Reciprocal Trust Doctrine

Overview

With the increased lifetime gifting opportunities, clients are often faced with seemingly conflicting objectives of reducing the taxable estate and retaining access to transferred assets at some point in the future. An irrevocable trust, created and funded by one spouse that names the other spouse as a permissible beneficiary (commonly referred to as a Spousal Lifetime Access Trust or "SLAT"), could be a way for an individual to make lifetime gifts of assets to an irrevocable trust, yet allow the beneficiary spouse to receive benefits in the future, which might indirectly benefit the grantor spouse. Husband and wife may each attempt to establish a trust benefitting the other to increase the amount transferred outside of the taxable estate, yet ensure that regardless of which spouse is the first to die, the surviving spouse continues to have access to at least a portion of the total transferred assets. When considering such an arrangement, planners should be extremely careful of the potential impact of the reciprocal trust doctrine. The reciprocal trust doctrine is a judicially-created doctrine developed in response to the perceived tax-avoidance where two parties create trusts for each other which, in effect, leave each other lifetime enjoyment over property while avoiding inclusion in the gross estates. Thus, if a husband and wife wish to employ the SLAT technique for each other, it will be crucial to draft the trusts in a way that avoids application of the reciprocal trust doctrine.

The following seeks to summarize several pertinent court cases and IRS private letter rulings, highlighting the varying interpretations of the reciprocal trust doctrine handed down by the U.S. Supreme Court. These cases and rulings may provide guidance in drafting trusts that might successfully meet most, if not all, of the client's objectives.

Court Cases and IRS Rulings

Estate of Grace

The seminal U.S. Supreme Court case, *U.S. v. Estate of Grace*,[1] clarified a split among Circuit Courts as to the requirement of a "bargained-for" exchange in order to apply the reciprocal trust doctrine. The Court in *Grace* held that application of the doctrine would not depend on a "finding that each trust was created as a quid

1 395 U.S. 316 (1969)

pro quo" for the other.[2] In order to apply the doctrine, the court required that the trusts be (1) "interrelated" and (2) that the arrangement leave the two grantors in "approximately the same economic position" as if they had created the trusts and named themselves as beneficiaries.[3] The Court concluded in *Grace* that the trusts created by Mr. and Mrs. Grace, naming each other as beneficiaries, were interrelated as they contained substantially identical terms, were created at the same time (15 days apart), and were part of a single transaction "designed and carried out by the decedent," Mr. Grace.[4] In addition, the trusts left each party in the same economic position, as each party continued to have an economic interest in trust property which would result in inclusion in the estate if the beneficiary were deemed to be the grantor of the trust. The Court "uncrossed" the trusts and concluded that Mr. Grace's estate should include the value of the trust established by Mrs. Grace in which her husband was a beneficiary, as if he had established and funded the trust himself.

There have been no reported court cases on point with the SLAT technique since *Grace* where the grantor's spouse is given a right to trust income and/or principal. However, the interpretation of the doctrine in subsequent cases is illustrative as to how a court may apply the test outlined in *Grace* to future cases. Subsequent to *Grace*, the application of the reciprocal trust doctrine has been uncertain for several reasons. First, the Court in *Grace* did not define how it would test the "interrelatedness" of two trusts. Subsequent courts have expanded the relevant factors to include the identity of beneficiaries, identity of trustees, relationship of the grantors, and the corpus of the trusts, among other considerations. In addition, the "economic position" element of the *Grace* test has been expanded, as will be seen below.

Estate of Bischoff

In *Estate of Bischoff*,[5] the Tax Court applied the reciprocal trust doctrine to trusts established by a husband and wife which named the other spouse as the trustee and the grandchildren as trust beneficiaries. The husband and wife were not trust beneficiaries. However, they were given, as trustees, the discretionary right to make income and principal distributions. The court concluded that the trusts should be "uncrossed" because they were interrelated. The court then determined that after uncrossing the grantors of the trusts, there was a basis for estate taxation under Section 2036(a)(2) and 2038(a)(1) where a grantor retains the power to determine who may possess or enjoy trust property. The court in *Bischoff* was unconvinced that the Supreme Court in *Grace* would provide for taxation of trust assets based on a retained life estate under Section 2036(a)(1), but would allow a transfer to escape taxation even if upon uncrossing two interrelated trusts, there would be potential inclusion under a different Code section. It appears that the court uncrossed the trusts solely on the basis of finding interrelatedness between the two trusts. After uncrossing the trusts, the court looked to see if the deemed transferor held a power or interest which would result in inclusion in the deemed transferor's estate.

Exchange Bank and Trust

The Federal Circuit Court followed the *Bischoff* rationale to conclude that UGMA accounts established by a husband and wife, naming each other as custodians, were reciprocal and therefore should be included in the estate of the husband who died while serving as custodian.[6] The court stated that the transfers were interrelated as they were made as a result of a common plan. In addition, "each spouse gained custodianship over assets equal in value to those assets relinquished, thus each donor was in the same

2 395 U.S. 324
3 *Id.*
4 *Id.* at 325
5 69 T.C. 32 (1977)
6 *Exchange Bank and Trust Company of Florida v. United States*, 694 F.2d 1261 (1982)

economic position as one who transfers assets to himself as custodian."[7] Thus, the court found a basis for uncrossing the custodial gifts and including assets in the husband's estate under §§2036 and 2038.

It appears from contemporary interpretations to the test as outlined in *Grace* that a taxpayer may avoid application of the reciprocal trust doctrine by employing one of two methods: (1) Avoid a characterization of the trusts as interrelated; or (2) even if the trust grantors are uncrossed, ensure that the grantor retains no power or interest which would result in inclusion in the grantor's estate. It would appear that with the SLAT technique in which each spouse creates and funds a trust, it will be imperative to avoid a ruling that the trusts are interrelated, if the non-grantor spouse is to be a permissible beneficiary of each trust.

Estate of Levy

Often, the case of *Estate of Levy*[8] is cited as providing a potential solution to avoiding the creation of interrelated trusts by giving one spouse, but not the other, a special power of appointment over trust assets. Thus, husband and wife could each create irrevocable trusts, naming the other spouse as a beneficiary. By giving only one spouse a special power of appointment, the trusts would not be considered interrelated as they would not have substantially identical terms, a requirement outlined in *Grace*. While the *Levy* court concluded that the trusts established by husband and wife were not interrelated, there are important facts to note in interpreting this case. First, *Levy* is not a case in which the husband and wife were beneficiaries of each other's trusts. Rather, husband and wife set up trusts on the same day, named each other as trustees with their son as the beneficiary. The court did not address whether the reciprocal trustee issue (as seen in *Bischoff* and *Exchange Bank & Trust*) would apply. Rather, the IRS agreed to a stipulated outcome that the reciprocal trust doctrine would not apply if the special power of appointment given to the wife was considered valid under New Jersey state law. Thus, while the *Levy* case may provide some support as to the use of a special power of appointment to break the interrelated prong of the reciprocal trust doctrine test, it would be difficult to rely on the court's reasoning as a means to avoid the application of the reciprocal trust doctrine in the case of two SLATs in which each spouse is a beneficiary of the other spouse's trust.

Private Letter Ruling 200426008

While Private Letter Rulings ("PLRs") cannot be cited as precedent for future cases and are only binding between the parties referenced in the individual ruling, a 2004 PLR[9] may provide guidance on how two trusts created by husband and wife, naming each other as permissible beneficiaries, may be drafted to break the interrelated prong established in *Grace*.

The facts presented in the PLR are as follows: Husband wishes to create a trust for the benefit of his wife and son, naming the wife as trustee. Husband wishes to contribute separate assets to the trust. Wife also wishes to establish a trust for the benefit of her husband and son, naming the husband as trustee and funding the trust with her sole and separate property. In the ruling, the IRS found five differences between the two trusts, and based on these differences, reached the conclusion that the trusts were not substantially identical and thus were not interrelated. Despite the fact that there may be a reciprocal trustee argument (although not addressed by the IRS in the ruling) and likely a reciprocal beneficiary argument (leaving the husband and wife in the same economic position), because the first prong of the *Grace* test was not met, the reciprocal trust doctrine would not apply.

The five differences between the two trusts listed in the ruling are the following:

- Husband's trust gives wife the right to withdraw the greater of $5,000 or 5% of trust assets, but only if the son were to predecease the wife.

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7 *Id.* at 1263
8 T.C.M. 1983-453
9 Priv. Ltr. Rul. 200426008 (June 25, 2004)

- ♦ Husband's trust gives wife a special power to appoint trust assets to husband's issue or spouses of issue, but only if the son predeceases the wife.
- ♦ Husband's trust gives wife a testamentary special power to appoint trust assets to husband's issue or to a charity, but only if the son predeceases the wife.
- ♦ If husband's trust establishes a marital trust, wife has a testamentary special power to appoint marital trust assets to husband's issue or to charity.
- ♦ Wife's trust provides that husband is a permissible beneficiary of the trust *only* if husband's net worth is less than a stipulated amount and *only* after wife has been deceased for two years. This limitation would not apply to a marital trust created under the wife's trust, presumably to allow the trust to qualify for the marital deduction.

While the first four provisions may be considered nominal or minor changes, the fifth difference, included in the wife's trust, may be viewed as a substantial difference that would break the interrelated prong. The drafting of the trusts analyzed in the PLR may be a creative way to avoid application of the reciprocal trust doctrine, while ensuring that one spouse (potentially the non-"breadwinner") would always have access to the trust in which he/she is the beneficiary. The other spouse (possibly the "breadwinner") would have limited access as a permissible beneficiary to the trust established for his/her benefit, which presumably may be suitable as he/she would likely have sufficient assets or earning capacity for his/her needs, leaving the trust as an asset of last resort.

Tax Implications

In addition to the above mentioned differences, one might consider incorporating one or more of the following variations into SLAT planning:

- ♦ Avoid a potential reciprocal trustee argument by naming different third party trustees, or co-trustees, for each trust.
- ♦ Fund the trusts with separate, different assets.
- ♦ Include different distribution standards, such as allowing one trustee to distribute income and principal based on the trustee's discretion, while allowing the other trustee to distribute income and principal subject to an ascertainable standard, such as health, education, maintenance and support.
- ♦ Draft one trust to continue for multiple generations while the other trust will distribute assets based on a vesting schedule.
- ♦ If the trusts are to be used in a leveraged asset shift, structure one trust as a grantor retained annuity trust and the other shift as a sale to an intentionally defective grantor trust.