



Swap Powers

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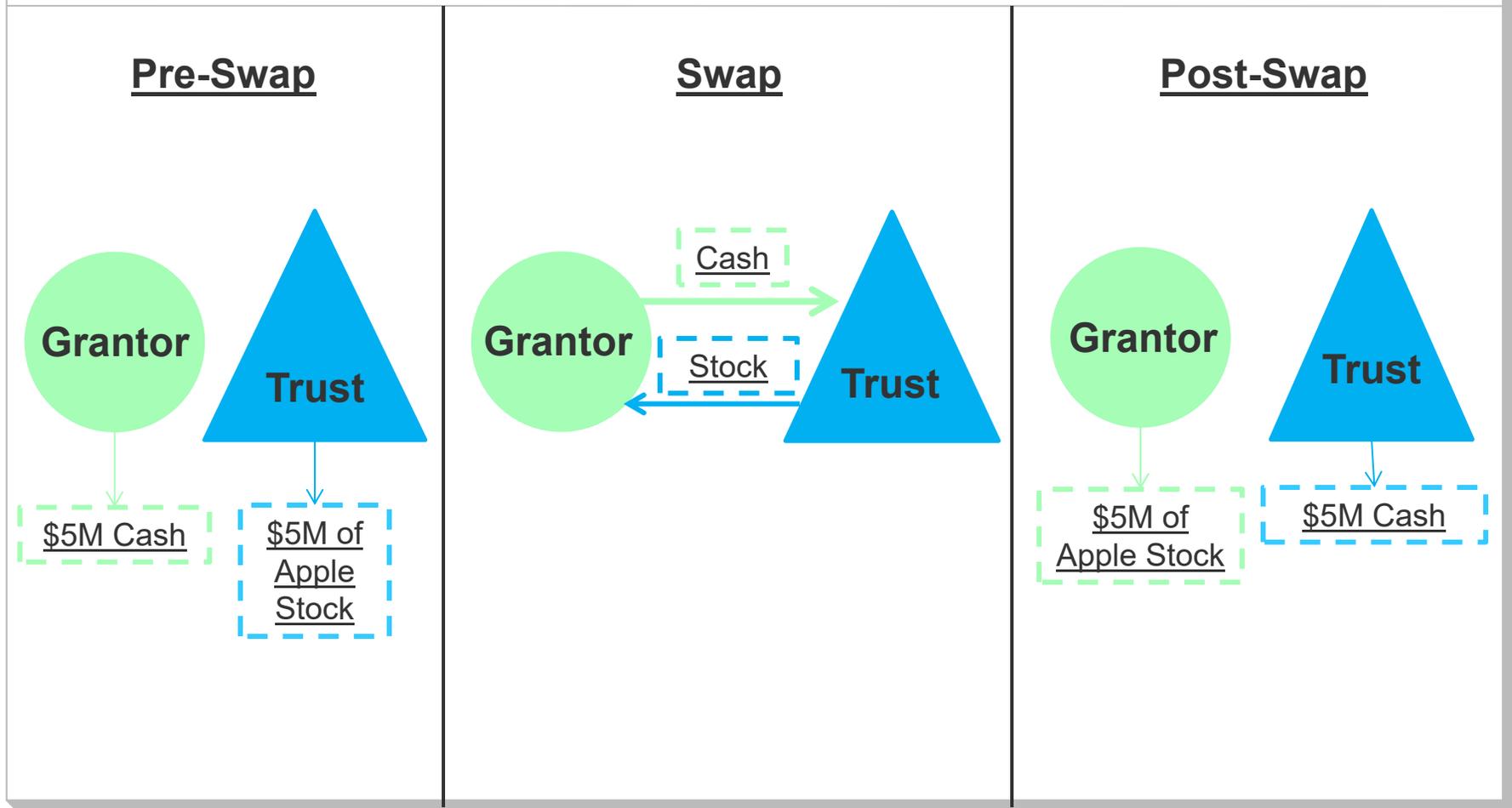
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Litigation Arising from the Grantor's Exercise of the "Swap" Power

- Essentially, the "swap" power (a/k/a the substitution power) is a provision in a trust instrument that
 - permits the grantor
 - of an irrevocable trust,
 - *without the trustee's consent,*
 - to reacquire trust assets
 - by substituting property of equivalent value
- While it appears that this is a unilateral right and the trustee cannot object, recent decisions have made it clear that a trustee has a duty to make sure that the substituted assets are of equivalent value

Example of the Exercise of a Swap Power



Why is the Swap Power Included in a Trust Instrument?

Part 1: General Overview

- Benefits of “Swap” Power for the Grantor
 - Flexibility
 - Control
 - Trust qualifies as a “grantor” trust
 - No gain or loss is recognized when assets are swapped (Rev. Rul. 85-13)
 - The trust grows on an income-tax free basis
 - The grantor is not treated as making a gift when he pays income taxes on behalf of the trust (Rev. Rul. 2004-64)
 - A well drafted swap provision should provide that the grantor can turn off “grantor” trust status by relinquishing his swap power
 - What is a “grantor” trust?

Estate Tax

The principal of the trust is not subject to estate tax at grantor’s death.

Income Tax

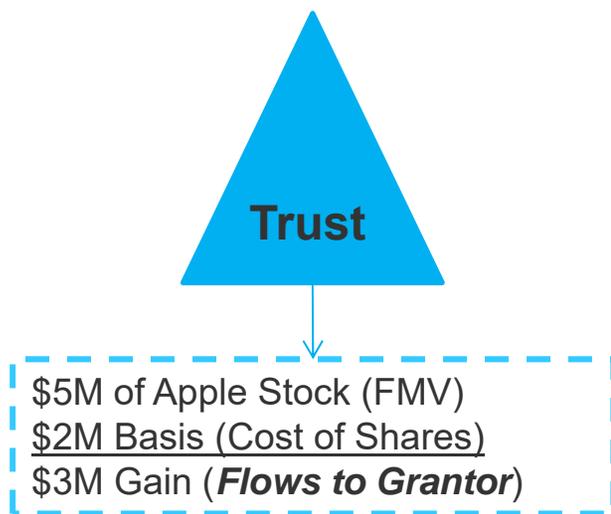
All items of income, deductions, and credits flow through to the grantor (similar to an LLC or a Partnership)

Why is the Swap Power Included in a Trust Instrument?

Part 2: Example of the Benefit of Non-Recognition

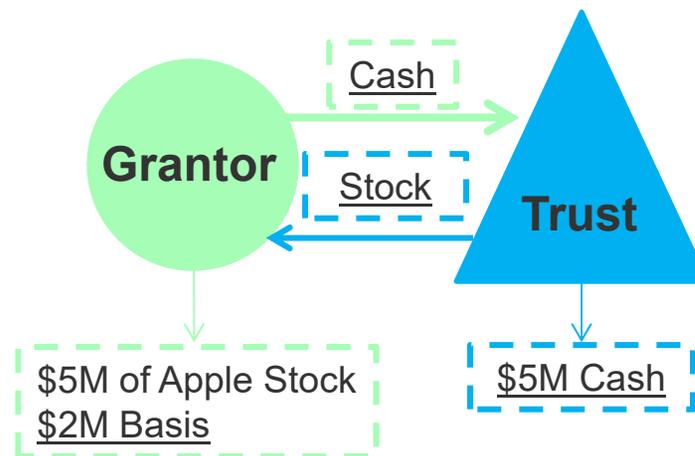
- Compare tax consequences of a sale to a third party versus a swap

Sale to Third Party



Grantor immediately recognizes
\$3M of Gain

Swap



Grantor does **NOT** immediately
recognize **\$3M** of Gain

Why is the Swap Power Included in a Trust Instrument?

Part 3: Example of the Benefit of Income-Tax Free Growth

- Assume Trust Sells Apple Stock to a Third Party

Grantor Trust



| | |
|--|---|
| $\begin{aligned} & \$100\text{K Gain (From Trust)} \\ & \times 28\% \text{ Tax Rate} \\ & \underline{\hspace{1.5cm}} \\ & \mathbf{\$28,000 \text{ Tax}} \end{aligned}$ | $\begin{aligned} & \$5\text{M of Apple Stock (FMV)} \\ & - \$4.9\text{M Basis (Cost)} \\ & \underline{\hspace{1.5cm}} \\ & \$100\text{K Gain (Flows to Grantor)} \end{aligned}$ |
|--|---|

Grantor only pays **\$28,000** of tax
Trust still has **\$5M** of assets

Non-Grantor Trust



| | |
|--|---|
| $\begin{aligned} & \text{No Tax Consequences} \end{aligned}$ | $\begin{aligned} & \$5\text{M of Apple Stock (FMV)} \\ & - \$4.9\text{M Basis (Cost)} \\ & \underline{\hspace{1.5cm}} \\ & \$100\text{K Gain} \\ & \times 40\% \text{ Tax Rate} \\ & \underline{\hspace{1.5cm}} \\ & \mathbf{\$40,000 \text{ Tax}} \end{aligned}$ |
|--|---|

Trust pays **\$40,000** of tax
Trust has **less than \$5M** of assets



How Do You Know if the Grantor Has a Swap Power?

- Trust instrument will include the “swap” power
- Sample provision:
 - “Power of Substitution. The Grantor shall have the power (the “Swap Power”) to reacquire any property held in such trust by substituting other property of equivalent value. The Swap Power shall be exercisable, in the sole discretion of the Grantor, at any time or from time to time and in a nonfiduciary capacity, without the approval or consent of the Trustees or of any other person acting in a fiduciary or a nonfiduciary capacity. It is the intention of the Grantor that the Power of Substitution shall constitute a power described in Section 675 of the Code.”



Why Now? Favorable IRS Rulings

- **1. Favorable IRS Rulings:**
 - Until recently, it was unclear if the
 - (i) inclusion of the swap power or
 - (ii) the exercise of the stock powerwould cause the assets of the irrevocable trust to be subject to estate tax at the grantor's death
 - Estate planners got the **green** light
 - In 2008 and 2011, the IRS issued favorable revenue rulings, Rev. Rul. 2008-22 and Rev. Rul. 2011-28, respectively



Why Now?

The Exemption Did Not Decrease in 2012

- **2. American Taxpayer Relief Act of 2012**
 - In 2012, it was unclear whether the estate and gift tax unified credit would decrease from \$5M to \$1M (both numbers are adjusted for inflation)
 - Clients were cautioned “use it or lose it.”



Why Now?

The Exemption Increased Again in 2018

- **3. Tax Cuts and Jobs Act**

- Exemptions increased to \$11.18 million for individuals and \$22.36 million for married couples.



Case Studies

- The exercise can affect
 - Trustees
 - Grantors
 - Beneficiaries
 - Creditors
- The following case studies explore how the exercise of the swap power can affect these parties and how it has led to litigation.

Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

- Don, Betty, and Sally Draper help us explore whether the grantor can exchange an unsecured promissory note for the principal of a trust
- Recall, a “swap” power
 - permits the grantor
 - of an irrevocable trust,
 - *without the trustee’s consent*,
 - to reacquire trust assets
 - by substituting **property** of **equivalent value**
- This case study explores
 - Classification of a Promissory Note as Property. Whether a promissory note is “property” or a “loan”
 - Ways that a Promissory Note can be Valued. Whether value is based upon
 - I.R.C. § 7872, which values loans with below-market interest rates or
 - A fair market value analysis

Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 1: Meet the Drapers



- **Creation of the Trust:**

- Approach of the Fiscal Cliff. Don heard that the estate tax exemption may decrease in 2013 and wanted to create a trust for his daughter, Sally
- Wife as Trustee. Don wanted his wife, Betty, to serve as Trustee
- Little to No Liquid Assets. Don's net worth is almost exclusively attributable to shares he owns in Sterling Cooper & Partners ("SC&P")
- Don Likes Control. Don's hesitant about transferring shares of SC&P to the trust

Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 2: Don is Confused by Estate Planning Concepts

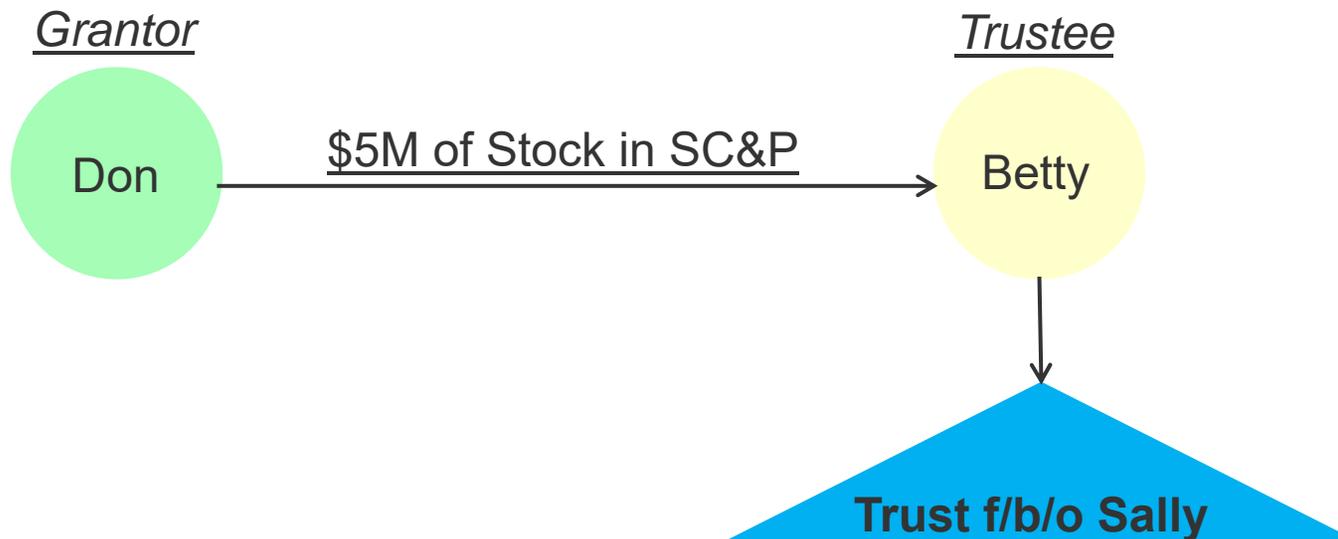


- Attorney discussed how Don can fund Sally's trust using SC&P stock but can retain the power to "swap" other assets of equivalent value for the shares

| | Grantor Trust | Non-Grantor Trust |
|---|---------------|-------------------|
| Principal of Trust Subject to Estate Tax at Don's Death? | No | No |
| Don pays Income Tax on Trust's Principal? | Yes | No |
| Don can Swap Property of Equivalent Value for Trust Assets? | Yes | No |

Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

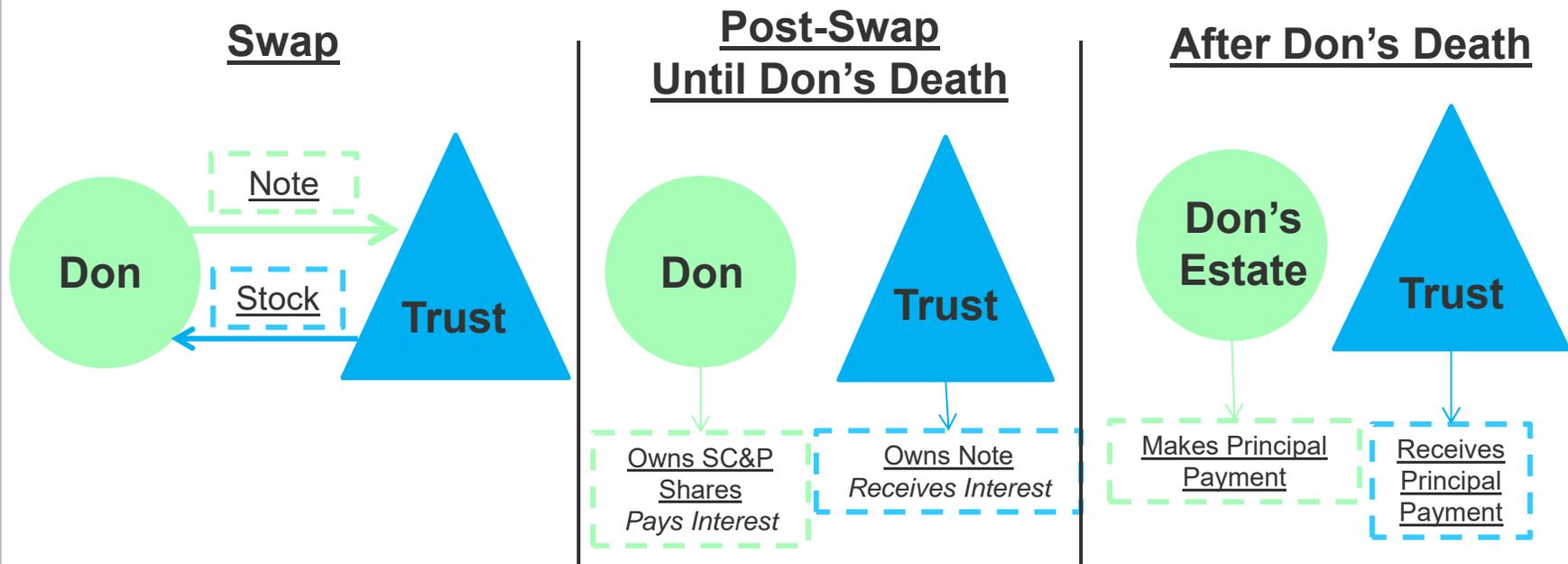
Part 3: Sally Gets a Trust



Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 4: Don Wants the Shares Back

- Swap. Attorney recommends that Don swap an unsecured promissory note for the shares of SC&P
- Terms of the Promissory Note.
 - Annual interest payments at the long-term applicable federal rate (2.94% for May 2018)
 - Principal payable on Don's death
- Control. Don can control the shares until his death





Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 5: Betty is Concerned that the Exercise of the Swap Power Could be a Breach of her Fiduciary Duties

- Betty is concerned about the following issues:
 - Is a note property or a loan?
 - What if Don’s estate doesn’t have sufficient assets to pay off the note?
 - Because the note is not secured, what if Don’s creditors have a higher priority to the assets of Don’s estate, and the note doesn’t get paid?
 - How can Betty diversify the assets of the trust if the trust only owns a note that can’t be sold or transferred?
 - How can the note be of “equivalent” value when a third party would never transfer shares for an unsecured note that pays interest at a rate that is below market?
 - Is Betty depriving Sally of income and principal during Don’s life because the trust will only receive small interest payments?

Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 6: Betty Consults a Florida Attorney Regarding the Exercise of the Swap

- If Betty Agrees to Accept the Note in Exchange for the Stock
 - If the note is (i) not property and (ii) not of equivalent value to the shares, Betty could have violated the following duties:
 - Duty to administer the trust in good faith Fla. Stat. § 736.0801
 - Duty of loyalty Fla. Stat. § 736.0802
 - Duty to administer the trust prudently § 736.0804
 - If Don defaults on the note, Betty could have violated the following duties:
 - Prudent Investor Rule Fla. Stat. §§ 518.10-11; 736.0901
 - If Don or Don's estate pays off the Note, Betty could still have violated the following duties:
 - Prudent Investor Rule Fla. Stat. §§ 518.10-11; 736.0901
 - Duty of Impartiality Fla. Stat. § 736.0803
- If Betty Refuses to Accept the Note in Exchange for the Stock
 - If the Note is (i) property and (ii) of equivalent value to the shares, Betty could have violated the duty to administer the trust in good faith and in accordance with its terms Fla. Stat. § 736.0801



Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 7: Existing Case Law

- While other cases have been filed, the first court to consider whether a promissory note qualifies as property of “equivalent value” was a Colorado state court in *In re Mark Vance Condiotti Irrevocable GST Trust*, Case No.: 11PR147 (District Court, La Plata County Colorado, April 2, 2014)
- Facts are very similar:
 - Grantor funded an irrevocable trust for child, naming spouse as Trustee
 - Grantor and Trustee subsequently divorce
 - Grantor attempted to swap a ~\$10M unsecured note, which paid interest annually at the then applicable federal rate of 1.27%
 - Trustee refused to swap the trust assets, and the Grantor threatened to sue her for breach of fiduciary duties
 - Trustee preemptively filed a Petition for Instructions requesting the court to instruct her regarding whether she had to swap the assets for the note



Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 7: Existing Case Law Continued

- Issue 1: Is a promissory note “property” or a “loan”?
 - Grantor argued that the note was property
 - Trustee argued that the note was a loan
 - Court ruled in favor of trustee
- Issue 2: How is the value of the promissory note determined?
 - Grantor argued that the note should be valued under I.R.C. § 7872
 - The value of a note is equal to the face value of the note as long as (i) the grantor is solvent and (ii) the note pays interest at the applicable federal rate
 - Trustee argued that the note should be based on a fair market value analysis
 - What a willing buyer would pay a willing seller for the note
 - Court effectively ruled in favor of the trustee



Case Study 1: Can a Grantor Swap a Promissory Note for Trust Assets?

Part 8: Attorney's Recommendations

- Before Doing Anything
 - Obtain a qualified appraisal of both the SC&P stock and the note
- If after Betty receives the qualified appraisals, she wants to proceed with the swap, she should
 - Obtain a Release from Sally under Fla. Stat. § 736.1012
 - Serve Sally with a Prompt Accounting with a Limitations Notice
- If after Betty receives the qualified appraisals she is unsure as to whether to proceed with the swap, she should:
 - File an action for declaratory judgment seeking a declaration regarding whether Don effectively exercised his swap power

Case Study 2: Can Creditors Challenge a Swap?



- Jordan Belfort, the “Wolf of Wall Street,” will help us explore whether a creditor can potentially challenge the grantor’s exercise of a swap power
- This case study explores
 - Conversion of Non-Exempt Assets to Exempt Assets
 - Fraudulent Transfers

Case Study 2: Can Creditors Challenge a Swap?

Part 1: Meet the Belforts

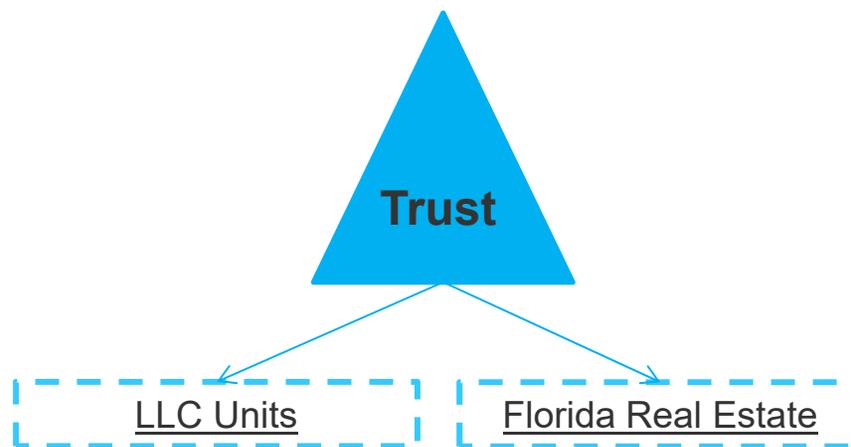


- Jordan Belfort established a trust for the benefit of his wife, Nadine, (a/k/a the Duchess) and their two children, Chandler and Carter
- Jordan named Nadine as Trustee
- Jordan retained a swap power over the trust

Case Study 2: Can Creditors Challenge a Swap?

Part 2: Funding the Trust

- At the time he created the trust, Jordan transferred his Florida residence to the trust and membership units in a multi-member Delaware, LLC
- A few years after he created the trust, Jordan, Nadine, Chandler, and Carter move to Florida



Case Study 2: Can Creditors Challenge a Swap?

Part 3: Fraudulent Activity Begins



- After he moved to Florida, Jordan began defrauding investors in a “pump and dump” securities scam
- After a particularly dicey interaction aboard his yacht with an FBI agent, who accused Jordan of attempting to bribe him, Jordan met a few of his co-workers at the country club to discuss ways to shield his assets from creditors

Case Study 2: Can Creditors Challenge a Swap?

Part 4: Rugrat's Advice



- One co-worker, Rugrat, who actually went to law school, recommended that Jordan swap cash (which Jordan had hidden all over) for the Florida property, which qualified for Florida homestead, and the interest in the LLC
- Jordan followed Rugrat's advice, then declared the Florida property as his homestead



Case Study 2: Can Creditors Challenge a Swap?

Part 5: Lawsuit

- Three and a half years later, judgment is entered against Jordan in favor of the investors he defrauded
- Can the creditors set aside the swap?
 - Conversion of Non-Exempt Assets to Exempt Assets
 - Fraudulent Transfers



Case Study 3: Swap Power as a Tool During Settlement Negotiations

- The Lannister family helps us explore how the swap power can be used as leverage during settlement negotiations
- Recall, if the grantor has a swap power over a “grantor” trust
 - The grantor exercises the power in a *nonfiduciary capacity*
 - The grantor can “swap” assets in and out of the trust without recognizing gain or loss
 - The trust grows income-tax free while the grantor retains the swap power
 - A properly drafted swap provision should permit the grantor to turn off grantor-trust status by releasing his swap power (and any other power the grantor has over the trust)
- This case study explores
 - Leverage. How the grantor can use his swap power as leverage during settlement negotiations

Case Study 3: Swap Power as a Tool During Settlement Negotiations

Part 1: Meet the Lannisters



- Tywin created an irrevocable trust for his grandson, Joffrey
- Tywin named his daughter, Cersei, and his son, Jamie, as successor Trustees
- Joffrey died after he was poisoned at his wedding
- Because Joffrey had no descendants, the trust instrument provided that the trust was to be divided into three equal shares for each of Tywin's children, Cersei, Jamie, and Tyrion, and each share was to be held in further trust

Case Study 3: Swap Power as a Tool During Settlement Negotiations

Part 2: Litigation Regarding Trust



- Tyrion filed suit against Cersei and Jaime, as Trustees, alleging various causes of action
- Cersei, Jaime, and Tywin wanted the matter to be resolved quickly, so they consulted with their attorney regarding ways they could induce Tyrion to settle

Case Study 3: Swap Power as a Tool During Settlement Negotiations

Part 3: Meeting with Attorney



- The attorney advised Tywin
 - That he had a “swap” power over the trust and that he could use this power as leverage against Tyrion to encourage him to settle the dispute
 - That he was not subject to liability for exercising his swap power because he held the power in a *nonfiduciary* capacity

Case Study 4: Revisiting the Issue of Substituting Property for a Note



- Tom Benson Litigation
 - Attempted exercise of his power of substitution over assets in trusts he established for his only daughter and her grandchildren.
 - Sought to reacquire certain assets including the nonvoting interests in both the New Orleans Saints (NFL) and the Pelicans (NBA)
 - Value of assets involved in the exchange exceeded \$500 million



Case Study 4: Revisiting the Issue of Substituting Property for a Note

- Descendants fought back
 - Tried to invalidate the exercise by having him declared incapacitated
- Trustees of the Trusts objected to the purported exercise
 - Argued that this was a request to make a loan (not substitute property of equivalent value)
 - That promissory notes were not appropriate trust investments
 - The exchange was not simultaneous
 - That Trustees had to make their own independent verification that the assets to be exchanged were of equivalent value
- Benson sued the Trustees in federal court



Case Study 4: Revisiting the Issue of Substituting Property for a Note

- Trustees' Motion for Judgment on the Pleadings
 - 1. Sought a ruling that the “exchange” was actually a request for a loan, so the trustee had the discretion to deny the request
 - 2. Sought a ruling that if a substitution did occur, at the earliest it occurred in August 2015 (the date that Tom supplemented his notices of exchange in accordance with the price adjustment clauses per the appraisals that were prepared) not January 1, 2015.
 - Clause at issue:
 - “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.”



Takeaways:

- Estate Planners
- Litigators
- Trustees



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- She graduated with a B.S. from Georgetown University, and a J.D. and LL.M. in taxation from the University of Florida. Prior to joining Gunster, Elizabeth was a clerk for the Honorable Donald M. Middlebrooks of the U.S. District Court for the Southern District of Florida.