a swap power that the instrument states is held in a nonfiduciary capacity, but **other facts** indicate the existence of a fiduciary relationship, e.g., the grantor could own a majority of the interests in a closely-held entity and initially fund the grantor trust with a minority interest in that entity.
- The grantor's fiduciary duty as majority shareholder could trump the trust instrument's declaration that the swap power is held in a **nonfiduciary capacity**, which would take you outside of the ambit of the swap power.

# Tax consequences of exercising the swap power

- **Exercise by a third party.** If a third-party holds and *exercises* the swap power, the transaction should be deemed to be an exchange between the third-party and the grantor, for income tax purposes.
- This could be a taxable exchange to the grantor, the third-party or both.

# Tax consequences of exercising the swap power

- If the third-party swaps appreciated assets with the trustee in exchange for other appreciated property of equivalent value, both the grantor and the third-party would recognize gain equal to the difference between their respective adjusted basis in the transferred asset and the fair market value of that asset on the date of the exchange unless the trust is a grantor trust as to the transferor. See IRC Sec. 1001.
- Note that the Treas. Reg. Sec. 39-22-22(e) provides that the power may be held by anyone who doesn't have a substantial adverse interest. Contrast that with the language of IRC Sec. 675(4)(C), which permits **anyone** to hold the swap power.
- **Query: is a swap power held by a third party really illusory? However, given that it is far less likely that the swap power would be exercised, perhaps the third person is the best holder of the swap power.**

# Who should hold the swap power and who shouldn't

- **Adverse party**-An adverse party is a defined term in IRC Sec. 672(a) and means “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.” The IRS has privately blessed situations where the beneficiary held the swap power. See PLRs 201216034 and 200546054.
- **Nonadverse party**-Treas. Reg. Sec. 1.675-1(b)(4). requires **nonadverse** party-IRC Sec. 675 says **any person**-surely the statute trumps the regulation? The regulation reflects the law under the *Clifford* Regulations, but not the law since 1954.



# Who should hold the swap power and who shouldn't

- **Beneficiary**-A beneficiary is going to be an adverse party, which takes you outside of the literal cover of IRC Sec. 675(4)(C). Nevertheless, the IRS has privately blessed situations where a beneficiary held the swap power. See, e.g., PLRs 201216034 and 200546054.
- **The trustee**-A swap power that's held by someone who is a trustee may be held in a nonfiduciary capacity, but the regulations presume that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by **clear and convincing** proof that the power is not exercisable primarily in the interests of the beneficiaries. Regs. § 1.675-1(b)(4)(iii). Nevertheless, the IRS has privately blessed situations where the trustee held the swap power. PLRs 200449029 and 9037011.

# Who should hold the swap power and who shouldn't

- **The Grantor-pro's and con's**
  - No reacquire issue.
  - If the trust holds voting stock in a closely held family corporation or life insurance on the life of the grantor swap power holder, pretty certain unnecessary estate tax exposure unless you cull those assets out of the swap power, and give the swap power over those assets to a third party.
  - Can swap assets out of the grantor trust with no tax consequences.
- **The grantor's spouse-pro's and con's**
  - No IRC Sec. 2036(b) or life insurance policy problem.
  - Possible reacquire issue.
  - Only good during the marriage and grantor trust status ends upon the spouse's death, unless additional plans are made.

# Who should hold the swap power and who shouldn't

- **Third party**-pro's and con's. A swap power to substitute assets held by someone who is not a trustee may still be deemed to be held in a fiduciary capacity. The determination of whether the power is exercisable in a nonfiduciary capacity depends on all the terms of the trust and the circumstances.
  - Reacquire issue
  - Given the tax cost of exercising the swap power, is giving the swap power to a third party really illusory from the beginning?

# How should the swap power be held and exercised, i.e., in a fiduciary or non-fiduciary capacity

- The literal language of IRC sec. 675(4) says that the swap power must be held in a **nonfiduciary** capacity.
- Nevertheless, the IRS has recognized and possibly required at one time that the swap power be exercised in a **fiduciary** capacity. cf. *Jordahl Estate v. Comr.* See, e.g., PLR 200842007 (trust property that grantor could substitute for assets of equivalent value not included in grantor's gross estate under IRC Secs. 2033, 2036, 2038, or 2039, where grantor held power in a fiduciary capacity.); PLR 200606006 (the IRS held that IRC Sec. 2036 would not apply to a situation in which the grantor held the swap power in a fiduciary capacity.) PLR 200603040 (Concerned a trust with a swap power where "[t]he instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity" where the taxpayer got a favorable ruling on grantor trust status.)

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- **Can a promissory note be substituted in for hard assets and be considered equivalent value?** All five grantors in the court actions sought to substitute promissory notes as partial or whole substitution for the assets in the trusts.
- The grantor was successful in *Benson v. Rosenthal*, where the notes were fully collateralized by security interests in assets and bore an appropriate rate of interest to reflect market rate interest, not merely interest at the applicable federal rate (AFR).
- However, in *Benson v. Rosenthal*, additional assets were sought to be swapped into the grantor trust as well as a significant amount (approximately \$100,000,000) of debt relief.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- In *In re Condiotti*, the grantor unsuccessfully sought to substitute in an unsecured \$9,500,000 promissory note that bore interest only at the AFR of 1.27% and paid interest only for nine years. The court determined that the proffered notes were not equivalent in value to the assets in the grantor trust.
- In *In re Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer*, the terms of the promissory notes were not discussed, but, in all likelihood, the proffered promissory notes were unsecured and bore an insufficient rate of interest.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- However, in *Schinazi et al. v. Eden*, 338 Ga. App. 793, 792 S.E.2d 94 (App. Ga. 2016), in response to an attempted substitution of a promissory note in the amount of \$58,290,000, but no other particulars about the note, i.e., whether it was negotiable, bore a market rate of interest or was secured by any assets for the trust assets, the trustee resisted, alleging lack of equivalent value, but the trial court granted summary judgment to the grantor on that issue. The trustee appealed that issue nominally, but she conceded the issue on appeal.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- Moreover, in *Manatt v. Manatt*, the court ruled that the grantor properly exercised the swap power and properly became the owner of the swapped out assets upon exercise of the swap power, notwithstanding that the trustee hadn't yet examined the evidence of equivalent value, but some pre-judgment transfers prevented the court from giving the grantor the relief that he sought.



# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- **Can a promissory note be substituted in for hard assets and be considered equivalent value? (Cont.)**  
It seems clear beyond cavil that trustees are right to reject promissory notes that don't bear a market rate of interest consonant with the risk that the trustee is assuming by taking the promissory note in substitution that isn't collateralized by security interests in assets of the grantor.
- This includes attempts to proffer a note that only bears interest at the AFR, which the grantor in *In re Condiotti* unsuccessfully tried to do.

Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- **Does the trustee of a grantor trust where the grantor has exercised a swap power have to go to court in all situations?** Note that neither Rev. Rul. 2008-22 nor Rev. Rul. 2011-28 requires the trustee to seek judicial approval in all cases as a precondition to the swap; hence, the “**satisfying itself**” language.
- The trustee need only satisfy itself that the swap will not diminish the trust’s value because the substituted property is of equivalent value to the property substituted out of the grantor trust.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- I submit that if a grantor who formed the trust has the unilateral ability to simply substitute property without it being tested for equivalence in value, **the underpinning requirement of an irrevocable trust may be missing.**
- Query whether it is still a trust where the grantor retains the unchecked power prior to the swap to substitute assets that may well be worth **less** than the value of the assets being substituted into the grantor trust.
- To allow the grantor of a trust to unilaterally substitute property in and out of the trust with no possible stopping by the trustee wastes time and is contrary in my opinion to the inherent fiduciary duty that the settlor owes to the trust on formation.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- Traditional notions of fiduciary duty and the very essence of the trust mandate that while the grantor's swap power be respected, the grantor should have to first meet some minimum good faith burden of going forward, not of the least of the swap power training wheels.
- If the grantor doesn't present enough evidence to meet his burden of moving forward, the trustee is required in my opinion to object and **defend** the trust, which **almost always requires legal action**.
- However, once the grantor has met his burden of going forward, the trustee's role shifts slightly from **defender** to **guardian**. In the **defender** role, the trustee is pretty much required to take some legal action to defend the trust's interests.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- However, in its **guardian** role, the trustee's role is much more passive and really is focused on making sure that the trust value is maintained after the swap. In its guardian role, the trustee may, but need not, take legal action to protect the trust's interests.
- Quite often, all the trustee needs to receive are qualified appraisals of the assets sought to be swapped into the grantor trust to ensure that equivalent value is received.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- What is clear is that courts are going to examine the actual words of the swap power.
- Suppose the court interprets the swap power to permit the unilateral and unchecked authority to swap out assets.
- Does the scrivener have some possible exposure to the beneficiaries of the trust if that exercise of the swap power damages the trust value? Possibly.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- However, it is easy to build in some intermediate protections in the swap power itself that can include what constitutes an equivalent value certification procedure and whatever else might be included in the grantor's good faith burden of moving forward, which I believe should be included.
- Additionally, why not draft to slow down the swap process by interposing a minimum amount of time, e.g., 90 days, before the swap becomes effective, which would permit appraisals to at least get substantially underway if not completed?
- I believe that this is how the swap power should be drafted.

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- **In these cases, does the trustee have a duty to, or, alternatively, should a trustee always seek cover from a local court before acceding to the swap power?**
- Clearly, the bigger the dollars involved, the more likely it is that the trustee, particularly, an institutional trustee (most of which are afraid of their own shadows), will lean on a court instructions action to provide insulation against liability to the beneficiaries of the trust for a breach of a duty in connection with a swap of assets. But whether a trustee goes to court or not probably will be dependent upon the role that the trustee is playing, i.e., **defender v. guardian**, as discussed earlier.
- This particularly is true where, as Howard Zaritsky astutely observed, relations between the grantor and the beneficiaries have soured either on some other issue or over exercise of the swap power, which was the situation in all five court cases thus far.



# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- **Is it possible for a trust asset to be so unique that nothing sought to be swapped in will be of equivalent value?** In light of *Benson v. Rosenthal*, the answer appears to be no. In *Benson v. Rosenthal*, the assets sought to be swapped out of the grantor trust were controlling interests in the NFL New Orleans Saints and the NBA New Orleans Pelicans.
- Assets don't get more unique and exclusive than controlling interests in major league sports teams, but this uniqueness/exclusivity issue doesn't appear to have been broached. Perhaps the trustee should have made such an argument. Maybe in a future case. **The delta between the cash flow from these different assets, i.e., team revenue, including share of television advertising revenue, and a fixed income promissory note, is gigantic.**
- The answer to this issue is, in my opinion, **much closer** than the efficacy of substituting secured promissory notes for hard assets if one focuses on the whole meaning of "equivalent value."

# Outer limitations on the swap power and what can be substituted for the grantor trust assets; promissory notes

- **If the desired asset swap attempts to substitute a promissory note for all or substantially all of the grantor trust's assets, is this akin to a loan, which must be authorized by applicable state law or by the governing instrument?** In *In re Condiotti*, the trust instrument prohibited the grantor from borrowing money from the trust. When the grantor attempted to substitute an unsecured promissory note bearing interest only at the AFR of 1.27% for all of the assets in the grantor trust, the trustee, in reliance in part on the loan prohibition, refused to comply because the ultimate real effect of the swap was effectively a loan of the entire trust corpus, which the trust instrument prohibited. In *In re Condiotti*, the appellate court decided the case adversely to the grantor on this issue alone.
- But this theory might be limited to **unsecured** promissory notes. See *Benson v. Rosenthal, infra.*, where the district court distinguished *In Re Condiotti* because, unlike the promissory note in *In Re Condiotti*, the grantor's 13 notes proffered in substitution were fully secured by pledges or other security interests in other assets.

# Meaning of “equivalent value”

- **What does the phrase “equivalent value” mean, and can equivalent value ever be supplied by promissory notes?** This was the issue in several of the litigated cases, with three of the five grantors being successful in substituting promissory notes at least in part for the swapped out assets.
- The phrase “equivalent value” only appears once in the Internal Revenue Code, in IRC Sec. 675(4)(C). Then what does the word “equivalent,” which the Internal Revenue Code doesn’t define, mean? According to the *Merriam-Webster Dictionary*, the word “equivalent” means “equal in force, amount, or value.”

# Meaning of “equivalent value”

- What did Congress intend by coining a new term in the Code? Equivalent value just might require **more than mere equality** in fair market value, as it is possible that it is a higher standard.
- It’s not out of the realm of possibility that the word “equivalent” requires **comparability** of tax and non-tax characteristics, e.g., quality of the asset, i.e., whether it is a nonmarketable minority interest, mere assignee interest, income/cash flow produced by each asset, likelihood of appreciation, the income tax basis of each asset, etc.

# Meaning of “equivalent value”

- The trustee owes a fiduciary obligation to the trust beneficiaries to receive at least equivalent value in the swap. Thus far, the **IRS appears to consider only fair market values of the involved assets, although the IRS hasn't yet addressed that issue head on, and none of the reported decisions thus far have dealt with this issue, meaning that it's still open.**
- In PLR 200846001, which involved a swap power that was held in a fiduciary capacity, the IRS held that an exchange of assets by the grantor and a grantor trust pursuant to the swap power was an exchange of assets of equivalent value as long as both assets (publicly traded stock) were valued pursuant to the gift tax regulations.

# Meaning of “equivalent value”

- Equivalent value seemingly effectively means fair market value, although, in *In Re Rigoni, supra.*, the court sided with the appraiser who posited that fair market value was not the proper standard because the seller was not a willing seller in that instance, thereby undercutting the principal tenet of fair market value, which involves a willing buyer and a willing seller.
- I would expect that very few of these contested exercise cases involves a willing seller, such that the proper standard of value in these cases probably is **fair value**, which means that valuation discounts are **inapplicable**. However, the proper standard for valuing the promissory note is **fair market value**.

# Meaning of “equivalent value”

- **What’s the proper valuation standard for valuing the proffered promissory notes? Is it the willing buyer-willing seller fair market value standard, or are they to be valued pursuant to a read of the Internal Revenue Code, such that interest at the AFR was to be considered a sufficient rate of interest?** These questions were at issue in *In re Condiotti*, and the trial court held that the willing buyer willing seller standard fair market value was the proper standard, and the court is correct in my opinion. The district court reached the same conclusion in *Benson v. Rosenthal*.

# Meaning of “equivalent value”

- **Can non-voting stock or an assignee interest ever be considered equivalent value to voting or full interests?** No one knows the answer for certain, but if the proper analysis is the “willing buyer-willing seller” fair market value standard, then it should be mathematically possible, assuming that the values are equivalent, **unless** the term “equivalent value” means something different than mere equality in dollar value.



# Meaning of “equivalent value”

- In *Benson v. Rosenthal*, while the plaintiff didn't attempt to make such a distinction, the trial court reasoned that the willing buyer willing seller fair market value standard of value was the proper standard in this situation. This is the only appropriate and sensical interpretation in my opinion.
- For an excellent article on a method of valuing the swapped in promissory note, see Samuel S. Nicolls, “The Perils of the “Power of Substitution” for “Intentionally Defective” Grantor Trusts,” *Insights* (a publication of Willamette Management Associates), Spring 2018.

# Should the swap power be held in a fiduciary capacity or a non-fiduciary capacity

- Treas. Reg. Sec. 1.675-1(b)(4) provides: *If a power is exercisable by a person as **trustee**, it is presumed that the power is exercisable in a **fiduciary** capacity primarily in the interests of the beneficiaries. This presumption may be **rebutted only by clear and convincing proof** that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity **depends on all the terms of the trust and the circumstances surrounding its creation and administration.** [Emphasis added]*

# Should the swap power be held in a fiduciary capacity or a non-fiduciary capacity

- On its face, the administrative powers in IRC Sec. 675(4) that are tainted with grantor trust status are only exercisable in a **nonfiduciary** capacity. So why does the IRS spill ink on swap powers that a fiduciary holds in Treas. Reg. Sec. 1.675-1?
- It's the last sentence of this regulation that usually prevents the IRS from ruling on whether a swap power is exercisable in a non-fiduciary capacity because it's a facts and circumstances test. See, e.g., PLRs 200709012, 200709011, 200434012, 200022028, 200022018, 200010036, 9810019 and 9648045.

# Rev. Ruls. 2008-22 and 2011-28; Rev. Procs. 2007-45 and 2008-46: Comfort to use the swap power?

- Rev. Rul. 2008-22 held as follows: A **grantor's** retained power, exercisable in a **nonfiduciary capacity**, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, **provided** the trustee has a **fiduciary obligation (under local law or the trust instrument)** to ensure the grantor's compliance with the terms of this power by **satisfying itself** that the properties acquired and substituted by the grantor are in fact of **equivalent value**, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

# Rev. Ruls. 2008-22 and 2011-28; Rev. Procs. 2007-45 and 2008-46: Comfort to use the swap power?

- Rev. Rul. 2008-22 held as follows (Cont.): *A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the **power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality** with respect to the trust beneficiaries; or (b) the **nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries**, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income. [Emphasis added]*

# Rev. Ruls. 2008-22 and 2011-28; Rev. Proc. 2007-45: Comfort to use the swap power?

- In Rev. Rul. 2011-28, the IRS held: A **grantor's** retention of the power, exercisable in a **nonfiduciary** capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042, **provided** the trustee has a **fiduciary obligation (under local law or the trust instrument)** to ensure the grantor's compliance with the terms of this power by **satisfying itself** that the properties acquired and substituted by the grantor are in fact of **equivalent value**, and further provided that the substitution power **cannot be exercised in a manner that can shift benefits** among the trust beneficiaries.

# Rev. Ruls. 2008-22 and 2011-28; Rev. Proc. 2007-45: Comfort to use the swap power?

- In Rev. Rul. 2011-28, the IRS held (Cont.): *A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.* [Emphasis added]

# Rev. Ruls. 2008-22 and 2011-28; Rev. Procs. 2007-45 and 2008-46: Comfort to use the swap power?

- Note that **neither** Rev. Rul. 2008-22 nor Rev. Rul. 2011-28 apply to a swap power held by a **third party** in a nonfiduciary capacity. Both rulings posited a grantor who possessed the swap power.
- The IRS has issued a number of private letter rulings, many involving grantor charitable lead trusts, where a third party swap power creates grantor trust status. See, e.g., PLR 200434012, 200010036, 199908022, 9810019, 9713017, 9642039, 9247024, 9126015, and 9037011.
- The Treasury Department issued Rev. Procs. 2007-45 and 2008-46 to provide sample forms for charitable lead trusts, the grantor trust versions of the charitable lead trust use a third-party swap power to achieve grantor trust status. Given the probable wrongful and unnecessary inclusion of the word reacquire from the *Clifford* Regulations, as I discussed earlier, the IRS position here is sound.



# Rev. Ruls. 2008-22 and 2011-28; Rev. Procs. 2007-45 and 2008-46: Comfort to use the swap power?

- Rev. Rul. 2008-22 provides as follows: *In situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a **duty to ensure** that the value of the assets being replaced is equivalent to the value of the assets being substituted. If the trustee knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust assets being replaced, the trustee has a **fiduciary duty to prevent the exercise of the power.*** [Emphasis added]
- The swap power language suggested by the IRS in its sample charitable lead annuity and unitrust forms is a nonfiduciary swap power held by someone other than the grantor. Rev. Proc. 2007-45, Sec. 7, Par. 11; Rev. Proc. 2008-46, Sec. 7, Par. 11.

# Effectiveness of the swap power

- Typically, the swap power is unilaterally held either by the grantor or a third party and is **effective at all times with no impediments** save satisfaction by the trustee of the equivalence in value of the swapped in assets.
- Nevertheless, a scrivener can put some conditions on the exercise of a swap power, including a **notice** requirement. Additionally, a scrivener could subject exercise of the swap power to an **approval of a non-fiduciary, non-adverse person**. Note that IRC Sec. 675(4)(C) won't allow a person in a **fiduciary** capacity to veto or refuse the attempted exercise of a swap power. However, the section says nothing about conditioning exercise of the swap power to the consent of a **non-adverse, non-fiduciary third party**, so this can be done, which can have some benefits for asset protection.

# Toggling the swap power and the consequences of such; Notice 2007-73

- In addition, allowing a third party to hold the swap power could create additional flexibility to “turn off” or to “toggle on” grantor trust status.
- Maximum flexibility of grantor trust planning involves restoring grantor trust status to a nongrantor trust that once was a grantor trust or making a trust a grantor trust that has never been one.
- However, it is critical that when the grantor or the grantor’s spouse has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute the swap power, i.e., to toggle back “on” the grantor trust status.
- Neither the grantor nor the grantor’s spouse should be permitted to toggle grantor trust status back on once it has been toggled off.

# Toggling the swap power and the consequences of such;

## Notice 2007-73

- If the grantor or the grantor's spouse has the right to relinquish a power that causes grantor trust status but has the right to get the power back, **query whether the relinquishment would be given effect.** Many of the grantor trust powers must be exercisable without the consent of any adverse party to result in grantor trust status.
- However, the power to eliminate or reinstate a grantor trust power could be **held by either an adverse party or a nonadverse party.** Having the status of an adverse or a nonadverse party is important for the person who holds the power that may make a trust a grantor trust, but that distinction has no relevance for a person who has the authority to eliminate or reinstate that power. Thus, **it is possible for a beneficiary to be given the power to toggle on or off grantor trust status.**

# Toggling the swap power and the consequences of such; Notice 2007-73

- IRS Notice 2007-73 identifies two rather complicated and highly unusual series of transactions involving toggling of grantor trusts. In each, a grantor trust would be formed that creates a unitrust interest and a noncontingent remainder interest for the grantor. The non-contingent remainder interest causes grantor trust status. The goal of the scenarios is either to generate a tax loss to the grantor that is not a real economic loss or to avoid the recognition of gain. The Notice states “transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest” that require disclosure.

# Duties of the trustee when a swap power is exercised

- The trustee owes several duties to the beneficiaries of the grantor trust where the grantor attempts to substitute new property of alleged equivalent value to the trust assets.
- **One thing that the trustee can't do is simply resist the effort without just cause.** However, the trustee must ensure that the interests of the grantor trust in the substitution are protected and that the grantor trust must receive assets of equivalent value.
- The trustee of the grantor trust has an **affirmative duty** under Rev. Rul. 2008-22 to resist exercise of the swap power if the trustee satisfies itself that the proposed assets to be swapped into the grantor trust are worth less than the assets that are being swapped out of the grantor trust.

# Uses of the swap power

- Grantor trust status is key to the grantor's ability to **swap assets and sell assets** to a grantor trust because transactions between the grantor and the grantor trust are ignored for federal income tax purposes. Rev. Rul. 85-13, notwithstanding a contrary decision in *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984), rev'g 574 F. Supp. 19 (D.C. Conn. 1983), nonacq. 1985-13, 1985-1 C.B. 184.
- **Cleanse taint of IRC Sec. 2036 exposure** for family limited partnerships by swapping the remaining partnership interests with the grantor trust.

# Uses of the swap power

- Given the current high applicable exclusion amount for federal transfer tax purposes, it makes imminent sense for **death bed planning** to utilize the swap power to bring low basis assets out of the grantor trust in exchange for cash, other high basis assets or a promissory note so that the grantor will die owning the low basis assets, which will then get a new basis for federal income tax purposes. IRC Sec. 1014.
- For non-taxable estates, consider swapping out minority interests in entities for high basis assets to **eliminate or substantially reduce at least minority interest valuation discounts**.



# Uses of the swap power

- The swap power also could be used to reconfigure the grantor's balance sheet to bring the grantor within the ambit of IRC Secs. **303 or 6166**.
- The swap power also should be considered for near death swaps to **preserve loss**. Remember that IRC Sec. 1014 gives a **new basis** at death, but **it cuts both ways**. Basis can and does go **down** at death unless something is done by **swapping the loss assets** into the grantor trust, which will preserve the loss.

# Asset protection implications of the swap power

- In Steve Leimberg's Asset Protection Planning E-Mail Newsletter No. 313 (February 3, 2016), Ed Morrow wrote an exhaustive analysis of the possible "dark side" of swap powers. **In my opinion, this article is required reading for anyone using a swap power.**
- By "dark side," he meant the potential asset protection and bankruptcy ramifications of the swap power if it was to get into the hands of the **wrong people**, like a creditor or bankruptcy trustee.
- Ed's lengthy article is divided into sections. He begins with a general review of the income tax consequences of the swap power, beginning with its source: IRC Sec. 675(4)(C).

# Asset protection implications of the swap power

- Ed then examines the federal estate tax consequences of the swap power, working from *Jordahl Est. v. Comr.* to the recently issued revenue rulings, 2008-22 and 2011-28, which have clarified the IRS position concerning the estate tax efficacy of the swap power.
- Ed then chronicles the explosion in the use of the swap power, particularly after the Congress enacted ATRA in the wee hours of the morning on January 1, 2013. Ed then reviews the many possible uses of the swap power in tax planning, from basis planning to preservation of loss basis.

# Asset protection implications of the swap power

- In the next section, Ed commences with a complete analysis of the bankruptcy code and how it impacts the swap power, **which, frankly, was sobering and scary.**
- Ed then closes with some suggested solutions to the swap power conundrum from an asset protection standpoint.
- These solutions range from parking the swap power in the hands of the grantor's spouse or a third party to **adding a non-adverse, non-fiduciary consent to the grantor's exercise of the swap power**, the latter of which is very clever.

# Analysis of the proper language for the swap power, including forms!

- Checklist of items to include in a swap power clause:
  - When and how exercisable.
  - Retained power to swap assets.
  - Exercisable in a nonfiduciary capacity without the consent or permission of anyone in a fiduciary position.
  - Swap must be of assets with an equivalent value within the meaning of IRC Sec. 675(4)(C).
  - The swap power must not be exercised in a manner that may shift benefits among the trust beneficiaries within the meaning of Rev. Rul. 2008-22.
  - The Trustee must have the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries at all times while the swap power is in effect.

# Analysis of the proper language for the swap power, including forms!

- Checklist of items to include in a swap power clause:
  - Cull out from swap power powers over life insurance on the grantor's life and voting stock of certain closely-held controlled corporations within the meaning of IRC Sec. 2036(b).
  - Surrender of swap power; effect.
  - Whether swap power is assignable.
  - Succession of swap power holder.
  - Certification process.
  - How disputes over equivalent value are to be resolved.
  - The timing of the swap, i.e., either before or after value is known.

# Third Party as Holder of a Swap Power

- If a taxpayer is concerned about the potential application of IRC Secs. 2036(b) or 2042, a third party might be given a swap power with respect to stock of a closely-held family controlled corporation and life insurance.
- Additionally, a third party might have to hold the swap power to avoid a prohibited transaction with a disqualified person, e.g., charitable lead trust situations.
- One might also consider a third party for asset protection purposes, and a third party might be the client's spouse, although this isn't a perfect solution either.

# Third Party as Holder of a Swap Power

- In addition, allowing a third party to hold the swap power could create additional flexibility to “turn off” or to “toggle on” grantor trust status, subject to my concerns about toggling discussed elsewhere in the presentation.
- Why wouldn’t you want a third party to hold a swap power? The swap power seems unlikely to ever be exercised because it would be a **wholly taxable transaction, but this fact could make it a perfect power to include if all that is desired is grantor trust status.**



# Third Party as Holder of a Swap Power

- Additionally, the grantor might want to have the swap power personally in case it's ever needed or wanted in the future.
- If the grantor wanted or needed the property, but the swap power was held by a third party, that wouldn't assist the grantor because the swap power holder might refuse to act on request, leaving the grantor little recourse other than to sue.
- What if this third person swap power holder never signs anything and/or agrees to accept the "right to reacquire" or even knows about the power? Is it illusory, or effective regardless?

# Third Party as Holder of a Swap Power

- What if this third person is besieged by creditors/files bankruptcy and the receiver/trustee would prefer the assets in the trust?
- Can the bankruptcy trustee succeed to the grantor's swap power and reach assets inside of the trust? **Quite possibly, as Ed Morrow discusses.**
- What if the third party dies or is incapacitated?
- Does the trust instrument name an adequate backup swap power holder?

# Swap Power Do's and Don'ts

- **Do** have the promissory note(s) **and** other assets tendered in the exercise of a swap power appraised by an independent qualified appraiser.
- **Do** make the swap power exercisable in a **nonfiduciary capacity**.
- **Don't** give the swap power to an **adverse party**.
- **Don't** give the swap power to the trustee.
- **Do** make sure that the swap power covers the entirety of trust assets.
- If substituting a promissory note for assets of a grantor trust, **do** secure the promissory notes and charge a market rate of interest.

# Swap Power Do's and Don'ts

- **Don't** give the swap power to a third person, including a spouse, except as necessary as a last resort to attaining grantor trust status.
- If a third party holds the swap power, **do** have the third party sign an acknowledgment of the grant of authority and accepting that grant.
- **Do** make the swap power non-assignable.
- **Do** provide for backup swap power holders.
- **Don't solely rely** upon the swap power to achieve grantor trust status.
- **Do** build in an exit strategy for the swap power.

# How does the swap procedure work?

- **Does exercise of the swap power require simultaneous substitution of property of equivalent value?** In *In re Rigoni*, the grantor argued that he had an absolute right to substitute the asset without deterrence or delay, and that the trustee's only recourse was to sue for the remaining equivalent value after the fact, a la eminent domain.
- The trial court rejected this argument, asserting that the swap power and the substitution of property of equivalent value pursuant to the swap power were "inextricably intertwined," and the appellate court affirmed on this issue.

# How does the swap procedure work?

- In rejecting the grantor's argument, the appellate court concluded:
- *In fact, Rigoni's argument would substantially rewrite the substitution clause by essentially causing it to read, "I may substitute any property for trust assets; if the trustee determines that the value of the property substituted was not equivalent, it may seek additional value afterwards." We decline to rewrite the unambiguous language of the substitution clause in such a fashion. [Emphasis added]*
- **Comment:** The *In re Rigoni* courts' conclusion on this point is correct. But see the district court's opinion in *Benson v. Rosenthal*, discussed *supra.*, in which the district court seems to allow for the significant time delays and valuation uncertainty of a complex exercise of the swap power. See also, *Manatt v. Manatt*, *supra.*

# How does the swap procedure work?

- **How should a grantor who seeks to exercise the swap power exercise that right?** The grantor in *Benson v. Rosenthal* must have believed that the third time was the charm, and, in my opinion, got it right on the third attempt, as the district court's opinion relates:
- *On August 24, 2015, after filing this suit, Plaintiff again supplemented the Notice of Exchange in accordance with the valuation adjustment clauses included in the promissory notes. Plaintiff had retained Empire Valuation Consultants ("Empire") to conduct a valuation of the assets that he sought to remove from the trusts as of December 31, 2014. Empire's services had been used in the valuation of assets of the trusts on prior occasions and had been relied upon by Rosenthal. Based on Empire's updated valuation of the trust assets, Plaintiff delivered to Defendants thirteen new promissory notes of specific values and collateral assignments securing each of those notes.*

# How does the swap procedure work?

- In *Benson v. Rosenthal*, the district court held that the grantor *complied with all of the requirements of the Substitution Provisions of the trusts to effect a substitution on January 24, 2015. Defendants must now comply with their obligations under the trusts in confirming the equivalence of value as of that date.*
- The district court seems to be keeping the exchange open until the trustee finishes his examination of the appraisals and evaluation of the 13 secured promissory notes.



# How does the swap procedure work?

- **Query: does the *equivalent value* require or in any way mandate that the swapped in assets be *similar* in nature or quality to the swapped out assets? Are promissory notes permissible assets to swap into a grantor trust for hard assets?**
- Clearly, the answer to the first question is no. Had Congress intended IRC Sec. 675(4)(C) to be so limited, it would have used the like-kind requirement of IRC Sec. 1031. In IRC Sec. 1031, the Congress clearly demonstrated that it well understood the difference between these standards and opted for the more expansive and relaxed standard of equivalent value in IRC Sec. 675(4)(C). But could Congressional use of a new term signal that it required more similarity than just dollar value? This is possible.

# How does the swap procedure work?

- **Query: does the *equivalent value* require or in any way mandate that the swapped in assets be *similar* in nature to the swapped out assets? Are promissory notes permissible assets to swap into a grantor trust for hard assets?**
- But does IRC Sec. 675(4)(C) nevertheless have an outside limit on the types of property that can be swapped into the grantor trust? The key is the meaning of the all important term “equivalent value,” which we discussed earlier.
- Whether a promissory note is a proper asset to swap into a grantor trust is a question of applicable state law, but, in my experience, every state of which I’m aware permits promissory notes to be held in trusts.

# Other Questions to Ponder

- What if the grantor encounters a “Millstein problem” (grantor no longer wants or is able to pay the income tax that a grantor trust is generating)? What recourse does a grantor have to force the third party (or their agent or guardian if incapacitated) to release the swap power?
- Following *Powell* and *Cahill*, might there be unseen negatives in having closely held business interests in intentionally defective grantor trusts subject to swap powers despite the two main taxpayer-friendly revenue rulings?
- What special problems occur with swap powers added to inter vivos QTIPs, GPOA marital or other mandatory income trusts?

# Conclusion

- In this webinar, we've examined the swap power from soup to nuts. While it can be a very helpful grantor trust power, cautious and conservative practitioners **should not solely rely upon the swap power** to create and maintain grantor trust status.
- I hope that you enjoyed this webinar and found something in it that will help you help a client **today!!!** This is my goal and that of Leimberg Information Services, Inc. **every single day!** If you have any questions, or if I can ever help you, please e-mail me at [paul@paulhoodservices.com](mailto:paul@paulhoodservices.com). Have a great rest of your day!!!

# Annexes

- Analysis of litigated cases involving contested exercise of a swap power.
- Compendium of private letter rulings of interest.

# Court cases involving the swap power

- Thus far, we have five reported decisions of which I am aware involving the attempted exercise of the swap power where the trustee of the grantor trust resisted, causing the matter to wind up in a courtroom, whether instigated by the trustee or by the grantor.
- If you hear of another case, please e-mail it to my attention [paul@paulhoodservices.com](mailto:paul@paulhoodservices.com) . Thanks!

# In re Matter of Condiotti

- No. 14CA0969 (Col. App. July 9, 2015 unpublished opinion), the settlor established an irrevocable grantor trust for his minor son in 2000.
- He appointed his wife as trustee of the trust.
- MidFirst Bank was later appointed as another trustee.

# In re Matter of Condiotti

- The swap power clause read as follows:  
*Notwithstanding any other provision of this instrument . . . to the contrary, [the] settlor, acting in a nonfiduciary capacity and without the approval or consent of any person acting in a fiduciary capacity, reserves the power to reacquire the trust corpus by substituting other property of an equivalent value.*
- In October 2011, the settlor sent a notification to the trustees. It stated that he had decided to exercise the swap power. He would do so by substituting a nine year interest only with a balloon payment of principal promissory note at the AFR of 1.27% for the full value of the trust's corpus, or about \$9,500,000.



# In re Matter of Condiotti

- The trustees replied that the grantor could not do what he had proposed because he had **failed** to provide equivalent value.
- First, they contended that the grantor was not actually invoking the substitution power; he was, instead, attempting to invoke the **loan power** that the trust instrument expressly denied him.
- Second, focusing on the language in the provision creating the swap power, they asserted that the property that the grantor proposed to substitute — the promissory note — was **not of “equivalent value”** to the trust’s corpus.
- The grantor threatened to sue the trustees. They responded by filing a petition with the probate court requesting instructions.

# In re Matter of Condiotti

- At issue was the proper valuation method to be applied to the promissory note that the grantor proffered in substitution for the assets of the grantor trust.
- The grantor asserted that, as the note offered in this case met all of the requirements under the Internal Revenue Code, it should be determined to be property of “equivalent value,” and the trustees should be required to accept the note under the swap power of the grantor trust.

# In re Matter of Condiotti

- The Trustees urged the probate court to use a **fair market value** standard of value, valuing the property proffered to be swapped into the grantor trust based upon what a willing buyer would pay a willing seller.
- Given the limited market for promissory notes, the comparatively low interest rate of the note offered by the grantor, and the fact that the note was unsecured, the Trustees argued that the promissory note that the grantor intends to use as substituted property is not of equivalent value and is in fact fairly valued at about half the value of the trust corpus.

# In re Matter of Condiotti

- In a written order, the probate court agreed with both of the trustees' contentions. It instructed the trustees that they could "properly reject" the promissory note because it was "not of equivalent value to the corpus of the trust and pursuant to their discretionary authority to make loans."
- The appellate court affirmed, but only on the ground that the settlor's proposed transaction was an attempt to exercise the loan power, not the swap power, so the trustees could properly reject it. The appellate court did not address the trial court's alternative holding that, even if the proposed transaction were an exercise of the swap power, the promissory note was not of "equivalent value" to the trust's corpus.

# In re Matter of Condiotti

- **Comments:** Remember that the grantor named his wife as initial sole trustee, and she later turned down his swap power exercise. While I'm not sure whether the Condiotti marriage was still extant when this litigation ensued, but it's highly likely that if it was, things were very tense at home!
- Despite that the probate court teed the case up as a matter of national first impression, the appellate court inexplicably made it an unpublished decision. **Strange.**
- The probate court opinion in this matter is worth reading because it talks about the fair market value standard of value of the note versus a minimum AFR note being valued at face value.

# In Re Dino Rigoni

## Intentional Grantor Trust

- *In re Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer*, 2015 WL 4255417 (unpublished opinion, Court of Appeals of Michigan July 14, 2015).
- Rigoni owned approximately 551 acres of farmland in Michigan. In 2001, Rigoni created an estate plan to convey that property to the Rajzers while minimizing tax consequences. To that end, Rigoni created a limited liability company named Rigoni Investments, LLC, of which he was initially the sole owner.
- Rigoni also created a revocable living trust for himself (the “Rigoni trust”) and transferred 100% of the ownership interest in Rigoni Investments to that trust. Rigoni then conveyed his farmland to Rigoni Investments. Rigoni then created an “intentionally defective grantor trust” for each of the Rajzers. The trusts each contained a swap power clause permitting Rigoni to substitute property of “equivalent value” for the trust property.

# In Re Dino Rigoni Intentional Grantor Trust

- The Rigoni trust then sold a 20% membership interest in Rigoni Investments to each of the Rajzer trusts. As consideration for the membership interests, the Rajzer grantor trusts each tendered a promissory note in the amount of \$185,416. Rigoni also created a second limited liability company called Rigoni Asset Management, LLC (“RAM”).
- The Rigoni trust transferred a 1% interest in Rigoni Investments to RAM, and RAM was appointed as the initial manager of Rigoni Investments. Later in 2001, the Rigoni trust gifted another 10% interest in Rigoni Investments to each of the Rajzer grantor trusts.

# In Re Dino Rigoni

## Intentional Grantor Trust

- In April of 2011, Rigoni, through counsel, sent a letter to the original trustee of the Rajzer grantor trusts, ordering the trustee, pursuant to the swap power, to substitute the promissory notes each trust for the 20% membership interest in Rigoni Investments that each trust had purchased.
- The original trustee responded that the language of the trust required substitution of property of equivalent value and that he believed that Rigoni had failed to offer property that met that criterion. Rigoni also informed the Rajzers that their lease would expire at the end of 2011 and would not be renewed.



# In Re Dino Rigoni

## Intentional Grantor Trust

- In January of 2012, Rigoni again attempted to exercise his right under the swap power, this time by ordering the trustee (now successor trustee Purkey) to substitute the promissory notes of each trust for the full 30% of interest in Rigoni Investments owned by each trust. The trustee responded in the same fashion as had the original trustee, stating that Rigoni had failed to offer property of equivalent value for substitution.
- In April of 2012, Rigoni filed a petition with the trial court, seeking to have the court compel the trustee to allow the substitution of property in the trusts. In June of 2012, the trustee of the grantor trust filed a petition requesting that the trial court determine the “equivalent value” of a 60% interest in Rigoni Investments. The two petitions were consolidated, and the matter was set for a bench trial.

# In Re Dino Rigoni Intentional Grantor Trust

- At trial, the principal issue was the valuation of the two 30% interests in Rigoni Investments.
- Rigoni presented his expert on valuation, David Distel, who opined that the fair market value of 60% of Rigoni Investments was **\$248,000**.
- Distel reached this conclusion by applying a “discounted cash flow” approach to value. Rather than value the underlying asset held by Rigoni Investments (the farmland), Distel determined the present value of the income stream received by Rigoni Investments, i.e., income from leasing the property. Distel used the offer from the Rajzers to lease the farmland in 2012 for \$125,000, as well as average agricultural and land leasing rates from a Michigan State University report as a basis for determining an income stream for 2012 through 2021.
- Distel then applied substantial discounts for lack of marketability (19%) and minority shareholder status (32%).

# In Re Dino Rigoni Intentional Grantor Trust

- The trustee offered the testimony of Eric Adamy, also an expert in business valuation. Adamy valued the 60% interest in Rigoni Investments at **\$2,388,000**. This figure represents 60% of the appraised value of the farmland held by Rigoni Investments (\$3,980,000), to which valuation the parties stipulated. Adamy testified that he had considered multiple methods of valuation, and concluded that the best method of valuation was the market value of the assets held by Rigoni Investments, i.e., **asset approach**. Adamy based his conclusion in part on Internal Revenue Service Revenue Ruling 59-60, Sec. 5(b).

# In Re Dino Rigoni Intentional Grantor Trust

- Adamy further testified that **he found it not appropriate to apply discounts for lack of marketability and minority shareholder status in this case**. He opined that the fair market value standard with discounts presumes a willing buyer and willing seller, and that in this case Christopher Rajzer was not a willing seller, which affected his analysis similarly to cases involving minority shareholder oppression.
- Adamy also opined that Distel's **use of the discounted cash flow method of valuation was inappropriate in this instance**, because Distel's method did not capture the value of the entire entity of Rigoni Investments, only its cash flow.
- Adamy stated that, in his opinion, "equivalent value to me means a [sic] asset that has similar characteristics in terms of risk and opportunities for rate of return." Adamy opined that the substitution of the promissory notes for the Rajzer trusts' shares in Rigoni Investments would not provide the same risk or rate of return.

# In Re Dino Rigoni

## Intentional Grantor Trust

- Following the bench trial and post-trial briefing, the trial court issued an opinion and order containing findings of fact.
- As to Issues I and II (interpretation of trust language), the trial court ruled that Rigoni's substitution right was *"inextricably linked"* with the requirement that he substitute property of equivalent value, and that *"the reacquisition of Trust Assets by Dino Rigoni be contemporaneous with the replacement of those assets with property of equivalent value as agreed upon by the Trustee."*
- As to issues III and IV (the valuation of the membership interests held by the Rajzer trusts), the trial court found Adamy's method of valuation to be correct, and that the value of the 60% membership interest was \$2,388,000.00.

# In Re Dino Rigoni

## Intentional Grantor Trust

- On appeal, Rigoni challenged the trial court's interpretation of the swap power clause and the valuation of the 60% membership interest in Rigoni Investments. The swap power was as follows:
- *As Grantor, I [Dino Rigoni] do hereby retain the power and right, exercisable only for my personal benefit and only in a non-fiduciary capacity, to reacquire trust assets by substituting property of an equivalent value without the approval or consent of the Trustee or any person acting in a fiduciary capacity. The Trustee shall comply with my written expressed intentions concerning the exercise of this power.*

# In Re Dino Rigoni

## Intentional Grantor Trust

- In affirming the trial court on all issues, the appellate court observed:
- *Rigoni essentially argues that the plain language of the clause required the trustee to effect a substitution of property upon his command, and if necessary seek additional value in a later proceeding. We disagree.*
- *In fact, Rigoni's argument would substantially rewrite the substitution clause by essentially causing it to read, **"I may substitute any property for trust assets; if the trustee determines that the value of the property substituted was not equivalent, it may seek additional value afterwards."** We decline to rewrite the unambiguous language of the substitution clause in such a fashion. [Emphasis added]*

# In Re Dino Rigoni

## Intentional Grantor Trust

- *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 Rigoni's substitution of equivalent value property. A necessary precondition to that substitution is that equivalent value be established: Rigoni may reacquire "trust assets by substituting property of an equivalent value." (Emphasis added.) **Once Rigoni has tendered property of equivalent value, the trustee lacks the discretion to deny the substitution.** The trustee, however, **still possessed the power and duty to determine whether the attempted substitution complied with the requirements of the substitution clause.** [Emphasis added]*



# In Re Dino Rigoni Intentional Grantor Trust

- **Comments:** Another unpublished opinion. Wow.
- The equities strongly militated in favor of the beneficiaries of the grantor trusts because it appeared clear beyond cavil that the grantor was trying to pull some shenanigans, using, probably impermissibly, his position as the sole member of the LLC that was the manager of Rigoni Investments.
- You have to wonder about Rigoni's appraiser. Didn't it bother him that the liquidation value of the interest was ten times **larger** than the value indication computed using his discounted cash flow method? Yet, he stuck to his guns and gave his client the low value that he craved, but yet couldn't keep.
- No one mentioned it, but did his derivative fiduciary duty as the sole member of the LLC that served as manager of Rigoni Investments trump his swap power, which is supposed to be exercised in a nonfiduciary capacity? Quite possibly.

# In Re Dino Rigoni

## Intentional Grantor Trust

- I wonder if Rigoni was trying to take advantage of some naïve people who were just simple country farmers with the byzantine entity structure, much of which was absolutely unnecessary in my opinion.
- Rigoni's position on how the swap power procedure operated was fanciful. It would have imposed a system similar in many respects to eminent domain proceedings, where the governing body that has expropriation authority simply exercises eminent domain, tenders some lowball number and forces the shafted property owner to sue for the remaining fair market value and damages. Thankfully, both courts got it right in this instance.

# Benson v. Rosenthal

- No. 15-782, 2016 WL 2855456 (E.D. La. 2016).
- The grantor established various trusts for the benefit of his adopted daughter and two grandchildren. He created three trusts in 2009, three trusts in 2012, a Grantor Retained Annuity Trust in 2012, and Grantor Retained Annuity Trust in 2014.
- Notwithstanding the dispute at issue, these trusts hold ownership interests in various entities that in turn own valuable property, including the New Orleans Saints and Pelicans franchises, the New Orleans Fox television affiliate, automobile dealerships, and the Benson Tower and Champions Square development.

# Benson v. Rosenthal

- In January of 2015, the grantor exercised his swap power and sent correspondence to the trustee, stating his intention to exchange the trust assets for promissory notes of equivalent value. This correspondence was sent to the trustee on January 12, 2015 but intended to make the exchange effective as of January 1, 2015.
- With the January 12 correspondence, the grantor included a preliminary schedule of values of the trust assets, a Notice of Exchange of trust assets, and blank promissory notes containing a valuation adjustment clause that would operate to adjust the notes automatically to a later-determined appraised value. The transfer also included certain real estate and the forgiveness of nearly \$100 million of indebtedness owed to the grantor by some of the trusts.

# Benson v. Rosenthal

- The trustee refused to execute the documents required to complete the exchange, stating that such an exchange requires a simultaneous transfer of property.
- He also stated that an unsecured promissory note is “not an appropriate trust investment” and that he must “make his own independent verification that the assets to be exchanged are of equivalent value [with the trust assets]” before the exchange could occur.

# Benson v. Rosenthal

- On January 24, 2015, the grantor supplemented his exchange request with additional documents, including certifications of the values of each trust signed by the grantor, collateral assignments granting the trusts security interests, and seven promissory notes for values based on the most recent valuations available.
- These promissory notes also contained valuation adjustment clauses. The grantor's supplements failed to assuage the trustee's concerns, and he again rejected the exchange, stating that there had "not yet been an exchange of assets of equivalent value."

# Benson v. Rosenthal

- On August 24, 2015, after filing suit to force the trustee to go forward with the swap, the grantor again supplemented the Notice of Exchange in accordance with the valuation adjustment clauses included in the promissory notes.
- The grantor had retained Empire Valuation Consultants (“Empire”) to conduct a valuation of the assets that he sought to remove from the trusts as of December 31, 2014. Empire’s services had been used in the valuation of assets of the trusts on prior occasions and had been relied upon by the trustee.
- Based on Empire’s updated valuation of the trust assets, the grantor delivered to the trustee thirteen new promissory notes of specific values and collateral assignments securing each of those notes. The trustee again rejected the grantor’s exchange.

# Benson v. Rosenthal

- The trustee sought a judgment holding either that (1) the grantor's attempted substitution was, in fact, a request for a loan, which the trustee had the discretion to deny, or that (2) the grantor's purported substitution did not occur on January 1, 2015 and occurred, at the earliest, on August 24, 2015, if the grantor can prove that he exchanged property of equivalent value.
- With respect to the loan argument, the district court was not persuaded by the trustee's citing of *In re Condiotti* because the promissory note in that instance was unsecured, whereas the grantor's promissory notes were secured adequately and based upon an appraisal by a qualified appraiser. Based upon that, the district court denied the trustee's motion to dismiss on the pleadings.



# Benson v. Rosenthal

- With respect to the efficacy of the swap power exercise, the district court again sided with the grantor, concluding: *The trusts grant [the grantor] the unilateral power to substitute assets, and while the trustee must ensure equivalent value, he does not have the power to prevent such an exchange.*
- Disagreeing with *In re Condiotti* on this point, ...*This Court does not read the Substitution Provisions of these trusts as requiring a contemporaneous exchange. The trusts merely require that when a grantor unilaterally effects a substitution, he is bound to offer equivalent value in exchange.*
- Applying this interpretation to the facts at hand, this Court holds that ***if the attempted exchange was a substitution***, it was effective on January 24, 2015. It is on that date that Plaintiff provided the trustee with a certification of value of the substituted property, as required by the 2009 Trusts, and promissory notes purporting to be of equivalent value, as required by all trusts.  
[Emphasis added]

# Benson v. Rosenthal

- **Comments:** While I get that valuation takes time, the conclusion that the trustee's remedy is to sue for additional value, like eminent domain, seems inconsistent with the word **exchange**, which connotes a **simultaneous** transfer. The grantor selected the assets to swap out of the trust, not the trustee.
- That the grantor selected subjectively valued assets that take time to appraise shouldn't be held against the trustee. The burden of proving equivalent value must rest with the grantor, not the trustee having to prove a negative, i.e., that the proposed swap is not of equivalent value. The district court's conclusion on this point could end up as a slippery slope in my opinion.
- However, this case lays out what is in my opinion the proper way that a grantor should prepare and present a swap power exercise.

# Schinazi v. Eden

- 338 Ga. App. 793, 792 S.E.2d 94 (Ga. App. 2016).
- The grantor established the Trust on August 23, 2005, naming Eden as Trustee and his daughter as the primary beneficiary. The Trust agreement authorized the grantor to deposit property into the Trust, and he retained a swap power.
- Two days after creating the Trust, the grantor and RFS & Associates, LLC, a corporation in which Schinazi held a controlling interest and served as manager, formed a limited partnership known as RFS Partners, L.P. The partnership agreement named RFS & Associates as "General Partner," designated the grantor as "Limited Partner," and set forth procedures for transferring partnership interests.

# Schinazi v. Eden

- Over six years later, on January 2, 2012, the grantor sent the trustee a promissory note in the amount of \$58,290,000, stating that he was "exercising [his] asset substitution right [under the Trust agreement] by substituting [the] Promissory Note for the limited partnership interest owned by the Trust in RFS Partners, L.P."
- The grantor asked the trustee to acknowledge in writing that he was now "the sole owner of all interest formerly owned by the Trust in the Partnership." The trustee refused to sign the acknowledgment, asserting that the promissory note did not constitute a substituted asset of equivalent value, as required by the Trust agreement. Despite this refusal, the grantor informed the trustee on September 11, 2012, that "the Trust's balance sheet consists of" the \$58,290,000 promissory note, rather than an interest in RFS Partners.

# Schinazi v. Eden

- The trustee sued the grantor and RFS & Associates in November 2012, seeking a declaratory judgment regarding which party—the Trust or the grantor—owned the RFS Partners interest that the grantor sought to reacquire in January 2012.
- The trustee also asserted claims for failure to tender assets of equivalent value, breach of fiduciary duty, litigation expenses under applicable state law, and punitive damages. Finding that the Trust still owned the partnership interest, the trial court granted summary judgment to the trustee on the declaratory judgment claim, but awarded the defendants summary judgment on the trustee's remaining allegations. Both parties appealed.

# Schinazi v. Eden

- In reversing the trial court's grant of summary judgment to the grantor on the trustee's claim for breach of fiduciary duty, the appellate court noted:
- *Furthermore, the record raises questions about the adequacy of the promissory note [the grantor] tendered in exchange for the transfer. Some evidence indicates that the value of the partnership interest increased just days after the tender, when Pharmasset—a company in which RFS Partners owned significant stock—was purchased by another entity.*
- *This purchase was not finalized until January 12, 2012, but had been announced several months before the grantor tendered the note. Material questions of fact, therefore, remain regarding breach.*

# Schinazi v. Eden

- **Comments:** The grantor appears to have been engaged in some questionable insider shenanigans relative to the trusts' interests.
- An appeal was granted in March 2018, but there doesn't appear to have been any further judicial developments.
- While the opinion doesn't provide much detail on the description of the note tendered in the swap, the mere fact that valuation was questioned probably means that the note was unsecured and may not have borne an adequate rate of interest to compensate the trustee for the risk of taking the note.

# Manatt v. Manatt

- 2018 WL 3154461 (S.D. Iowa May 2, 2018).
- In 2012, the grantor established an intentionally defective grantor trust (IDGT), called the BJM 2012 Trust for the Benefit of Erik M. Manatt (BJM Trust).
- When he established the BJM Trust, Brad was the president of Manaco Corporation, which is a closely-held Iowa company owned by members of the Manatt family. Erik, who is Brad's first cousin once removed, was named trustee of the BJM Trust. In his capacity as grantor of the BJM Trust, Brad devised 53.57 shares of Manaco stock to the BJM Trust. Of those shares, 5.36 were gifted to the BJM Trust and 48.21 were sold to the trust via promissory note.
- Erik executed a guaranty on the promissory note, payments for which were to come from the dividends of Manaco stock held in the BJM Trust.



# Manatt v. Manatt

- On September 20, 2017, purporting to exercise his swap power under the BJM Trust, the grantor acted to substitute the 53.57 shares of Manaco stock for money, at a rate of \$83,000 per share.
- The sum of money was reduced by the outstanding promissory note debt, leaving a balance of \$2,326,947.25.
- Two days later, however, the trustee sent a letter to the grantor's attorney, indicating that as trustee of BJM Trust, he "rejected" the substitution, challenging that it did not constitute equivalent value.
- Four days later, the trustee sent the grantor a second letter, informing the grantor that he had arranged to pay off the promissory note holding the 48.21 shares of Manaco stock in the BJM Trust and had transferred the payoff amount to the grantor, thereby creating the appearance that the trustee was the outright owner of the stock.

# Manatt v. Manatt

- Brad, as grantor of the BJM Trust, brought this declaratory judgment action against Erik, as the Trustee of the BJM Trust.
- The Complaint sought a declaratory judgment ordering the trustee to sign and deliver 53.57 shares of Manaco stock; accept the substitution tendered on September 20, 2017; order the trustee to execute and deliver all instruments and documents necessary to effectuate the exchange of assets; and award the grantor all legal and equitable remedies to fully restore him to his property.

# Manatt v. Manatt

- The grantor filed a motion for judgment on the pleadings asking the Court to determine the rightful ownership of the stock held in the BJM Trust.
- The grantor argues this is a legal question, which depends on whether the trustee of the grantor trust has the legal authority to stop Brad, as grantor of the trust, from changing the kinds of assets held in the trust by asserting the new assets are not as valuable as the old assets.

# Manatt v. Manatt

- The grantor asserts that now that the pleadings are closed, the Court may decide this question based on the unambiguous language of the trust documents.
- Quoting *Benson v. Rosenthal*, Civil Action No. 15–782, 2016 WL 2855456, at \*5 (E.D. La. May 16, 2016), the grantor argues that under the plain language of the substitution provision of the trust, as grantor he retains “the unilateral power to substitute assets, and while the trustee must ensure equivalent value, he does not have the power to prevent such an exchange.”

# Manatt v. Manatt

- The trustee asserts the BJM Trust was structured as an intentionally defective grantor trust for income tax purposes, and therefore it had to comply with various terms.
- The trustee countered that he has the fiduciary duty to ensure compliance with the swap power.

# Manatt v. Manatt

- Citing Revenue Ruling 2008–22, the trustee further asserted that his fiduciary duty **requires** that he be assured the substituted asset is of equivalent value.
- According to the trustee, in June 2017, the grantor valued shares of Manaco stock held by the grantor's children at \$133,000 per share and, therefore, a value of \$83,000 per share under the purported substitution of assets on September 20, 2017, was not an equivalent value.

# Manatt v. Manatt

- The trustee concludes that because compliance with that term is required, the letter regarding substitution of assets was merely an offer, which the trustee summarily rejected.
- Moreover, the trustee notes that he has now paid off the promissory note and owns the shares outright.

# Manatt v. Manatt

- The swap power read as follows:
- *10.14 Power to Exchange Assets. During my lifetime, I, acting alone in my individual and not in any fiduciary capacity, shall have the power, with respect to any trust created under this instrument, to reacquire trust assets by substituting other property having an equivalent value herewith; provided, however, that this substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries as provided in Rev. Rul. 2008–22. Neither the consent of the trustee nor the consent of any other person shall be required. The power described in this paragraph may be exercised by an agent appointed under a durable power of attorney or through any other means, whose actions shall be conclusive and binding.*



# Manatt v. Manatt

- The swap power read as follows (cont.):
- ***In all events, the trustee shall satisfy himself or herself that the properties acquired and substituted pursuant to this paragraph are, in fact, of equivalent value; and, further the trustee shall ensure that this substitution power is exercised in a manner that cannot shift benefits among the trust beneficiaries as such phrase is used in Rev. Rul. 2008–22. By written instrument delivered to the trustee, I (or an agent appointed under a durable power of attorney) may irrevocably release the power under this paragraph 10.14; and on the first to occur of (a) my death, (b) the expiration of the term beginning on September 1, 2012 and ending on August 31, 2027 and (c) the release of my power pursuant to this paragraph 10.14, my power under this paragraph 10.14 shall terminate and have no further legal force or effect under this instrument. [Emphasis added]***

# Manatt v. Manatt

- The parties do not dispute that the swap power gives the grantor the power to substitute assets nor do they contest that the trustee has a fiduciary duty to satisfy himself that the properties acquired and substituted are of equivalent value.
- Rather, the dispute is in regard to the **timing** of the trustee's duty.
- The grantor contends that a challenge regarding the **value** of the substituted asset **does not prevent the substitution** from occurring.
- The trustee contends that the valuation of the substituted asset must occur **before** substitution takes effect.

# Manatt v. Manatt

- In the *Benson* case, on which the grantor relies, the court found that the plain language of the swap power allowed the grantor unilateral power to substitute assets without the approval of anyone. *Benson*, 2016 WL 2855456, at \*6. In that case, the grantor substituted promissory notes and other assets, including some significant amount of debt forgiveness, for various trust assets. *Id.* at \*1.
- The trustee challenged the substitution and refused to execute the documents required to complete the exchange, arguing, *inter alia*, that as trustee, he had to “make his own independent verification that the assets to be exchanged are of equivalent value [with the trust assets] before the exchange could occur.” *Id.* (alterations in original) (internal quotation marks omitted).
- Reasoning the dispute was a matter of trust interpretation, the court found that the grantor’s intent was unambiguous based on the plain language of the swap power.

# Manatt v. Manatt

- The district court noted:
- *Under [the trustee's] interpretation of the provision, the trustee's duty to ensure the substituted asset is of equivalent value becomes a **condition precedent** to the substitution of assets.*
- ***This interpretation contradicts the plain language of the swap power***, which allows that the grantor, “during [his] lifetime” and “acting alone in [his] individual and not in any fiduciary capacity,” can reacquire trust assets by substituting other property of equivalent value, and in doing so, “[n]either the consent of the trustee nor the consent of any other person shall be required.” [Emphasis added]

# Manatt v. Manatt

- Ruling in favor of the grantor, the district court reasoned:
- ***A plain language reading of the substitution provision, read together with the other provisions in the BJM Trust, compels the conclusion that [the grantor] had the unilateral right of substituting the assets. [The trustee's] fiduciary duty to determine whether the substitution of assets was of equivalent value did not abridge, delay, or block [the grantor's] right of substitution. [Emphasis added]***

# Manatt v. Manatt

- Ruling in favor of the grantor, the district court reasoned (Cont.):
- *Having concluded [the grantor] had the unilateral power to substitute assets, the Court finds [the grantor's] reacquisition of assets was legally effective on September 20, 2017, making the grantor the true and lawful owner of the assets he reacquired. On the current record, however, the Court is unable to order [the trustee] to deliver the 53.57 shares of Manaco stock as it is unclear that [the trustee] has possession of those shares. [The trustee] stated in answer to the complaint that he has no control over the shares. At the hearing, it was disclosed that [the trustee] sold the shares to family members. Because there is a dispute regarding who is in possession of the shares, the remainder of the relief [the grantor] requests is outside the scope of this motion for judgment on the pleadings and cannot be granted at present.*

# Manatt v. Manatt

- **Comments:** The trustee-beneficiary's shocking pre-decision act to transfer the shares at issue before the court had a chance to rule at least temporarily thwarted the grantor's right to take possession of the subject shares after the ruling and underscores the reason why I believe that, notwithstanding the *Benson* and *Manatt* decisions, the exchange must be **simultaneous** in nature, and the only way that this can happen is to use promissory notes that have an adjustment clause to increase or decrease the amount passing to the trustee of the grantor trust in the exercise of the swap power.

# Manatt v. Manatt

- **Comments:** I disagree with part of the *Manatt* court's interpretation of the subject swap power, the second paragraph of which reads as follows:
- ***In all events, the trustee shall satisfy himself or herself that the properties acquired and substituted pursuant to this paragraph are, in fact, of equivalent value; and, further the trustee shall ensure that this substitution power is exercised in a manner that cannot shift benefits among the trust beneficiaries as such phrase is used in Rev. Rul. 2008–22. [Emphasis added]***



# Manatt v. Manatt

- **Comments:** The subject swap power expressly references Rev. Rul. 2008-22, which expressly requires a trustee who is not satisfied that he has received equivalent value from the grantor (or third party exerciser of the swap power) has a duty to resist and oppose any attempted substitution of assets worth less than the value of trust's assets sought to be swapped out of the grantor trust.
- The above paragraph is different from any of the other four swap powers in the other cases, but the *Manatt* court seems to have glossed over it. **I interpret that paragraph as allowing the trustee to hold up finalization of exercise of the swap power until the trustee is satisfied that he has received equivalent value.**

# Manatt v. Manatt

- **Comments:** To allow the grantor of a trust to unilaterally substitute property in and out of the trust with no possible stopping by the trustee wastes time, potentially greatly exposes the trustee to loss and is contrary in my opinion to the inherent fiduciary duty that the settlor owes to the trust on formation.
- I submit that if a grantor who formed the trust has the unilateral ability to simply substitute property without it being tested for equivalence in value, the underpinning requirement of an irrevocable trust may be missing.
- Query whether it is even still a trust where the grantor retains the unchecked power prior to the swap to substitute assets that may well be worth less than the value of the assets being substituted into the grantor trust.

# Manatt v. Manatt

- **Comments:** Traditional notions of fiduciary duty and the very essence of the trust mandate that while the grantor's swap power be respected, the grantor should have to first meet some minimum good faith burden of going forward, not of the least of the swap power training wheels.
- If the grantor doesn't present enough evidence to meet his burden of moving forward, the trustee is required in my opinion to object and **defend** the trust, which **almost always requires legal action**.
- However, once the grantor has met his burden of going forward, the trustee's role shifts slightly from defender to **guardian**. In the **defender** role, the trustee is pretty much **required** to take some legal action to defend the trust's interests.

# Manatt v. Manatt

- **Comments:** However, in its **guardian** role, the trustee's role is much more **passive** and really is focused on making sure that the trust value is maintained after the swap.
- In its **guardian** role, the trustee **may, but need not**, take legal action to protect the trust's interests.
- Quite often, all the trustee needs to receive are qualified appraisals of the assets sought to be swapped into the grantor trust to ensure that equivalent value is received.

# Manatt v. Manatt

- **Comments:** What is clear is that courts are going to examine the actual words of the swap power. Suppose the court interprets the swap power to permit the unilateral and unchecked authority to swap out assets.
- Does the scrivener have some possible exposure to the beneficiaries of the trust if that exercise of the swap power damages the trust value? **Possibly.**

# Manatt v. Manatt

- **Comments:** However, it is easy to build in some intermediate protections in the swap power itself that can include what constitutes an equivalent value certification procedure and whatever else might be included in the **grantor's good faith burden of moving forward**, which I believe should be included.
- Additionally, why not draft to slow down the swap process by **interposing a minimum amount of time, e.g., 90 days, before the swap becomes effective**, which would permit appraisals to at least get substantially underway if not completed? I believe that this is how the swap power should be drafted.

# Manatt v. Manatt

- **Comments:** Equivalent value seemingly effectively means fair market value, although, in *In Re Rigoni, supra.*, the court sided with the appraiser who posited that fair market value was not the proper standard because the seller was not a willing seller in that instance, thereby **undercutting the principal tenet of fair market value, which involves a willing buyer and a willing seller.**
- I would expect that very few of these contested exercise cases involves a willing seller, such that the proper standard of value in these cases probably is **fair value**, which means that valuation discounts are **inapplicable.**

# Private Letter Rulings of Interest

- **PLR 200846001**-approved the **exercise of a swap power** that determined value of shares exchanged using “mean between highest and lowest quoted selling prices” on day of the swap.
- **PLR 200842007**-determined that the **exercise of a swap power** was not taxable because the trust was a wholly grantor trust under IRC Secs. 675(4)(C) and 677.
- **PLR 200514002**-a trust instrument providing that the grantor’s swap power did not extend to stock of a **controlled corporation** was approved.
- **PLR 200603040**-concluded that the swap power would not cause estate inclusion under IRC Secs. 2033, 2036(a), 2036(b), 2038, or 2039 because the trust instrument provided that the grantor’s swap power could be exercised only in a **fiduciary** capacity.



# Private Letter Rulings of Interest

- **PLR 200434012**-third parties as swap power holders for a stock sale.
- **PLRs 9253010**; 9419990; 800237023; 9227013; 9413045; 8808018; 200010036; 9642039; 9224029; 9247024; 9037011; 9713017; 9810019; 9713017 (provided for backup swap power holders); 9407014; 200434012; 200010036; 199908002; 9810019; 9713017; 9642039 9247024-Third party holder of the swap power for a charitable lead trust.
- **PLR 201730018**-conversion of non-grantor trust to grantor trust.

# Private Letter Rulings of Interest

- **PLRs 201216034 and 200546054**-Primary beneficiary given swap power.
- **PLRs 9352017; 9345035; 9248016; 9239015; 9416009; 9352004; 9351005; 200001015; 200001013; 9239015; 9352007; 9525032**-Grantor given swap power over a GRAT, some of which were holding stock in S corporations.
- **PLRs 200449029 and 9037011**-Swap power given to trustees.

# Private Letter Rulings of Interest

- **PLRs 201216034 and 200546054**-Primary beneficiary given swap power.
- **PLRs 9352017; 9345035; 9248016; 9239015; 9416009; 9352004; 9351005; 200001015; 200001013; 9239015; 9352007; 9525032**-Grantor given swap power over a GRAT, some of which were holding stock in S corporations.
- **PLRs 200449029 and 9037011**-Swap power given to trustees.

# Private Letter Rulings of Interest

- **PLR 200848015-16-17**-Modification of irrevocable trust to add a swap power.
- **PLR 201235006; 201647001; 200842007**-Drafting of swap power clause referenced Rev. Rul. 2008-22.
- **PLR 9442017**-A charitable remainder trust can't be a grantor trust, even with the addition of a swap power.
- **PLR 200011012**-Grantor as holder of the swap power for a grantor charitable lead annuity trust, even though the grantor's exercise of the swap power would be considered an act of self-dealing.

# Private Letter Rulings of Interest

- **PLRs 200845015**; 9253010; 9239015; 9418024; 9416009; 9352004; 9227023; 9335028; 8932063; 9227013; 9645013; 9337011; 9351005; 199942017; 200729016; 8801008; 200729005; 9227013; 199908002; 9504024 (provided for release of swap power) 9126015 (beneficiary held swap power and had backup swap power holders)-Swap powers to hold S corporation stock.
- **PLR 8930021**-Trust **modification** to add swap power to make the trust a valid S corporation shareholder.
- **PLRs 200729006-16**-Jointly held Swap Powers (ruling is silent as to whether the powers were jointly held or whether each had a separate and independent Swap Power.

# Private Letter Rulings of Interest

- **PLR 9525032**-Grantor held swap power and had the right to borrow the trust assets without adequate security to make a GRAT a wholly grantor trust.
- **PLR 201730018**-conversion of trust to grantor trust for charitable lead trust.
- **PLRs 199927010; 200404009; 9808031**-negating grantor trust status.

# Private Letter Rulings of Interest

- **PLR 9548013**-IRS ruled that existence of a swap power made grantor trust holding S corporation stock but does not trigger inclusion under IRC Sec. 2038(a); swap power **assignable**.
- **PLR 9318019**-IRS declined to rule on whether amending GST Tax “grandfathered” trust to give the grantor a swap power would cause loss of GST Tax grandfathered status, or whether it would create estate tax exposure to the grantor.
- **200408015**-Culled out life insurance policy from swap power.