

FEATURE: ESTATE PLANNING & TAXATION



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Swap Powers

Consider some often overlooked practical and technical aspects

Grantor trusts and swap powers have become ubiquitous in trust planning. That frequent use, however, belies the underlying complexity and myriad of issues that might affect the optimal, even the proper, application of such powers.

Here are some often overlooked practical and technical aspects of the swap power.

Common Provision in the IDGT

One of the most powerful estate-planning techniques is the intentionally defective grantor trust (IDGT). Transfers to an IDGT are completed gifts for gift tax purposes, and the IDGT isn't included in the grantor's estate for estate tax purposes. However, the grantor is treated as the owner of the trust for income tax purposes. The substitution or swap power is one of the most common provisions in an IDGT.

Benefits of Grantor Trust Status

Because the grantor is treated as the owner of the trust for income tax purposes, he's taxable on the trust's income and gains. As a result, each time the grantor makes an income tax payment on the trust's income and gains, he's effectively shifting additional wealth out of his estate, free of estate and gift tax. This shifting of assets enables the trust to grow at a tax-free rate of return.

The Internal Revenue Service has conceded that the grantor's payment of the income tax isn't an additional taxable gift.¹

Because the grantor is treated as the owner of the trust's income and assets, transactions between the grantor and the trust are disregarded for income tax purposes.² This treatment allows the grantor to buy assets from the trust or sell assets to the trust, either for cash or in an installment sale, with no income tax consequences. While commentators disagree as to whether there are any income tax consequences if the note isn't paid off during the grantor's lifetime, they all agree that there are no income tax consequences if the note is paid off during the grantor's lifetime.³

Grantor Trust Provisions

There are several provisions that will result in a trust being treated as a grantor trust:

- In general, related trustees with discretion to sprinkle income or principal;⁴
- If the grantor or a non-adverse party has the power to deal with the trust's income and assets for less than adequate consideration;⁵
- If the grantor or a non-adverse party has the power to borrow from the trust without adequate interest (which many practitioners caution against) or security (other than when a trustee other than the grantor has a general lending power);⁶
- If any person may exercise any of the following administrative powers in a non-fiduciary capacity, without the approval or consent of any person in a fiduciary capacity: (1) to vote or direct the voting of stock or securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control (which many practitioners caution against); (2) to control the investment of the trust funds to the extent the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are

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significant from the viewpoint of voting control; or (3) to reacquire the trust corpus by substituting other property of equivalent value.⁷

Swap Power

The most common way for a grantor to achieve grantor trust status is to retain the power to substitute assets in a non-fiduciary capacity (a swap power). The swap power is popular because it achieves grantor trust status without affecting the economic interests of the beneficiaries.

In a revenue ruling, the IRS conceded that the retention of a swap power won't cause the trust assets to be included in the grantor's estate, provided the trustee has a fiduciary obligation under local law or the trust instrument to ensure the grantor's compliance with the

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terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value.⁸ The ruling also provided that the grantor can't exercise the swap power in a manner that can shift benefits (that is, the swap power won't cause estate tax inclusion) if: (1) the trustee has both the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries, or (2) the nature of the trust's investments or the level of income produced by any or all of the trust's investments doesn't impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.

The ability to swap assets is useful in obtaining a basis step-up for appreciated assets. Assets passing at death generally obtain a basis step-up.⁹ However, assets transferred during lifetime and not included in the estate don't receive a basis step-up at death.¹⁰ This is the tradeoff in making gifts during lifetime. The swap power

allows the client to obtain the best of both worlds. It permits the grantor to reacquire appreciated assets from the trust, including them in the grantor's estate, where, on the grantor's death, they'll receive a basis step-up, eliminating any capital gains tax heirs may later incur on the appreciation during the grantor's lifetime. At the same time, the trust assets, including the assets swapped in, won't be included in the grantor's estate.

Similarly, the grantor may wish to swap assets that have declined in value into the trust, so as to preserve the loss on the grantor's death.

Clients shouldn't presume that the trustee will accept any attempted swap. In a recent case, the court held that the grantor's attempt to swap a note for trust assets was tantamount to the grantor borrowing assets, not exercising a swap power and, therefore, wasn't permitted.¹¹ This case should serve as a warning to all trustees that the acquiescence to any proposed swap may not comport with the terms of the trust and may expose them to liability.

Monitoring the Swap Power

The swap power is a personal power. However, to best exercise it, the appreciation of the trust assets should be monitored. The best person to monitor the appreciation will depend on the nature of the assets. The client's stockbroker or investment advisor, if any, could assume this responsibility for marketable securities. Perhaps an appraiser or business associate could monitor closely held business interests. The frequency of monitoring should increase as the client's age or health risks increase or in anticipation of an event that may result in a large increase in the value of the trust assets. While there's no guarantee that the swap power can or will be exercised at the optimal time to maximize growth outside the estate and basis step-up inside the estate, failing to have a plan to monitor its use will almost assure sub-optimal results.

Whether a power of administration is exercisable in a non-fiduciary capacity is a question of fact.¹²

Reporting for Gift Tax Purposes

Consider whether the exercise of a swap power should be reported on the client's gift tax return. Even though no gift is intended, if the value of what was swapped isn't equivalent, the IRS could argue that the swap power was improperly exercised. The IRS could then claim that the grantor retained control over the trust assets so that the initial transfer to the trust was incomplete or the powers



retained constituted a “string” sufficient to bring the assets back into the estate under Internal Revenue Code Section 2036.

Prepare Before Exercising Power

Many calls to exercise swap powers will arise when the grantor is terminally ill. Practitioners can recommend ways to facilitate a quick exercise. Consider:

- Establishing lines of credit or other arrangements to facilitate the rapid exercise of a swap power. If the grantor needs to raise cash when he’s incapacitated, it might be difficult or impossible to obtain the required funds.
- Preparing documents or templates of documents to effectuate the swap in advance. For example, if the grantor trust holds interests in corporations, partnerships or real estate limited liability companies (LLCs), prepare the necessary documents to purchase interests in the entities from the trust. The most likely time to exercise a swap power is just prior to the grantor’s death. Illness and other challenges or an unforeseeable accident might make exercising the swap power a time-sensitive and critical endeavor. Preparing the requisite documents in advance may facilitate completing the swap in a timely manner.

Incapacitated Client

Take steps to ensure that your client can exercise the swap power, from both a legal and a practical perspective, even if he becomes incapacitated. Approximately 50 percent of those age 85 and older have some degree of cognitive impairment. Who will exercise the swap power if the grantor isn’t capable of doing so? If the grantor has a power of attorney (POA) that permits the agent to exercise the swap power, the agent should be able to do so if the trust terms allow it. Also, consider whether the swap powers specified in the POA are clear and broad enough to satisfy the IRS and third parties who might be involved in or affected by the swap. For example, if the trust owns an interest in a closely held business, will counsel for the business be satisfied that the agent can properly effectuate the transfer? What if the agent needs to borrow money to purchase appreciated trust assets? Consider updating the client’s POA to expressly provide that the agent has authority to exercise any power given under a grantor trust and to borrow funds to facilitate the swap.

Life Insurance and Voting Stock

If a decedent held any incidents of ownership in a life insurance policy, then the proceeds will be included in the gross estate for estate tax purposes.¹³ However, citing Revenue Ruling 2008-22, the IRS has conceded that the power to swap assets won’t result in estate tax inclusion with respect to insurance on the grantor’s life held by the trust, 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 the grantor acquired and substituted are in fact of equivalent value and that the substitution power can’t be exercised in a manner that can shift benefits among the trust beneficiaries.¹⁴

The consequences of a bad appraisal or no appraisal can be worse than just the difference between the fair market value and the value used.

If a decedent transferred stock of a controlled corporation and retained the voting rights to the stock, it will be included in the gross estate. For this purpose, a “controlled corporation” is one in which the decedent owned (with the application of the IRC Section 318 attribution rules) or had the right to vote stock possessing at least 20 percent of the voting power at any time within three years of death.¹⁵ If the grantor can swap cash for voting stock in a controlled corporation, it would seem that, based on the reasoning of Rev. Ruls. 2008-22 and 2011-28, this swap shouldn’t cause the stock to be included in the estate. Moreover, while the voting stock is in the trust, the grantor has no power to vote the stock, and after the grantor acquires the voting stock from the trust, the grantor’s voting the stock won’t affect the dividend flow to the trust, at least when the grantor acquires all of the trust’s stock of the corporation. Nevertheless, until there’s specific authority on point, a practitioner concerned about this issue might want to exclude voting stock of a controlled corporation from



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the scope of the swap power, though another grantor trust power will then be needed with respect to the voting stock.

Equivalent Value

The trustee has a fiduciary obligation 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.¹⁶ What can be done to corroborate that the trustee has confirmed equivalency in value and compliance with the terms of the trust? Should the trustee execute a contemporaneous document confirming compliance with any requirements the trust instrument has concerning a swap power and documenting that the trustee has confirmed the equivalency of value? Perhaps whatever analysis or documentation has been used to confirm that equivalency should be attached as an exhibit to the confirmation document.


If the asset isn't a publicly traded security, consider obtaining an independent appraisal to determine the value. The consequences of a bad appraisal or no appraisal can be worse than just the difference between the fair market value and the value used. The bad swap might taint the entire transaction and allow the IRS (and creditors) to argue that the grantor retained control over all of the trust assets so that the trust remains in the grantor's estate. The need for an appraisal for non-marketable asset swaps can present a significant impediment to the quick exercise of a swap power in the event of an urgent situation affecting the grantor (for example, an accident and a short time to live). Ideally, practitioners should counsel clients to consider having periodic updates of appraisals of non-marketable assets likely to be swapped so that something is in place to update quickly if needed. The problem with this precautionary approach is the cost could be prohibitive.

It might be advisable to incorporate a defined value mechanism into the exercise of a swap if a hard-to-value asset, such as real estate or a family business interest, is involved. Practitioners should consider including a defined value mechanism in the documents used to effectuate the swap so that only the interests (for example, LLC units) equivalent in value to the cash the grantor swaps into the trust will be distributed to the grantor.

No Shifting of Benefits

A substitution power can't be exercised in a manner

that can shift benefits among the trust beneficiaries. No shift of benefits should occur if: (1) 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 (2) the nature of the trust's investments or the level of income produced by any or all of the trust's investments doesn't 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. Because most IDGTs are discretionary trusts, this won't usually be a concern. However, questions may arise if the trust isn't discretionary. What can be done to confirm that the interests of the respective beneficiaries aren't impacted differently? What if, for example, the interest being swapped is in a family business, and one of the beneficiaries is an investment trustee with the power to determine if that business should be held? What if one or more beneficiaries are actively involved in that business and others aren't? Will the inclusion or exclusion of that business interest from the trust result in an impermissible shift of benefits?

While the swap power is a common technique to achieve grantor trust status, it can also produce substantial value. However, care and maintenance are required to take advantage of it. 

Endnotes

1. Revenue Ruling 2004-64.
2. Rev. Rul. 85-13.
3. A discussion of the income tax consequences if the note isn't paid off during the grantor's lifetime is beyond the scope of this article.
4. Internal Revenue Code Section 674.
5. IRC Section 675(1).
6. Section 675(2).
7. Section 675(4).
8. Rev. Rul. 2008-22, modified by Announcement 2008-46.
9. IRC Section 1014.
10. Revenue Procedure 2015-37, 2015-26 IRB 1196.
11. *In re the Matter of the Mark Vance Condiotti Irrevocable GST Trust* (unpublished opinion, Colorado Court of Appeals No. 14CA0969, July 9, 2015), www.fiduciarylawblog.com/helen-rogers-blog-link1.pdf.
12. Private Letter Ruling 200554012 (released Aug. 26, 2005).
13. IRC Section 2042(2).
14. Rev. Rul. 2011-28.
15. IRC Section 2036(b).
16. See *supra* note 8; *supra* note 14.