COLORADO COURT OF APPEALS

DATE FILED: July 9, 2015
CASE NUMBER: 2014CA969

Court of Appeals No. 14CA0969
La Plata County District Court No. 11PR147
Honorable William L. Herringer, Judge

In re the Matter of The Mark Vance Condiotti Irrevocable GST Trust

Mark Vance Condiotti, Settlor,

Appellant,

v.

Patricia G. Condiotti, Co-Trustee; and MidFirst Bank, Co-Trustee,

Appellees.

ORDER AFFIRMED

Division II
Opinion by JUDGE BERNARD
Loeb, C.J., and J. Jones, J., concur

NOT PUBLISHED PURSUANT TO C.A.R. 35(f)
Announced July 9, 2015

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Do trustees of a type of trust called an "intentionally defective grantor trust" have the authority to decide whether the settlor's attempt to exchange a promissory note for the corpus of the trust was (1) a substitution of property of equivalent value for the corpus; or (2) a request for a loan? The answer to this question is pivotal to the outcome of this appeal because,

- if the trustees do not have such authority, the settlor is entitled to substitute the promissory note for the corpus; but
- if the trustees have such authority, they can prevent the settlor from substituting the promissory note for the corpus.

We answer the question "yes" because we conclude that the trust instrument gave the trustees this power. As a result of this conclusion, we affirm the probate court's order that instructed the trustees that they could "properly reject" the settlor's proposed transaction.

I. Background

The settlor, appellant Mark Vance Condiotti, established an irrevocable trust for his minor son in 2000. He appointed his wife, appellee Patricia G. Condiotti, as trustee of the trust. Appellee MidFirst Bank was later appointed as another trustee.

A. Intentionally Defective Grantor Trusts

An intentionally defective grantor trust is "a hybrid creature" that is designed to avoid estate tax on the trust's corpus. Martha L. Westbrook, *Can You Disinherit the IRS?*, 49 Res Gestae 28, 28 (2005). For the purposes of estate tax, the trust is a "separate entity, excluded from the grantor's estate." *Id.*

But the grantor must pay income, gift, and capital gains taxes on the trust's corpus. *Id.*; Kathryn G. Henkel & Judith K. Tobey, *Estate Planning & Wealth Preservation* ¶ 6.06 (Thomson Reuters/WG&L 2015). To achieve its tax objectives, the trust must be irrevocable, and the grantor cannot be a trustee. Westbrook, *Can You Disinherit the IRS?*, at 28.

Normal trust rules exempt a grantor from paying income, gift, and capital gains taxes on a trust's corpus. Henkel & Tobey, *Estate Planning & Wealth Preservation*, at ¶ 6.06. But the trust becomes "intentionally defective" if the burden to pay those taxes on the corpus is on the grantor, not the trust's beneficiary. *Id.* By paying those taxes, the grantor can make "an additional gift" to the beneficiary. Robert E. Madden, *Tax Planning for Highly*

Compensated Individuals ¶ 3.04[7] (Thomson Reuters/WG&L 4th ed. 2015).

Why do this? Such trusts provide "a good opportunity for the grantor to . . . increase the value of property transferred to the trust with no additional gift tax." *Id.* In other words, such trusts "attempt[] to take advantage of the discrepancy between the federal income and estate and gift tax regimes" by allowing the beneficiaries "to receive the transferred asset and its subsequent appreciation free of gift, income and capital gains taxes which are paid by the grantor." Frederick M. Sembler & Michael J. Feinfeld, *Planning an Estate: A Guidebook of Principles and Techniques* § 8.44 (Thomson Reuters 4th ed. 2014).

How does a grantor do this? One way is to give the grantor the "power (exercisable in a nonfiduciary capacity) to reacquire trust assets by substituting assets of equivalent value." Madden, *Tax Planning for Highly Compensated Individuals*, at ¶ 6.06[3][a]. "The power of the grantor . . . to reacquire trust assets by substituting other property of equivalent value is the most commonly included power in a trust instrument to create an intentionally defective grantor trust." 1041 Deskbook Key Issues, Key Issue 26H:

Intentionally Defective Grantor Trusts (Thomson Reuters 19th ed. 2014); *see also* 26 U.S.C. § 675(4)(C) (2012)(“The grantor shall be treated as the owner of any portion of a trust in respect of which” he or she retains an administrative power “to reacquire the trust corpus by substituting other property of equivalent value.”).

A second way is “to include the power to lend [all or part of the corpus] to the grantor without adequate interest or security.” David K. Johns, Julia Griffith McVey & Constance B. Wood, *Colorado Estate Planning Handbook* § 16.4.5 (6th ed. 2010); *see also* 26 U.S.C. § 675(3) (“The grantor shall be treated as the owner of any portion of a trust in respect of which” he or she “has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest.”).

B. The Trust Instrument

The trust instrument in this case contained a provision that gave the settlor the power to substitute property for the corpus. The provision giving the settlor the substitution power, 21.22.2, stated:

> 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.

As indicated above, giving the settlor the substitution power was one way to create an intentionally defective grantor trust in order to reap its various tax advantages. *See* 1041 Deskbook Key Issues, Key Issue 26H: *Intentionally Defective Grantor Trusts*; *see also* 26 U.S.C. § 675(4)(C).

But the trust instrument also contained a provision that expressly eliminated another kind of power associated with intentionally defective grantor trusts: the settlor's power to take the trust's corpus as a loan. The provision denying the settlor the loan power, 21.21, stated:

> 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 of the trust estate, directly or indirectly, without adequate interest or security.

There are five other provisions in the trust instrument that are directly relevant to our analysis.

The first two described the settlor's reasons for creating the trust. Provision 16.2.1 stated that the settlor's "primary purpose" was to provide the beneficiary with "long-term financial security." Provision 16.2.2 stated that the settlor's "secondary purpose" was "to minimize the impact on the trust estate of the federal estate and generation-skipping transfer taxes."

The other three described the trustees' powers. Provision 21.1 stated that the trustees "may perform every act reasonably necessary to administer any trust under this instrument." Provision 21.2 stated that the trustees "may exercise all the powers in the Colorado Fiduciaries' Powers Act [§§ 15-1-101 to -1401, C.R.S. 2014]." And provision 21.3 stated that, "[u]nless otherwise provided in this instrument," the trustees shall, "in all matters pertaining to trust administration . . . exercise any discretionary powers in a manner which will achieve optimum tax results, taking into account all relevant circumstances."

C. The Facts

In October 2011, settlor sent a notification to the trustees. It stated that he had decided to exercise the substitution power. He would do so by substituting a promissory note for the full value of the trust's corpus, or about $9,500,000.

The trustees replied that the settlor could not do what he had proposed. First, they contended that the settlor was not actually invoking the substitution power; he was, instead, attempting to invoke the loan power that the trust instrument expressly denied him. Second, focusing on the language in the provision creating the substitution power, they asserted that the property that the settlor proposed to substitute — the promissory note — was not of "equivalent value" to the trust's corpus.

Settlor threatened to sue the trustees. They responded by filing a petition with the probate court that requested the court's instructions. *See* § 15-16-201(1)(c), C.R.S. 2014 ("The [probate] court has exclusive jurisdiction of proceedings initiated by interested parties concerning . . . questions of construction of trust instruments [and] instruct[ions] [to] trustees . . . ."); *In re Estate of Scott*, 77 P.3d 906, 910 (Colo. App. 2003)("[P]robate courts have the authority to administer the internal affairs of trusts[,] . . . the administration and distribution of trusts, the declarations of rights, . . . the determination of other matters involving trustees and beneficiaries of trusts . . . [and] instructing trustees . . . ."), *aff'd*, 136 P.3d 892 (Colo. 2006).

In a written order, the probate court agreed with both of the trustees' contentions. It instructed the trustees that they could "properly reject" the promissory note because it was "not of equivalent value to the corpus of the trust and pursuant to their discretionary authority to make loans."

As we explain in detail below, we affirm the probate court's order because we conclude that the settlor's proposed transaction was an attempt to exercise the loan power, not the substitution power, so the trustees could properly reject it. We therefore do not address the order's alternative holding that, even if the proposed transaction were an exercise of the substitution power, the promissory note was not of "equivalent value" to the trust's corpus. *See Blood v. Qwest Servs. Corp.*, 224 P.3d 301, 329 (Colo. App. 2009)(The court of appeals "can affirm on any ground supported by the record.").

II. The Trustees Had the Authority to Determine Whether the Proposed Transaction Was a Request for a Loan

The settlor contends that the proposed transaction invoked the substitution power, not the loan power, and that the trust instrument did not give the trustees the authority to reject his proposed transaction for that reason. We disagree.

A. Standard of Review

The proper construction of a trust document presents a question of law that we review de novo. *Denver Found. v. Wells Fargo Bank, N.A.*, 163 P.3d 1116, 1122 (Colo. 2007); *Meier v. Denver U.S. Nat'l Bank*, 164 Colo. 25, 29, 431 P.2d 1019, 1021 (1967).

B. Legal Principles

Our primary goal in construing a trust instrument is to give effect to the grantor's intent in establishing the trust. *See Denver Found.*, 163 P.3d at 1122. To ascertain this intent, we look to (1) the language used in the trust instrument; and (2) "the relevant circumstances in effect at the time the parties entered into the trust agreement." *Van Gundy v. Van Gundy*, 2012 COA 194, ¶ 21. And "we construe the [t]rust instruments in their entirety to harmonize and give effect to all the provisions, rendering none meaningless or superfluous." *Denver Found.*, 163 P.3d at 1122.

C. Analysis

We conclude, for the following reasons, that (1) the trustees had the authority to determine whether the proposed transaction was an exercise of the substitution power or the loan power; (2) the record supports the probate court's finding that the proposed transaction was an attempt to exercise the loan power; and (3) the probate court properly instructed the trustees that they could reject the proposed transaction.

1. Analysis of the Trust Instrument

As an initial matter, we reject the settlor's argument that it was his intent when he proposed the transaction in 2011 that controls our analysis. That is not the case; we must, instead, determine his intent when he created the trust in 2000. And we do that by looking at the language of the trust instrument and the "relevant circumstances in effect" at *that* time. *See Van Gundy*, ¶ 21.

So we look at the language of the trust instrument, focusing on the wording of the provisions that give the settlor the substitution power, deny him the loan power, describe the trust's purposes, and set forth the trustees' fiduciary duties. *See id.* We conclude that, when we read these provisions together, *see Denver Found.*, 163 P.3d at 1122, it was the settlor's intent that (1) he could exercise the substitution power without the trustees' consent;

he was not required to act as a fiduciary when he did so; but he had to replace the corpus with property of "equivalent value"; (2) he *could not* exercise the loan power; (3) minimizing the effect of estate taxes on the trust's corpus was one of the trust's fundamental purposes; and (4) the trustees had important fiduciary duties, which included the direction that they act to "achieve optimum tax results."

Turning to the statutory fiduciary powers given to trustees, they included the power "[t]o . . . preserve the assets of the . . . trust," § 15-1-804(2)(a), C.R.S. 2014; the power "[t]o retain the initial assets of the . . . trust without liability for loss, depreciation, or diminution in value resulting from such retention until, in the judgment of the fiduciary, disposition of such assets should be made[,]" § 15-1-804(2)(b); and, in the exercise of these powers, the trustees had the "duty to act reasonably and equitably with due regard" for their "obligations and responsibilities toward the interests" of the beneficiary, the trust, and the trust's purposes, and "with due regard for the manner in which men of prudence, discretion, and intelligence would act in the management of the property of another[,]" § 15-1-804(1).

Applying the settlor's clear intent, as expressed by provisions 21.1, 21.2, and 21.3, and sections 15-1-804(1), (2)(a) and (b), we conclude that the trustees had a fiduciary duty to determine whether the settlor's proposed transaction was an exercise of the substitution power or of the loan power. We reach this conclusion for the following reasons.

First, in a context like this one, in which the substitution power existed for the sole benefit of the settlor, "the primary duty of the trustee . . . [was] to ascertain whether an attempted exercise is within the terms of the power and to refuse to comply if it [was] not." Restatement (Third) of Trusts § 75 cmt. d (2007).

Second, because one of the fundamental purposes of the trust was to avoid estate taxes and one of the duties of the trustees was to achieve optimum tax results, the trustees had an obligation to determine whether the settlor's proposed transaction would have adverse tax consequences. For example, in the analogous context of a grantor's exercise of the substitution power, the

> grantor's retained power . . . to substitut[e] property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate . . . *provided the trustee has a fiduciary obligation*

> (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value.

Rev. Rul. 08-22, 2008-16 I.R.B. 796 (emphasis added).

In other words, if a trust instrument or state law does *not* impose upon a trustee the fiduciary duty to ensure that the property a grantor wants to substitute is of equivalent value to a trust's corpus, then there will be adverse tax consequences. The value of the corpus will be subject to estate tax. *See id.* So it is clear to us that the provisions in the trust instrument in this case gave the trustees the power to ensure that any proposed transaction fulfilled the trust's tax-related purposes.

Third, if the trustees decided that the proposed transaction invoked the loan power and not the substitution power, they had a fiduciary duty to prevent it. *See* Restatement (Third) of Trusts § 75, cmt. d. Again referring to the analogous context of the exercise of the substitution power,

> [i]f the trustee knows or has reason to believe that the exercise of the substitution power does not satisfy the terms of the trust instrument because the assets being substituted have a lesser value than the trust

> assets being replaced, the trustee has a fiduciary duty to prevent the exercise of the power.

Rev. Rul. 2008-22-16 I.R.B. 796.

III. The Record Supports the Probate Court's Finding That the Proposed Transaction Was a Request for a Loan

The settlor contends that the probate court erred when it found that his proposed transaction was a request for a loan. We disagree.

The determination of whether a transaction is a loan is a question of fact. *See Hayes v. Hayes*, No. W2010-02015-COA-R3-CV, 2012 WL 4936282 at *7 (Tenn. Ct. App. Oct. 18, 2012); *see also Minchem Int'l, Inc. v. Comm'r of Internal Rev.*, 109 T.C.M. (CCH) 1273 at * 9 (Mar. 24, 2015)("Deciding whether a particular transaction constitutes a loan, however, is a question of fact to be determined upon consideration of all the pertinent facts in the case."). We therefore defer to the probate court's factual determination if it is supported by the record. *See Love v. Olson*, 645 P.2d 861, 862-63 (Colo. App. 1982).

A court may consider the following questions when determining whether a particular transaction constitutes a loan.

1. Do the parties “stand in the relationship of debtor and creditor?”
2. Was a promissory note executed?
3. Was interest “agreed to or paid?”
4. Did the parties agree that the recipient would repay the money received?

Id. at 863.

The record contains evidence that (1) the settlor would have become the trust’s debtor, and the trust would have become the settlor’s creditor; (2) the settlor offered a promissory note in exchange for the entire trust corpus; (3) the trust corpus was valued at about $9,500,000; (4) the promissory note bore an interest rate of 1.27%; and (5) the promissory note stated that the settlor would repay the amount received in exchange for the promissory note. So we conclude, based on the answers to the four questions from *Love*, that the evidence in the record supports the probate court’s finding that the proposed transaction constituted a request for a loan. *See id.*

Next, this case is similar to one that the Internal Revenue Service considered in Rev. Rul. 85-13, 1985-7 I.R.B. 28. This ruling held that a 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." *Id.* (emphasis added); *see also Rothstein v. United States*, 735 F.2d 704, 708 (2d Cir. 1984)(an exchange of an unsecured promissory note bearing annual interest for the trust's corpus was a "borrowing" or a "loan" for the purposes of 26 U.S.C. § 675(3)).

Last, the probate court found that settlor "essentially conceded [that] in any other context the transaction would qualify as a loan." The record supports this finding.

We therefore conclude that the record supports the probate court's finding that the settlor's proposed transaction was a loan.

IV. Conclusion

We have concluded above that (1) the trustees had the authority to scrutinize the settlor's proposed transaction and to reject it because it was a request for a loan; and (2) the record support's the probate court's finding that the proposed transaction was a request for a loan. As a result of these conclusions, we last conclude that the probate court's instructions were proper.

The probate court's order is affirmed.

CHIEF JUDGE LOEB and JUDGE J. JONES concur.

Court of Appeals

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CHRIS RYAN
CLERK OF THE COURT

PAULINE BROCK
CHIEF DEPUTY CLERK

NOTICE CONCERNING ISSUANCE OF THE MANDATE

Pursuant to C.A.R. 41(b), the mandate of the Court of Appeals may issue forty-three days after entry of the judgment. In worker's compensation and unemployment insurance cases, the mandate of the Court of Appeals may issue thirty-one days after entry of the judgment. Pursuant to C.A.R. 3.4(l), the mandate of the Court of Appeals may issue twenty-nine days after the entry of the judgment in appeals from proceedings in dependency or neglect.

Filing of a Petition for Rehearing, within the time permitted by C.A.R. 40, will stay the mandate until the court has ruled on the petition. Filing a Petition for Writ of Certiorari with the Supreme Court, within the time permitted by C.A.R. 52(b) will also stay the mandate until the Supreme Court has ruled on the Petition.

BY THE COURT: Alan M. Loeb
Chief Judge

DATED: October 23, 2014

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