

<b>DISTRICT COURT, LA PLATA COUNTY, COLORADO</b>  Court address: 1060 East 2 <sup>nd</sup> Avenue, Durango, Colorado 81301  Phone Number : (970) 247-2304	DATE FILED: April 2, 2014 10:45 AM CASE NUMBER: 2011PR147
<b>In the Matter of the Trust Created By:</b>  <b>MARK VANCE CONDIOTTI</b> <b>(The Mark Vance Condiotti Irrevocable GST</b> <b>Trust)</b> <b>Settlor</b>	<input type="checkbox"/> COURT USE ONLY <input type="checkbox"/>  Case Number 11PR147 Division: 2
<b>ORDER ON PETITION FOR INSTRUCTIONS</b>	

The Petition for Instructions filed by the Trustee presents, as far as the Court can tell, a case of first impression both within Colorado and nationally. The issue the Court must resolve is: when a settlor decides to exercise his reserved power under the substitution clause of an Intentionally Defective Grantor Trust (IDGT), can a promissory note qualify as property of “equivalent value” for a trust corpus that consists of cash and securities? 26 U.S.C. §675(4)(C).

The parties offer competing views of what body of law and what valuation techniques should be applied in resolving this issue. The Settlor takes the position that, as the swap provision of the Mark Vance Condiotti Irrevocable GST Trust (“MVC Trust”) was included in the trust to effectuate the Settlor’s tax objectives, the determination of “equivalent value” should be made using the provisions of the Internal Revenue Code, more specifically 26 U.S.C. § 7872 (Treatment of loans with below-market interest rates) which would allow for the Settlor to exercise the swap power using a promissory note as long as

the note paid the Applicable Federal Rate (AFR) (26 U.S.C. § 1274(d)(1)(A)) at the time the promissory note was substituted. From a common sense perspective, and as suggested in at least two I.R.S. Private Letter Rulings, this assumes that the Settlor is solvent and there is no reason to believe that the note will not be paid according to its terms. See, I.R.S. Private Letter Rulings 9535026 and 9408018. The Settlor asserts that, as the note offered in this case meets all of the requirements under the Internal Revenue Code, it should be determined to be property of “equivalent value” and the Trustee should be required to accept the note under the substitution clause of the MVC Trust.

The Trustees urge the Court to use a fair market value approach, valuing the property proffered to be substituted based upon what a willing buyer would pay a willing seller. Given the limited market for promissory notes, the comparatively low interest rate of the note offered by the Settlor, and the fact that the note is unsecured, the Trustees argue that the promissory note that the Settlor intends to use as substituted property is not of equivalent value and is in fact fairly valued at about half the value of the trust corpus.

Secondarily, the Trustees argue that the promissory note cannot be considered to be “property” but it is in fact a loan, and as a loan the Trustees have proper authority to reject the Settlor’s request to borrow the corpus of the MVC Trust. The Settlor responds to this argument by asserting that, as Mr. Condiotti has retained an ownership interest in the corpus of the trust, that at a minimum is sufficient for the income earned by the trust to be attributed to him for income tax purposes, the substitution cannot fairly be characterized as a loan, and instead should be viewed as him exercising a right he retained when he created the MVC Trust.

The Court finds that, in order for substituted property to be considered to be of equivalent value, the property must both meet the requirements of the Internal Revenue Code and have an equivalent fair market value. As the promissory note offered by the Settlor does not meet both of these requirements, the Court instructs the Trustees not to accept the Settlor's promissory note as property of equivalent value.

### **Burden of Proof Regarding Valuation of the Promissory Note**

The Court agrees with the Trustees that there should be a presumption that the Trustees have acted in good faith when Settlor or another party questions the actions of the trustees. See, *Jarvis v. Boatmen's National Bank of St. Louis*, 478 S.W.2d 266 (Mo.1972); *First National Bank of Kansas City v. Hyde*, 363 S.W.2d 647 (Mo.1962); *In re Rolf H. Brennemann Testamentary Trust*, 21 Neb. App. 353, 367, 838 N.W.2d 336, 346 (2013), review sustained (Dec. 31, 2013). While most of the case law that addresses the issue of the burden of proof involves fact patterns where a beneficiary is questioning the actions of the trustee, the Court sees no reason why the same rationale would not apply to a settlor of a trust questioning the actions of a trustee in regards to a power reserved by the settlor. The Court will presume that the Trustees have acted in good faith and require that, for the Settlor to prevail, he must show by a preponderance of the evidence that the Trustees' failure to accept the promissory note in substitution for the trust corpus is improper.

### **Analysis of Promissory Note Regarding Value of Promissory Note**

There is no material dispute that under the Internal Revenue Code the promissory note would be valued at its face value as long as it pays the AFR and the Settlor is solvent, while under a fair market analysis it would have a considerably lesser value, even with the pledge agreement. The Settlor argues that, as the swap provision was included in the trust instrument to advance the Settlor's tax objectives, the Internal Revenue Code should control. The Court believes that to be an insufficiently nuanced view of the purpose of the swap provision and the underlying purpose of the trust. The Court notes that the primary purpose of the swap provision is to provide a tax benefit *to the beneficiary* of the trust, because it requires the settlor to continue to be responsible for taxes on the income on the trust as if he were the owner of the trust corpus, even though the trust corpus is not treated as part of the settlor's property for estate tax purposes. This allows the corpus of the trust to increase in value tax free, at least as to the beneficiary. Additionally, there is no evidence that the swap provision was included for the actual purpose of allowing the Settlor to regain control over the corpus of the trust or that, at the time the trust was created, the Settlor intended to exercise his power of substitution in a manner that would diminish the fair market value of the trust corpus. The Court believes that the swap provision should be interpreted in a manner consistent with the dual purposes of providing a tax benefit to the beneficiary and increasing the value of the trust corpus for the beneficiary.

The promissory note satisfies the general tax objectives of the Settlor as the trust will still qualify for IDGT status and the Settlor will still be treated as the owner of the corpus of the trust for federal income tax purposes. However, the corpus of the trust will

go from consisting of diversified, fairly liquid assets to a single instrument that has an extremely limited market. The Settlor contends that there is no harm to the beneficiary as the interest that is to be paid under the note is sufficient to cover the present needs of the beneficiary and ultimately, when the promissory note becomes payable, the corpus of the trust will be restored. He also asserts that the promissory note has advantages as a guaranteed fixed income asset and could be viewed as preferable to the assets of the trust being invested in securities, which are more risky and more volatile. The Court is not persuaded by this argument. The promissory note deprives the trust of both flexibility and opportunity for a significant time period. The promissory note would certainly not comply with the prudent investor rule and, given the age of the beneficiary, holding the entire assets of the trust in a mid-term low-interest investment is contrary to standard investment objectives.

The duties of the trustees to the settlor and the beneficiary are at a minimum of equal priority and arguably the duty of the trustee to comply with powers reserved by a settlor should be strictly construed against the settlor. While there is no case law establishing a requirement that a settlor's reserved power of substitution should be strictly construed, a narrow construction of reserved powers is consistent with how courts have construed reserved power of revocation, holding that, if a trust is revocable by the settlor, the mechanism for revocation must be strictly complied with and that, if it is not, the courts will not find revocation regardless of the clear intent of the settlor. If a trust agreement provides a specific method for revocation, that method must be strictly adhered to in order to revoke the trust. *Denver National Bank v. Von Brecht*, 137 Colo. 88, 95, 322 P.2d 667, 670-

71 (1958); Restatement (First) of Trusts § 330(1) cmt. j (1935). *In re Estate of McCreath*, 240 P.3d 413, 418 (Colo. Ct. App. 2009). Such an interpretation is not only consistent with the idea that a trustee should be presumed to have acted in good faith, but also comports with the general concept that, once the trust is established, the settlor is a stranger to the trust and, outside of explicitly reserved powers, is “of historical interest only.” 3A Colo. Prac., Methods Of Practice § 106:4 (5th ed.).

The Court finds that the Settlor has failed to overcome, by a preponderance of the evidence, the presumption that the Trustees have acted in good faith in refusing to accept the promissory note in substitution for the trust corpus. The Court instructs the Trustees that any property the Settlor seeks to substitute must be of equivalent value under both the Internal Revenue Code and based upon a fair market value analysis. The Trustees, because the promissory note does not, and cannot, meet this requirement, may reject the Settlor’s proposed substitution.

**The Proposed Substitution of the Promissory Note is Properly Characterized as a Loan**

The Trustees assert that the promissory note is in no way distinguishable from a loan and as such they have the authority to reject it under §21.1 of the MVC Trust. The Settlor argues that, as he is the owner of the trust corpus for income tax purposes, and as this is an inter-familial transaction, the factors that would normally be used to determine if a transaction is a loan should not apply.

### **Burden of Proof as to Loan vs. Substitution of Property**

The Settlor argues that, based upon the Trustees' duty to comply with the exercise of a reserved power by the Settlor, the Trustees should have the burden of proving the transaction should be characterized as a loan. See, *Restatement (Third) of Trusts* § 75. The Court rejects that argument and will apply the same presumption of good faith that was applied in the analysis of the value of the promissory note above. The Court will presume that the Trustees' characterization of the promissory note as a loan is in good faith and require Settlor to prove otherwise by a preponderance of the evidence in order to prevail.

### **Analysis of the Character of the Transaction**

The Settlor's primary support for the idea that the Promissory Note is a "substitution of property" rather than a loan rests largely on the fact that he has chosen to call it a "substitution of property." However, the transaction meets all of the elements of a loan and the Settlor has essentially conceded in any other context the transaction would qualify as a loan. See, *Love v. Olson*, 645 P.2d 861, 863 (Colo. App. 1982).

Further, the idea that the Settlor intended to be able to exercise his power of substitution in this manner is severely undercut by the fact that, in creating the trust, he could have specifically reserved the power to borrow the corpus of the trust without adequate security. 26 U.S.C. § 675(2). Mr. Condiotti did not reserve that power in the MVC Trust and the Court cannot discern how a loan with less than adequate security would look any different than what the Settlor is now trying to characterize as a substitution of property. An interpretation that the submission of a promissory note as substitution for

the corpus of the trust qualifies as an “exchange” of “equivalent value” under 26 U.S.C. § 675(1) and 26 U.S.C. § 7872 would render the 26 U.S.C. § 675(2) superfluous.

The Court finds that the Trustees have properly characterized the transaction as a loan and as such the Trustees may decline to make the loan pursuant to their authority under § 21.1 of the MVC Trust.

### **Conclusion**

The Court instructs the Petitioners/Co-Trustees that they may properly reject the Settlor’s proffered Promissory Note on the grounds that the Promissory Note is not of equivalent value to the corpus of the trust and pursuant to their discretionary authority make loans.

So Ordered.

Done and Dated this 2<sup>nd</sup> day of April.

BY THE COURT:

/s/ William L. Herringer  
District Court Judge