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TOPIC: New Case Study Series: The Power of Substitution Powers in Grantor Trusts – Flexibility in Transfer & Income Tax Planning.

MARKET TREND: Using substitution powers in irrevocable trust planning has taken on renewed importance as a way to provide flexibility in investment and basis step-up planning for trusts.

SYNOPSIS: A non-fiduciary substitution power allows a grantor to re-acquire irrevocable trust assets by substituting other assets of equivalent value. While this power results in grantor trust treatment for federal income tax purposes, it will <u>not</u> cause inclusion of the trust assets in the grantor's estate. Inclusion of a substitution power in a trust allows flexibility (1) to manage the investment performance of assets in accordance with fiduciary responsibilities, which is particularly crucial in estate "freezes" that transfer asset appreciation, and (2) to allow the grantor to achieve a basis step-up for low basis trust assets.

TAKE AWAYS: Grantor trusts with substitution powers can (1) address estate and income tax planning issues, (2) facilitate basis step-up planning, and (3) maximize flexibility. The substitution power can be exercised to replace underperforming trust assets or to solidify high-investment performance. Using that same power to achieve a basis-step up for trust assets also can limit capital gains for the grantor's heirs. Proper valuation of the assets exchanged and compliance with IRS requirements, however, is critical for success.

Given the changing tax and economic environment, clients may be leery of planning with "irrevocable" trusts without some assurance that they can later adapt their plans. This case study demonstrates how substitution powers can minimize those concerns.

FUNDAMENTALS: WHAT IS A POWER OF SUBSTITUTION?

A non-fiduciary power of substitution provides the grantor of an irrevocable trust[1] with the ability to re-acquire the trust assets by substituting other assets of equivalent value ("**substitution power**"). This power causes the trust to be treated as a grantor trust for federal income tax purposes, which means the grantor is treated as the owner of, and subject to income tax on all income from, the trust assets.[2] The power, however, will not cause inclusion of the trust assets in the grantor's estate at death, including any life insurance policy owned by the trust (assuming compliance with Rev. Rul. 2008-22 and Rev. Rul. 2011-28, discussed below).

IMPORTANCE: WHY HAVE A SUBSTITUTION POWER?

Create a Grantor Trust. In the current environment, successful trust planning will: (1) address estate tax planning, (2) facilitate basis step-up planning, and (3) maximize flexibility. Grantor trusts can meet all these needs:

- The grantor pays the trust income tax liability without making an additional gift to the trust.
- The grantor's payment of the trust's income taxes reduces the value of the grantor's estate and allows the trust assets to grow without income or estate taxes, according to longstanding and appropriate tax principles.
- The basis of the trust assets can be managed exercising the grantor's substitution power, allowing the grantor to reacquire low basis assets for inclusion in his or her estate and substitute high basis assets in the trust.[3]

SUBSTITUTION POWER IN ACTION: GRAT CASE STUDY

GRAT Overview. With a GRAT, the grantor transfers assets to an irrevocable trust, reserving the right to receive, for a specified period, fixed annual annuity payments as determined using a federally-set, monthly adjusted interest rate under IRC §7520 ("**7520 rate**").[4] At the end of the annuity term, any remaining GRAT assets pass to the grantor's designated remainder beneficiaries (*e.g.*, the grantor's children).[5] If the grantor survives the GRAT term, and the GRAT assets appreciate more than the applicable 7520 rate, that appreciation passes to the GRAT remainder beneficiaries without gift or estate tax, according to longstanding and appropriate tax principles.

Since a GRAT only transfers asset appreciation above the 7520 rate, it depends heavily on the investment performance of the trust assets for success. Initial low performance or significant fluctuations in annual performance can undermine the GRAT's objectives. But if a GRAT provides the grantor with a substitution power, the grantor can exercise this power to either aid an underperforming GRAT or solidify a successful GRAT by substituting in less volatile investment assets.

<u>Client Background – Meet Jack</u>. Jack is a former executive of Z Co., a large public company. He has a concentrated position in Z Co. stock with a very low basis. Jack spent most of his career at Z Co. and believes strongly in the company. He is generally bullish regarding Z Co.'s stock performance and intends to hold some portion of it for the remainder of his life.

<u>Jack's GRAT</u>. Jack created a 3-year, zeroed-out GRAT and funded it with 30,000 shares in Z Co., retaining the right to an annuity that increased by 20% each year. The applicable 7520 rate was 1%. Jack named his three children as the GRAT remainder beneficiaries and, since he had already implemented other long-term, dynastic trust planning, he decided to provide for outright distributions of the GRAT remainder to the children to provide them with some independent wealth. The GRAT provided Jack with a substitution power.

Jack's tax basis in the shares was $30 per share. At GRAT funding, the share price was $66 ($1.98 million total). In Year 1 of the GRAT, however, the Z Co. shares substantially jumped in value to $85/share (almost 29%, for a total gain of $570,000).

<u>Jack's Concerns</u>. Although Jack expected strong growth, he had not anticipated it this quickly. While Jack wanted the GRAT to keep its gains, he was concerned that more assets would pass to his beneficiaries than he initially intended if the stock kept growing at that rate. Given the low basis of the GRAT's Z Co. shares and its current value, Jack also was concerned about excessive capital gains tax exposure.

<u>Solution - Exercising Jack's Substitution Power</u>. Jack decided to exercise his substitution power shortly after Year 1 and replace the GRAT's Z Co. stock with a bond portfolio of equivalent value that had a fairly stable 3% annual return. Exercising the substitution power addressed **<u>both</u>** of Jack's concerns: (1) it solidified the gain achieved in Year 1 of the GRAT, ensuring that his children would receive this benefit without

providing them with "too much," and (2) it brought the Z Co. stock back into Jack's estate, making it eligible for a basis step-up at his passing.

Post-Exercise Outcome. After Jack exercised his substitution power, the price for Z Co. fell and stayed at $68/share for Years 2 and 3 of the GRAT. Compare the outcomes if Jack had left the Z Co. shares in the GRAT instead of exercising the substitution power.

End of GRAT Term – Year 3	Substitution	No Substitution
GRAT Remainder to Beneficiaries	**$629,298**	**$128,947**

Jack later passed away holding the 30,000 shares of Z Co. stock when it had returned to $85 per share. Those shares were eligible for a basis step-upfrom $30 to $85, addressing Jack's federal capital gains and net investment income ("NII") tax concerns. And since the zeroed-out GRAT did not use any of Jack's available unified gift and estate tax exemption, it left more exemption available at his passing for use by his estate.

Planning Complement - Life Insurance. Since estate freezes like GRATs are closely linked to a client's life expectancy for success, life insurance can serve as protection if an unexpected death occurs. In this case, as part of his dynastic trust planning, Jack created an ILIT that acquired life insurance on his life, the proceeds of which would have been available to help offset the estate tax liability if Jack had died during the GRAT term.

But Proceed with Caution. Substitution transactions with GRATs have received attention from the IRS, which is carefully reviewing whether (1) the exchanged assets have equivalent values, (2) the assets were properly valued, and (3) all formalities were followed. Ensuring proper valuation of the assets by a qualified appraisal and compliance with the requirements noted below are crucial.[6]

WHAT'S NEEDED: SUBSTITUION POWER REQUIREMENTS

To achieve the intended results of exercising a substitution power, the trust agreement or its governing law should impose the following requirements, pursuant to Rev. Rul. 2008-22 and Rev. Rul. 2011-22:

- The trustee must have a fiduciary obligation to ensure that the substituted assets and the trust assets are, in fact, of equivalent value; and

- The substitution power cannot be exercised in a manner that shifts benefits among the trust beneficiaries. This requirement is met if:

- o The trustee has both the power to reinvest the trust principal and a duty of impartiality with respect to the trust beneficiaries; or
- o The nature of the trust's investments or the level of income produced by any of the trust's investments does not impact the respective interests of the beneficiaries (*e.g.*, the trust is administered as a unitrust or distributions from the trust are limited to discretionary distributions of principal and income).

TAKE-AWAYS

- Grantor trusts with substitution powers can (1) address estate and income tax concerns, (2) facilitate basis step-up planning, and (3) maximize flexibility.
- The substitution power can be exercised to replace underperforming trust assets or to solidify high investment performance. Using that same power to achieve a basis-step up for trust assets also can limit capital gains for the grantor's heirs.
- Proper valuation of the assets exchanged and compliance with IRS requirements, however, is critical for success.

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[1] Or other person designated in or appointed pursuant to the terms of the trust agreement.
[2] See IRC §675(4)(C).
[3] Other grantor trust aspects include: (1) the grantor can engage in sales or exchanges with his or her grantor trust without triggering income or gain recognition (although the assets sold likely will take a carry-over basis, subject to potential future IRS guidance in this ares (see discussion in *WRMarketplace* #15-45), (2) a transfer of a life insurance policy from a wholly-owned grantor irrevocable life insurance trust ("**ILIT**") to the grantor or to another wholly-owned grantor ILIT created by the same grantor will avoid application of the "transfer for value" rules, which can be important when adjustments are needed in future policy coverage or trust planning and the insured is no longer insurable, and (3) the trust can be drafted to provide flexibility to later terminate grantor trust status, if needed, to remove the income tax burden on the grantor.
[4] Generally, the IRC §7520 rate set for the month of the GRAT's creation.
[5] Generally, to transfer wealth to the trust's remainder beneficiaries, the assets must appreciate more than the IRC §7520 rate set for the month of the GRAT's creation. The grantor also must survive the GRAT term to avoid inclusion of some or all of the GRAT assets in his or her taxable estate.
[6] Clients could consider (1) using a defined value clause when exercising a substitution power (see *WRMarketplace #12-34* for a discussion of defined value clauses) and/or (2) adequately disclosing the exercise of the power as a non-gift transaction on a gift tax return to trigger the statute of limitations for the transaction (see *WRMarketplace #15-46* for a discussion of adequate disclosure requirements for federal gift tax returns). See Steve R. Akers, "Estate and Transfer Planning Under the "New Normal'," October 29, 2015, Bessemer Trust, p. 3.