Curing Basis Discrepancy: Exercise of Substitution Power

by Matthew S. Beard

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In this article, Beard examines drafting and reporting considerations for the exercise of a grantor's power to substitute appreciated property of a trust for other property of equivalent value, so that the appreciated property held by the grantor at death receives a step-up in basis under section 1014, the discrepancy between sections 1014 and 1015.

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I. Introduction

As discussed in my most recent article, the IRC contains an income tax discrepancy between testamentary and lifetime transfers.[1] For testamentary transfers, section 1014 provides that the basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death, without recognition of gain under section 102. For lifetime transfers, section 1015 provides that the basis of property acquired by gift is the same as it would be in the hands of the donor, without recognition of gain under section 102. Thus, a testamentary transfer of appreciated property results in stepped-up basis, but a gift does not.

This discrepancy is not favorable to the grantor who transfers property to an irrevocable trust during life. The grantor may later wish to reacquire appreciated property of the trust so that the property will receive a step-up in basis at the grantor's death under section 1014, and thus cure the discrepancy between sections 1014 and 1015. My earlier article addressed the tax implications of three ways to accomplish this goal, including the exercise of a grantor's substitution power.

A trust agreement that provides the grantor with a substitution power is one way to create a grantor trust. Section 675(4)(C) provides that "the grantor shall be treated as the owner of any portion of a trust in respect of which 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," and "power of administration" includes the power to reacquire trust corpus by substituting other property of an equivalent value. The substitution power is a popular grantor trust power because the IRS has ruled that the substitution power results in grantor trust treatment without gross estate inclusion.[2] A typical substitution power tracks statutory language, as follows:

> Notwithstanding any other provision herein to the contrary, the grantor shall have the power, exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, to reacquire trust corpus by substituting other property of an equivalent value.

[1] Matthew S. Beard, "Curing Basis Discrepancy: Sales and Substitutions of Trust Property," *Tax Notes Federal*, Oct. 19, 2020, p. 389.

[2] Rev. Rul. 2008-22, 2008-16 IRB 796.

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Although drafting a substitution power appears simple, complex questions will arise when the grantor exercises it. How should the substitution be structured? What are the applicable values for substitution? How should objections by the trustee or the IRS be addressed? This article examines these issues and other drafting and reporting considerations for the exercise of a grantor's substitution power.

II. Substitution Structure

A. Initial Considerations

Before developing a structure for the exercise of a grantor's substitution power, the fiduciary duties of the trustee should be considered because they limit available structures and terms. The trustee has a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law.[3] A trustee commits a breach of trust by improperly failing to act, as well as by improperly exercising the powers of the trusteeship.[4] If the terms of a trust reserve to the grantor a power to direct or otherwise control specific conduct of the trustee, then the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power, and to comply with any exercise of that power unless the attempted exercise is contrary to the terms of the trust or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries.[5] The primary duty of the trustee regarding a power for the benefit of the power holder is to ascertain whether an attempted exercise is within the terms of the trust and to refuse to comply if it is not.[6] If the trustee knows or has reason to believe that an attempted exercise of power exceeds the scope or would otherwise constitute an abuse of power, the trustee has a duty to not comply with the direction given by the power holder.[7] If inquiry does not satisfy the trustee's concerns on one of these grounds, and the power holder insists upon compliance despite the trustee's objections, then the trustee may apply to the court for instructions.[8]

Valuation questions should also be considered because there is a substantial risk that the grantor and trustee will disagree on the value of all or a portion of the property exchanged. What is the value of the trust property transferred to the grantor? What is the value of the property transferred to the trust? Are the values equivalent? The grantor cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase the grantor's net worth.[9] By substituting property of equal value to the property replaced, the grantor is prohibited from depleting the trust corpus.[10]

In *In re Rigoni Trust*, the grantor, Dino Rigoni, created a revocable trust that owned a limited liability company that owned approximately 550 acres of farmland in Michigan.[11] To convey an interest in the farmland for the benefit of the tenants of the land, the revocable trust sold a portion of the membership interests in the LLC to two irrevocable trusts created by Rigoni for the benefit of the tenants in exchange for promissory notes of the irrevocable trusts. After the sale and gifts, membership interests were owned 60 percent by the two irrevocable trusts, 39 percent by the revocable trust, and 1 percent by Rigoni. The tenants invested approximately $1 million in improvements to the farmland, which was profitable and increased substantially in value. The two irrevocable trusts were treated as grantor trusts for income tax purposes. The trust agreements included the following substitution clause:

> As Grantor, I [Rigoni] do hereby retain the power and right, exercisable only for my

[3] Restatement (Third) of Trusts section 76(1); and Tex. Prop. Code section 113.051 ("The trustee shall administer the trust in good faith according to its terms and this subtitle. In the absence of any contrary terms in the trust instrument or contrary provisions of this subtitle, in administering the trust the trustee shall perform all of the duties imposed on trustees by the common law.").

[4] Restatement (Third) of Trusts section 76, at cmt. b.

[5] *Id.* at section 75.

[6] *Id.* at cmt. d.

[7] *Id.*

[8] *Id.*

[9] Rev. Rul. 2008-22.

[10] *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975).

[11] *Rigoni v. Rajzer (In re Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer)*, No. 321589 (Mich. Ct. App. July 14, 2015).

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> 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.

Rigoni exercised the substitution power by first sending a letter to the trustee of the irrevocable trusts ordering them to substitute the promissory notes of the trusts for a collective 40 percent membership interest in the LLC that the trusts had purchased, and later another letter that increased the substitution to a 60 percent membership interest. The trustee responded to both letters that Rigoni failed to offer property of equivalent value. The parties resorted to judicial resolution: Rigoni filed a petition to compel the trustee to allow substitution of property, and the trustee requested a court determination of equivalent value for the 60 percent membership interest.

At trial, experts in business valuation presented significantly different opinions on and approaches to determining value. The trustee's expert determined that the value of the 60 percent membership interest was $2,388,000 based on the underlying assets of the LLC with no discounts for lack of marketability or control. In contrast, Rigoni's expert determined that the value of the 60 percent membership interest was $248,000 (approximately 10 percent of the value determined by the trustee's expert) based on the income stream received from leasing the farmland (rather than on the underlying assets) and then applying discounts for lack of marketability and minority shareholder status of 19 percent and 32 percent, respectively (rather than no discounts).

The significant disagreement on value was resolved in favor of the trustee. The court recognized that nothing in the language of the substitution clause required the trustee to accept *any* tender of property as a substitution for trust assets; rather, the substitution clause prohibited the trustee from declining to comply with Rigoni's substitution of equivalent-value property. A necessary precondition to substitution is that equivalent value be established. The trustee possesses the power and duty to determine whether the attempted substitution complies with the requirements of the substitution clause.[12] Also, the court rejected the use of discounts by Rigoni's expert because application of substantial discounts to the membership interests upon their removal from the trusts, when no evidence was presented that the interests were subject to similar discounts upon their acquisition by the trusts (and thus Rigoni could essentially "buy" the interests for much less than he "sold" them), would make it highly likely that Rigoni's net worth would be increased by the substitution, and that the value of the trust corpus would be reduced.[13]

B. Unsecured Promissory Note

The grantor may be tempted to propose the substitution of trust property for the grantor's unsecured promissory note because of the perceived ease of providing a note. However, this structure raises the recurring issue of whether the structure should be treated as a substitution or an indirect borrowing from the trust. The trustee may not be as attracted to this structure because of the risk associated with an unsecured promissory note, and they may refuse to comply with the grantor's proposed terms for substitution.

The IRS has held that substitution of trust property for the grantor's unsecured promissory note should be treated as an indirect borrowing of the trust corpus. In Rev. Rul. 85-13, 1985-1 C.B. 184, a grantor created an irrevocable trust with his spouse as trustee and funded the trust with all outstanding stock of a corporation with a basis of $20x. When the FMV of the shares later increased to $40x, the spouse, as trustee, transferred the shares to the grantor in exchange for the grantor's unsecured promissory note with a face amount of $40x, bearing adequate interest, payable semiannually beginning six months after the date on which the shares were transferred to the grantor, and principal due in 10 equal annual installments. The IRS recognized that the grantor acquired the stock in exchange for an unsecured note and that if, instead of giving the spouse a

[12] Citing Restatement (Third) of Trusts section 75, at cmt. d.

[13] Citing Rev. Rul. 2008-22 and *Jordahl*, 65 T.C. 92.

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note in exchange for the shares, the grantor had made a cash payment of $40x to the spouse and later borrowed that cash, giving the spouse the unsecured note to confirm the borrowing, then section 675(3) would have been applicable, and the grantor would have been the owner of the trust.

Although the grantor did not engage in this kind of direct borrowing, the grantor's acquisition of the entire corpus of the trust in exchange for an unsecured note was, in substance, the economic equivalent of borrowing trust corpus. Thus, the IRS ruled that the grantor's receipt of the entire corpus of the trust in exchange for the grantor's unsecured promissory note constituted an indirect borrowing of the trust corpus, which caused the grantor to be the owner of the entire trust under section 675(3). Similarly, the Second Circuit held in *Rothstein* that a grantor was the owner of a trust under section 675(3) because, by exchanging an unsecured note for the entire trust corpus, the grantor had indirectly borrowed the trust corpus.[14]

In *Condiotti*, a man established an irrevocable trust for his minor son and appointed his wife as trustee.[15] A corporate trustee was later appointed as co-trustee. The trust agreement provided the husband a substitution power and expressly eliminated the power to take trust corpus as a loan, 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.
>
> No power enumerated in this instrument or accorded to trustees generally pursuant to law shall be construed to . . . enable any person to borrow the principal or income for the trust estate, directly or indirectly, without adequate interest or security.

Eleven years after creating the trust, the husband notified the trustees that he decided to exercise his substitution power and substitute all trust property for the grantor's unsecured promissory note of $9.5 million with annual interest of 1.27 percent. The trustees replied that the husband could not do what he proposed because he was attempting to invoke a loan power expressly denied by the trust agreement, rather than the substitution power. The husband threatened to sue the trustees, and the trustees responded by filing a petition requesting court instruction.

The court concluded that the husband's proposed transaction was an attempt to exercise a loan power, not a substitution power, so the trustees could properly reject it. The court stated that the primary duty of the trustee is to ascertain whether an attempted exercise is within the terms of the power and refuse to comply if it is not.[16] If the trustees decide that the proposed transaction involves the loan power and not the substitution power, then they have a fiduciary duty to prevent it.[17] Further, citing Rev. Rul. 85-13 and *Rothstein*, the court acknowledged that the husband's receipt of the entire corpus of the trust in exchange for his unsecured promissory note constituted an indirect borrowing of the trust corpus. Thus, the court held that the trustee had the authority to scrutinize the husband's proposed transaction and to reject it because it was a request for a loan.

C. Secured Promissory Note

A more conservative structure involves the substitution of trust property for the grantor's secured promissory note. This may be viewed more favorably as a substitution rather than an indirect borrowing of trust corpus because the grantor's promissory note is secured, rather than unsecured.

In *Benson*, the grantor, Thomas Benson, established various trusts for the benefit of his daughter and grandchildren.[18] The trusts held

[14] *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984).

[15] *In re the Matter of the Mark Vance Condiotti Irrevocable GST Trust*, No. 14CA0969 (Col. App. July 9, 2015).

[16] Citing Restatement (Third) of Trusts section 75, at cmt. d.

[17] *Id.*

[18] *Benson v. Rosenthal*, No. 15-782 (E.D. La. 2016).

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ownership interests in various entities that in turn owned the New Orleans Saints franchise, the New Orleans Pelicans franchise, the New Orleans Fox television affiliate, automobile dealerships, and the Benson Tower and Champions Square development. The trust agreements provided that neither the trustee nor Benson may exchange or dispose of any part of the principal of the trusts for less than adequate consideration in money or money's worth; that the trustee had the right to loan Benson up to 100 percent of trust assets, but that the loan would be made on terms and conditions deemed appropriate by the trustee; and that Benson had the power to substitute trust property for other property of equivalent value without the approval or consent of the trustee.

Benson initially proposed substitution for his unsecured promissory notes. On January 12, 2015, he sent correspondence to the trustee to exchange trust assets for unsecured promissory notes of equivalent value, effective as of January 1, 2015. Benson included a preliminary schedule of values of 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 trustee refused to execute documents to complete the exchange, stating that an unsecured promissory note was not an appropriate trust investment and that the trustee must make his own independent verification that the assets to be exchanged are of equivalent value.

Benson quickly responded by modifying the proposed terms of substitution with his secured (rather than unsecured) promissory notes and provided further documentation of values. On January 24, 2015, he supplemented his correspondence with certifications of values of each trust signed by himself, collateral assignments granting the trust security interests, and promissory notes for values based on the most recent valuations available. These promissory notes also contained valuation adjustment clauses. However, the trustee again rejected the proposed exchange, stating that there had not yet been an exchange of assets of equivalent value.

On August 24, 2015, Benson supplemented the notice of exchange with an appraisal as of December 31, 2014, prepared by an appraiser that he engaged in accordance with the valuation adjustment clauses. Based on the appraisal, Benson delivered promissory notes of specific values and collateral assignments securing each of the notes. The trustee again rejected his proposed terms for substitution.

Benson sought a declaratory judgment declaring the exchange effective. The trustee, citing Rev. Rul. 85-13, *Rothstein*, and *Condiotti*, argued that the proposed exchange was in fact a loan because Benson sought an extension of credit from the trusts, and thus the trustee had discretion to deny his request for a loan. The court was not persuaded by the trustee. The court distinguished Rev. Rul. 85-13, *Rothstein*, and *Condiotti* because the notes in those cases were unsecured, whereas Benson tendered fully secured promissory notes based on qualified appraisals bearing adequate interest rates. The court recognized that there was no provision in the trusts prohibiting the use of a promissory note in a substitution, and a promissory note certainly has value.

D. Substitution Documents

Although each situation is unique, the substitution of trust property for the grantor's secured promissory note generally involves five core documents: (1) a written exercise of the power of substitution; (2) documentation of the transfer of title; (3) a secured promissory note; (4) a security agreement; and (5) an appraisal.

First, the grantor should execute a written letter or memorandum, such as a notice of substitution or notice of exchange, that exercises the grantor's power of substitution. This document should be drafted to demonstrate the grantor's intent to exercise his or her power of substitution, provide notice to the trustee of that exercise, identify the property of the trust to be transferred to the grantor, identify the property of the grantor to be transferred to the trust (that is, the grantor's secured promissory note), propose terms for substitution, and satisfy any requirements under the trust agreement for substitution.

Second, the trustee should execute any documents necessary to transfer legal title to trust property to the grantor. Real property is

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transferred by deed.[19] A certificated share of stock in a corporation in registered form is delivered with endorsement.[20] A partnership interest is transferred by assignment.[21] A membership interest in an LLC is transferred by an assignment.[22] Also, any transfer requirements under a partnership agreement, company agreement, buy-sell agreement, or other applicable document should be satisfied.

Third, the grantor should execute a promissory note drafted under article 3 of the Uniform Commercial Code (UCC). The note should be in writing, include an unconditional promise to pay a fixed amount of money with interest, be payable on demand or at a definite time, identify the grantor as the maker of the note, identify the trustee of the trust as the person to whom the note is payable, state the effective date, and not state any other action undertaken by or instruction to the borrower to do any act other than pay money.[23] To avoid imputed interest for federal income tax purposes, interest should be payable at least equal to the applicable federal rate.[24] Also, the parties may wish to address the death of the grantor with an acceleration clause.[25]

To secure the grantor's promissory note, the grantor should also execute a security agreement drafted in accordance with article 9 of the UCC that provides a security interest in the trust property transferred to the grantor.

Finally, an appraisal of the value of the substituted property as of the effective date of substitution should be obtained. The appraisal helps satisfy the requirement of the substitution power under the trust agreement that property of the trust be substituted with property of equivalent value and may be used for adequate disclosure for federal tax purposes. Accordingly, the appraisal should be prepared by an appraiser who: (1) is an individual who holds themselves out to the public as an appraiser or regularly performs appraisals; (2) is qualified to make appraisals of the type of property being valued, as described in the appraisal, detailing their background, experience, education, and membership, if any, in professional appraisal associations; and (3) is not the donor or the donee of the property or a member of the family of the donor or donee, or that of any person employed by the donor, the donee, or a member of the family of either.[26]

The appraisal should contain: (1) the date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal; (2) a description of the property; (3) a description of the appraisal process employed; (4) a description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analysis, opinions, and conclusions; (5) the information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value; (6) the appraisal procedures followed, and the reasoning that supports the analysis, opinions, and conclusions; (7) the valuation method used, the rationale for the valuation method, and the procedure used in determining the FMV of the asset transferred; and (8) the specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transitions, etc.[27]

E. Effective Date

The substitution documents should state an effective date. A time lag necessarily exists between the date on which the grantor exercises the substitution power, the closing date for transfers of property between the trustee and grantor, and the date on which the values are

[19] Tex. Prop. Code section 5.021.

[20] Tex. Bus. & Com. Code sections 8.106 and 21.209.

[21] Tex. Bus. Org. Code at section 153.251.

[22] *Id.* at section 101.108.

[23] Tex. Bus. & Com. Code at section 3.104; UCC section 3-104; UCC section 3-401; UCC section 3-402; and UCC section 3-110(a) and (c)(2)(i).

[24] Section 7872(e)(1)(A); prop. reg. section 1.7872-3(c)(1); and LTR 9535026.

[25] For example: "If [grantor] dies before the maturity date, then the outstanding principal and accrued unpaid interest under this promissory note shall be and become due and payable as of [grantor]'s date of death."

[26] Reg. section 301.6501(c)-1(f)(3)(i).

[27] Reg. section 301.6501(c)-1(f)(3)(ii).

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determined. Should the effective date be the date of exercise, the date of closing, or another date?

In *Benson*, the initial notice of exchange was dated January 12, 2015, and stated an effective date of January 1, 2015, and the supplemental notices were dated January 24, 2015, and August 24, 2015. Benson argued that the effective date was retroactive to January 1 because the valuation of trust assets necessarily takes time and is based on some date in the past. The trustee argued that the effective date was August 24 because the trust requires a contemporaneous exchange of property of equivalent value. The court rejected the trustee's argument because a reading that substitution requires an up-to-the-minute valuation would all but prevent Benson from making an exchange. The court recognized that a time lag exists in determining the value of trust property for substitution because the trust assets were units of closely held LLCs owning sports franchises and other real estate that are not readily valued and, as a practical matter, valuation of trust assets must necessarily be based on some date in the past. The court held that substitution was effective on January 24 because that was the date Benson provided the trustee with a certification of the value of the substituted property and promissory notes purporting to be of equivalent value as required by the trusts.

F. Refusal to Comply

The grantor can unilaterally exercise his or her substitution power. The grantor, however, cannot unilaterally execute an exchange of property between the trustee and grantor because the trustee holds property of the trust and thus has the power to transfer legal title to trust property.[28] A risk exists that the trustee refuses to comply when the grantor exercises a power of substitution. The trustee might believe that the equivalent value requirement is not satisfied, reject the proposed property for substitution, disapprove of other terms for substitution, or otherwise wish to block substitution.

For example, in *Schinazi*, the grantor, Raymond Schinazi, established an irrevocable trust for the benefit of his daughter and initially funded the trust with $500,000.[29] The trust agreement provided Schinazi the following substitution power:

> 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.

Schinazi assigned a 99 percent limited partnership interest to the trust in exchange for the trust's $7 million promissory note. To accomplish the transfer, a "sale and assignment of interests" was executed that satisfied transfer restrictions under the partnership agreement.

After significant appreciation over six years, Schinazi attempted to exercise his substitution power by 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 the partnership, provided his promissory note of approximately $58 million, and asked the trustee to sign an "Acknowledgment of Transfer of Interest" acknowledging that Schinazi was the sole owner of all partnership interests formerly owned by the trust. The trustee refused to comply, asserting that Schinazi's promissory note did not constitute a substitution of equivalent value. Schinazi responded by informing the trustee that the trust's balance sheet included Schinazi's $58 million promissory note, rather than a limited partnership interest. The trustee sought a declaratory judgment to determine who owned the partnership interest.

The court held that Schinazi had the right to reacquire the partnership interest, but that he failed to follow the necessary steps to complete the acquisition. A partnership interest could be transferred only after compliance with the transfer procedures in the partnership agreement and execution of the appropriate form. These requirements were satisfied for the original

[28] Tex. Prop. Code section 111.004(18); Uniform Trust Code sections 815 and 816; and Restatement (Third) of Trusts section 42, at cmt. a.

[29] *Schinazi v. Eden*, 792 S.E.2d 94 (Ga. App. 2016).

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transfer of partnership interests to the trust under the "Sale and Assignment" document, but were not satisfied for the proposed substitution that transferred partnership interests to the grantor merely by obtaining an "Acknowledgment of Transfer of Interest."

In *Benson*, a different result was reached when the trustee refused to comply. The court held that the trusts granted Benson the unilateral power to substitute assets and, while the trustee must ensure equivalent value, the trustee did not have the power to prevent that exchange. The substitution provisions clearly granted Benson the power to affect a substitution without approval. To do so, he must first "certify in writing that the substituted property is of equivalent value to the property for which it is substituted." The trusts then stated that the "trustee has a fiduciary obligation to independently 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." The court recognized that the trusts did not say that the trustee may delay the substitution while that verification is made. Under that reading, the trustee would be able to block a substitution indefinitely while valuation was disputed, rendering the phrase "without approval or consent of any person" meaningless.

Good drafting anticipates the risk that the trustee refuses to comply. To reduce this risk, the trust agreement should include provisions expressly directing the trustee on how to proceed with substitution following the exercise of the grantor's power of substitution. This requires more than merely tracking the language of section 675(4)(C), which does not address how to proceed with substitution. For example, a trust in *Benson* provided:

> 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.

To encourage cooperation, the trust agreement should also provide the grantor the power to remove a trustee. Without an express removal power in the trust agreement, a court proceeding is required to remove a trustee.[30] For federal estate tax purposes, the removal power is a rare power that can be retained by the grantor without causing the trust to be included in the grantor's gross estate if the grantor is prohibited from appointing a successor trustee that is related or subordinate to the grantor (within the meaning of section 672(c)).[31]

III. Tax

A. Formulas

To address the time lag in determining value as well as the potential for future changes in the determination of value, documents are frequently drafted with formulas that calculate an amount depending on a final determination of value. For example, in *Benson*, Benson exercised his substitution power by providing a notice of exchange, a preliminary schedule of the value of trust assets, and blank promissory notes containing valuation adjustment clauses. The value adjustment clauses in the promissory notes provided that "if there is a final determination that the value of this Note is not equal to the Net

[30]Tex. Prop. Code section 113.082(a); and Uniform Trust Code section 706.

[31]Rev. Rul. 95-58, 1995-2 C.B. 191 ("Rev. Rul. 77-182 is modified to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income.").

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Value, [Benson] shall reform this Note to reflect the Net Value as finally determined," which allowed for the substituted property to be adjusted automatically to ensure that equivalent value was being given.

This strategy has roots in *King*.[32] The grantor, John McCandish King, sold stock to the trustee of trusts that King created for his descendants. The purchase agreements contained the following valuation adjustment clause:

> However, if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service.[33]

King and the trustee agreed that the price of the stock should be $1.25 per share. The IRS determined that the stock had an FMV of $16 per share, and argued that the valuation adjustment clause should not be given effect to alter the terms of a complete transfer, and thus avoid gift tax.[34] The district court rejected the IRS's view, finding that it was intended that the trusts pay the FMV of the stock and that the valuation adjustment clause was a proper means of overcoming uncertainty in ascertaining the FMV of the stock. On appeal, the Tenth Circuit agreed with the district court and noted that there was at no time and in no way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustee to reconvey the stock back to King or to cancel the notes in anticipation of an unfavorable valuation ruling. The Tenth Circuit further held that the authorities relied on by the IRS deal with contingencies that, upon fruition, alter, change, or destroy the *nature* of the transaction, and those authorities do not apply when the proviso for adjustment of the purchase price of the stock to equal its FMV did not affect the *nature* of the transaction.

A defined value clause is another type of formula frequently used to address valuation issues.[35] A defined value clause calculates a specific dollar amount of property, rather than a set quantity of property. In *Wandry*,[36] the Wandrys executed assignments and memorandums of gifts that included the following defined value clause and value adjustment clause:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	$261,000
Jason K. Wandry	$261,000
Jared S. Wandry	$261,000
Grandchild A	$11,000
Grandchild B	$11,000
Grandchild C	$11,000
Grandchild D	$11,000
Grandchild E	$11,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date

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[32] *King v. United States*, 545 F.2d 700 (10th Cir. 1976).

[33] *Cf. Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the donors assigned gifts of remainder interests in two trusts to their children under the following clause: "In the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property" of donors.

[34] The IRS cited *Procter*, which held that when the taxpayer transferred property to a trust that he had previously established (retaining the income from it during his lifetime with the remainder of the trust property to be distributed to his children upon his death), the price adjustment clause it contained was void as against public policy.

[35] Federal courts have held formulas used to limit the value of a completed transfer as valid. *Wandry v. Commissioner*, T.C. Memo. 2012-88; *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280; and *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).

[36] *Wandry*, T.C. Memo. 2012-88.

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> of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

At all times, the Wandrys understood and believed that the gifts were of a dollar value, not a specified number of membership units. If a subsequent determination revalued membership interests gifted, no membership units would be returned to them; rather, accounting entries to the LLC's capital accounts would reallocate each member's membership units to conform to the actual gifts. The IRS argued that the adjustment clause did not save the Wandrys from gift tax because it created a condition subsequent to completed gifts and was void for federal tax purposes as contrary to public policy.[37] The Tax Court recognized that the IRS's argument raised an old issue that has evolved through a series of cases in which the IRS has challenged a taxpayer's attempt to use a formula to transfer assets with uncertain value at the time of the transfer. Citing *King*, the Tax Court held that the adjustment clauses at issue were valid formula clauses. The gift documents did not allow the Wandrys to "take property back." Rather, the gift documents corrected the allocation of membership interests in the LLC among the Wandrys and the donees because the appraisal understated the LLC's value.

B. Reporting of Substitution

Retention of a substitution power causes a trust to be treated as a grantor trust under section 675(4)(C). As a result, a substitution of property of equivalent value between the grantor and the grantor trust is not treated as a sale for federal income tax purposes, and neither the grantor nor the trust recognizes gain or loss.[38] For federal gift tax purposes, the gift tax is not applicable to a transfer for full and adequate consideration.[39] Regardless, the grantor and trustee should consider reporting a substitution by making adequate disclosure of the exchange on federal income and gift tax returns.

For purposes of the accuracy-related penalty for a substantial understatement of income tax, the amount of understatement is reduced by the portion of the understatement attributable to the tax treatment of any items if the relevant facts affecting the items' tax treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of that item by the taxpayer.[40] In other words, items for which there is adequate disclosure are treated as if they were shown on the return.[41] Disclosure is adequate for an item or a position on a return if the disclosure is made on a properly completed Form 8275, "Disclosure Statement," attached to the return or a qualified amended return.[42]

For purposes of the statute of limitations, tax shall generally be assessed within three years after the return was filed, and within six years if the taxpayer omits from gross income an amount properly includable and that amount is more than 25 percent of the amount of gross income stated in the return.[43] However, in determining an amount

[37] Citing *Procter*, 142 F.2d at 824.

[38] Rev. Rul. 85-13; LTR 200001013; LTR 200434012; and LTR 200842007.

[39] Reg. section 25.2511-1(g)(1).

[40] Section 6662(d)(2)(B).

[41] Reg. section 1.6662-4(e)(1).

[42] Reg. section 1.6662-4(f)(1).

[43] Section 6501(a), (e)(1), and (e)(2); reg. section 301.6501(a)-1(a); and reg. section 301.6501(e)-1(a)(1)(i) and (b)(1).

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omitted, there shall not be taken into account any amount that is omitted from gross income and disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise of the nature and amount of that item.[44]

For non-gift completed transfers, gift tax may generally be assessed at any time if the transfer is not adequately disclosed on a gift tax return.[45] However, any completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed if the following is provided on, or attached to, the return: (1) a description of the transferred property and any consideration received by the transferor; (2) the identity of, and relationship between, the transferor and each transferee; (3) if the property is transferred in trust, the trust's taxpayer identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument; (4) a statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings published at the time of the transfer; and (5) an explanation of why the transfer is not a transfer by gift.[46]

Although the regulations do not require an appraisal for adequate disclosure of a non-gift completed transfer, the grantor may wish to include an appraisal that meets the requirements of reg. section 301.6501(c)-1(f)(3) out of an abundance of caution and in light of the valuation issues involved with a substitution.[47]

An accuracy-related penalty also applies to the portion of an underpayment attributable to any substantial income tax or gift tax valuation misstatement.[48] There is a substantial valuation misstatement if the stated value of any property claimed on an income tax return is 150 percent or more of the amount determined to be the correct amount of that valuation, and there is a substantial gift tax valuation understatement if the stated value of any property claimed on any return of tax is 65 percent or less of the amount determined to be the correct amount of that valuation.[49] However, the accuracy-related penalty does not apply to any portion of an underpayment for which it is shown that there was reasonable cause and that the taxpayer acted in good faith.[50]

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.[51] Generally, the most important factor is the extent of the taxpayer's effort to assess their proper tax liability.[52] Reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, that reliance was reasonable and the taxpayer acted in good faith.[53] However, reasonable cause and good faith ordinarily are not indicated by the mere fact that there is an appraisal of the value of the property.[54] Other factors to consider include the method and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayers or to the activity in which the property is used.[55]

C. Death of Grantor

Uncertainty exists under the tax law concerning the income tax implications of the death of the grantor of a grantor trust. There are no statutory provisions for a transaction in which grantor trust status terminates.[56] The IRS has declined to rule on the issue, and its current

[44] Section 6501(e)(1)(B)(iii) and (2); and reg. section 301.6501(e)-1(a)(1)(iv) and (b)(2).

[45] Reg. section 301.6501(c)-1(f)(1).

[46] Reg. section 301.6501(c)-1(f)(4).

[47] *Id.* ("The information required for adequate disclosure under paragraphs (f)(2)(i), (ii), (iii), and (v) of this section.") (Paragraph (f)(2)(iv) is omitted from the list of information required. That paragraph requires a detailed description of the method used to determine FMV of the property transferred, or submission of an appraisal under paragraph (f)(3) in lieu of information required under paragraph (f)(2)(iv).).

[48] Section 6662(b)(3) and (5).

[49] Section 6662(e) and (g).

[50] Section 6664(c)(1).

[51] Reg. section 1.6664-4(b)(1).

[52] *Id.*

[53] *Id.*

[54] *Id.*

[55] *Id.*

[56] *Madorin v. Commissioner*, 84 T.C. 667 (1985).

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position is to not rule on whether the assets in a grantor trust receive a section 1014 basis adjustment at the date of death of the deemed owner of the trust for income tax purposes when those assets are not includable in the gross estate of that owner.[57] Guidance on the basis of grantor trust assets at death under section 1014 is listed as item one for gifts and estates and trusts priorities for Treasury and the IRS.[58]

Further, even though testamentary transfers are generally free of income tax, the IRS may be tempted to extend the result under Example 5 of reg. section 1.1001-2(c), which addresses the lifetime renunciation of a grantor trust power to the grantor's death so that upon the trust ceasing to be a grantor trust at the grantor's death, the IRS would presumably argue that the grantor is considered to have transferred ownership of property then held by the trust to the trust, and that the deemed transfer results in recognition of gain.[59] Attorneys disagree on the anticipated implications of termination of grantor trust status on the grantor's death. Some commentators argue that the deemed transfer of property from the grantor to the trust on the death of the grantor should result in nonrecognition of gain, but no step-up in basis because that property is excluded from the grantor's gross estate.[60] Others argue that the deemed transfer should result in both nonrecognition of gain and a step-up in basis.[61]

This uncertainty can be avoided by exercise of the grantor's substitution power so that appreciated property of the trust is transferred to the grantor in exchange for their secured promissory note. At the grantor's death, appreciated property held by the grantor receives a step-up basis, and beneficiaries receive that property without recognition of gain. Although Rev. Rul. 85-13 addresses some tax implications of the transfer of trust property in exchange for a grantor's promissory note, the ruling does not address the adjusted basis of the note or the consequences of the grantor's subsequent death. Accordingly, assuming that death of the grantor results in a deemed transfer of trust property (that is, the grantor's secured promissory note) from the grantor to the trust, adequate disclosure should be made of positions taken for federal tax purposes that the deemed transfer does not result in recognition of gain, the trust takes a basis in the promissory note equal to its face value, and unrealized gain will be reported as income in respect of a decedent when received.[62]

D. Change in Tax Law

Stepped-up basis under section 1014 has recently come under increased political scrutiny. President Biden proposed treating a transfer of appreciated property at death as a recognition event so that a deceased owner of an appreciated asset would realize a capital gain at the time of the transfer equal to the excess of the asset's FMV on the decedent's date of death over the decedent's basis in that asset, subject to a $1-million-per-person exclusion from recognition.[63]

This proposal appears to have the effect of repealing section 102, which otherwise provides that gross income does not include the value of property acquired by bequest, devise, or inheritance. Reasons for change include that the distribution of wealth among Americans has grown increasingly unequal, concentrating economic resources among a steadily shrinking percentage of individuals, and inequity in the tax treatment of capital gain. When an appreciated asset is held by a decedent at death, the basis of the asset for the decedent's heirs is adjusted to the

[57] Rev. Proc. 2021-3, 2021-1 IRB 140, section 5.01(11); Rev. Proc. 2015-37, 2015-26 IRB 1196; and LTR 200434012.

[58] Treasury, "2020-2021 Priority Guidance Plan" (Nov. 17, 2020).

[59] *See*, *e.g.*, reg. section 1.684-2(e)(2), Example 2 (concerning death of grantor of foreign trust).

[60] Austin Bramwell and Stephanie Vara, "Basis of Grantor Trust Assets at Death: What Treasury Should Do," *Tax Notes*, Aug. 6, 2018, p. 793 ("That is, the IRS need only hold, consistent with Rev. Rul. 2008-41, that when section 1014(b) does not cause grantor trust property to be treated as passing from the decedent, section 1015(b) provides for carryover basis at death.").

[61] Elliott Manning and Jerome M. Hesch, "Deferred Payment Sales to Grantor Trusts, GRATS and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Est., Gifts and Tr. J.* 3 (March 31, 1999) ("Our view is that the basis of the trust assets is a purchase price basis equal to the amount of the note, but that neither the grantor-seller nor his estate recognize gain on death and that the note receives a basis step-up because the note does not represent income in respect of a decedent.").

[62] Section 453B(c) ("Except as provided in section 691 (relating to recipients of income in respect of decedents), this section shall not apply to the transmissions of installment obligations at death."); *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989) (concerning section 351) ("But here, the 'basis' in the hands of the corporation should be the face amount of the taxpayer's obligation."); *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998); and section 691.

[63] Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," at 61-64 (May 2021).

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FMV of the assets at the date of the decedent's death, and thus the amount of appreciation accruing during the decedent's life on assets that are still held by the decedent at death completely avoids federal income tax. In other words, because a person who inherits an appreciated asset receives a basis in that asset equal to the asset's FMV at the time of the decedent's death, appreciation that had accrued during the decedent's life is never subject to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement pay income tax on their realized capital gains.

A grantor may arrange his or her affairs so that taxes are as low as possible.[64] A substitution power provides the grantor flexibility to address future changes in the tax law because the grantor can transfer property from themselves to the trust via sale, and have property transferred from the trust to themselves via substitution. If current law remains in place, then the grantor should generally prefer for federal income tax purposes to have appreciated property of a trust transferred to themselves so that the property is held by the grantor at death, and thus receives a step-up in basis under section 1014. If, however, Biden's proposal becomes law, then the grantor would generally prefer for federal income tax purposes to delay recognition of gain by instead having appreciated property of a trust remain in trust and out of the grantor's gross estate so that gain on the property is not recognized at the grantor's death.

Biden also proposed treating a transfer of property into, and a distribution in kind from, a trust (other than a grantor trust that is deemed to be wholly owned and revocable by the donor) as a recognition event. Thus, this proposal appears to have the effect of repealing section 643(e), which otherwise provides a trustee the election to treat a distribution in kind to the beneficiary as if that property had been sold to the beneficiary at its FMV, and Rev. Rul. 85-13, which rules that a transfer between a grantor and grantor trust is not a sale for federal income tax purposes. If this proposal becomes law, then a grantor with a substitution power over a trust has flexibility to have property transferred to (via sale) or from (via substitution) the trust, but incentive for these transfers will be lacking because of their treatment as a recognition event.

[64] *Gregory v. Helvering*, 293 U.S. 465 (1935).

IV. Conclusion

Drafting a trust agreement to provide the grantor a power to substitute property of the trust for property of equivalent value is a simple task and enables the grantor to later cure basis discrepancy under sections 1014 and 1015. However, complex valuation and other issues ripen when the grantor exercises the power. In anticipation of potential disputes with the trustee, the trust agreement should direct the trustee on how to proceed after the grantor exercises a substitution power, as well as provide the grantor a power to remove a trustee and replace them with an independent trustee, and the substitution structure should incorporate a secured promissory note rather than an unsecured promissory note.

In anticipation of potential disputes with the IRS, substitution documents should be drafted to incorporate formulas, such as a defined value clause and a value adjustment clause, and, in light of the uncertainty under the current tax law concerning the loss of grantor trust status on the grantor's death, positions should be reported with adequate disclosure following substitution and the grantor's death. Finally, regarding changes in the tax law, a grantor with a substitution power will have greater flexibility to react and arrange his or her affairs under the applicable law. ■

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