

Traps of Swap Powers

By Martin M. Shenkman, CPA, MBA, PFS, AEP, JD

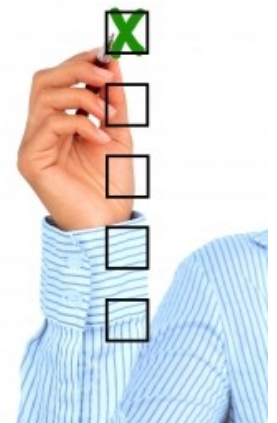
Swap powers have proliferated like Tribbles (you are a Trekkie aren't you?). Most trusts that are created are structured to be grantor trusts so that the income is taxed to the settlor creating the trust. That continues to reduce the settlor's estate by the tax paid on income inside the trust. Grantor trusts often include a swap or substitution power that permits the settlor to swap cash into the trust for appreciated trust assets. Swaps are a key to obtaining the new tax planning holy elixir of basis step up because the trust assets swapped back into the settlor's estate will, on death, have their tax basis increased to the fair value of the assets. This will eliminate any capital gains. But alas, like so many planning techniques, once the magic lingo is included in the documents most folks don't give the swap power the attention it deserves, or many simply ignore it.

Example: You set up an irrevocable grantor trust in 2012 and made a gift of \$5M of cash. If most of that cash was invested in equities (likely because the growth would be outside your estate), you're sitting on some mega appreciation. What have you done about swapping the most appreciated assets out?

Monitor: How do you see swap powers monitored and administered? Too many wealth managers generally ignoring these and not monitoring them which is a great concern.

Credit: Proactively creating lines of credit or other steps to facilitate the quick exercise of a swap power if necessary. Otherwise how will the settlor find the cash, especially if the swap has to be done quickly?

Documents: The drafting attorney should prepare in advance templates of documents to be used to effectuate a swap. The most likely time to try to exercise a swap power is just prior to



death. Illness and other challenges, or an unforeseeable accident, might all make it a time sensitive situation. Once the requisite legal documents are ready in the on-deck circle, the settlor will have a much better shot at completing the swap in time.

Reporting: Should the settlor report the exercise of a swap power on a gift tax return? Arguably no, there is no gift, but if the value of what was swapped is not equivalent and it is not reported, the statute of limitations won't run.

Appraisal: If you're swapping Apple stock in the trust for cash you can look up the stock value. There should be little risk of not assuring equivalent values. But if the trust holds 25% of the stock in the settlor's family Widget Corp. what is the real value? You should consider having an independent appraisal completed and using the value of that appraisal to corroborate that the cash swapped into the trust for the stock is really of equivalent value. Sometimes folks try to save a buck by using an old outdated appraisal, or tinkering with some numbers on their own. The consequences of a bad appraisal can be worse than just the difference from the real value to the value used. The "bad" swap might taint the entire transaction. If the cash put into the trust for the trust asset swapped out is substantially less, the IRS (and creditors) might argue that the settlor really retained control over all of the

trust assets and so all of those assets remain in the settlor's estate.

Defined Value Mechanism: If you're going to swap a hard to value asset such as real estate or a family business, consider including a defined value mechanism so that only the interests (e.g., LLC units) equivalent in value to the cash swapped in will be distributed to the settlor. This might avoid violating the equivalency requirement.

Disability: Who can exercise the settlor's swap power if he or she cannot do so? On death the swap power terminates along with the grantor trust status of the trust. But what occurs if the settlor becomes incapacitated? The stats are that about 50% of those 85 and older have some degree of cognitive impairment. Who will exercise the swap power? Don't jump to conclusions that the agent under the settlor's power of attorney can do it. Perhaps, but it is the terms of the trust that control. What does it say? If the trust says that the agent under a power of attorney can exercise the power if the settlor cannot do so, see the next planning tip below. If the trust document designates a successor, does that person know they are so designated? Will the effectiveness of the swap power be adversely impacted by a designated third party exercising it on the settlor's behalf?

Power of Attorney: While the general powers given to an agent under the settlor's power might suffice to exercise a swap, will they? What if the agent needs to borrow \$5M to swap for \$5M of appreciated trust assets? Consider updating the power 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.

Person Exercising Should be Non-Fiduciary: Some trusts name the same person in several capacities: the trust protector might also be a successor holding the swap power, etc.

Voting Stock: Watch out for IRC Sec. 2036(b). If the settlor can swap cash for voting stock held in the trust, will that trigger estate inclusion? While there are different views among the tax gurus, some do believe that this is an estate planning "no-no." Some trusts are intentionally prepared forbidding a swap for voting stock. If that is the case how will it affect assets in the trust? What can be swapped? Are their options?

All this and more will be discussed on my educational teleconference with The Ultimate Estate Planner entitled, "The New Paradigm: Planning an Estate for Best Income Tax Results". For more information and to register, [click here](#).

Also, If you would like to receive bi-monthly electronic (or if

you prefer, paper) newsletter that provides practical and creative ideas to address estate, tax, business, personal, financial, and asset protection planning, please sign up at www.shenkmanlaw.com.

ABOUT THE AUTHOR:

Martin "Marty" Shenkman, CPA, MBA, PFS, AEP, JD is an



estate planning attorney and Certified Public Accountant from Paramus, New Jersey. He received his Bachelor of Science degree from Wharton School, University of Pennsylvania 1977 with a concentration in accounting and economics. He received a Masters degree in Business

Administration from the University of Michigan 1981, with a concentration in tax and finance.

Mr. Shenkman is a widely quoted expert on tax matters and is a regular source for numerous financial and business publications, including The Wall Street Journal, Fortune, Money, The New York Times, and others. He has appeared as a tax expert on numerous television and cable television shows including The Today Show, CNN, NBC Evening News, CNBC, MSNBC, CNN-FN and others. He is a frequent guest on radio talk shows throughout the country and has a regular weekly radio show on Money Matters Financial Network.

Mr. Shenkman is a prolific author, having published thirty-four books and more than seven hundred articles. Mr. Shenkman has served as contributing editor to a host of publications, including: New Jersey Lawyer, The Journal of Real Estate Finance, Real Estate Insight, Commercial Leasing Law & Strategy, The Journal of Accountancy, Real Estate Accounting and Taxation, Shopping Centers Today, and others.

Mr Shenkman is active in numerous charitable organizations, sitting on many boards and planned giving committees and lectures regularly for these and other organizations.

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