Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1339

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From: Steve Leimberg's Estate Planning Newsletter

Subject: **Estate Inclusion Issues of Reciprocal Trusts and Self Settled Estate Planning Trusts**

The Doctrine of Reciprocal Trusts – Part V

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm** which is a boutique firm emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection – first edition, The Asset Protection Planning Guide (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*.

Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, and the Asset Protection Journal. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal.

Mark speaks nationally on estate planning and asset protection and is giving an upcoming five day estate planning seminar sponsored by the University of Denver Graduate Tax Program http://www.InternationalCounselor.com/HotoffthePress.htm

This **LISI** is part of a continuing series known as the **Modular Approach to Estate Planning**.™[1]

Part I of Mark's series on Reciprocal Trusts is LISI Estate Planning Newsletter # 1281.
Part II is LISI Estate Planning Newsletter # 1273.
Part III is LISI Estate Planning Newsletter # 1283
Part IV is LISI Estate Planning Newsletter # 1332.

EXECUTIVE SUMMARY:

In my last installment of the reciprocal trust doctrine (LISI **Estate Planning Newsletter # 1332**), for the more aggressive planners, I discussed possible methods of hopefully drafting around the doctrine of reciprocal trusts. Yet, what if someone is unsuccessful when there are reciprocal beneficiaries and the doctrine of reciprocal trusts applies. Some estate planners take the position that all is not lost, the estate tax inclusion rules governing self settled trusts apply.

This **LISI** generally disagrees with this "no harm, no foul" argument. If a court finds that the trusts are reciprocal, a Delaware Chancery case, the Restatement (Third) of Trusts ("Restatement Third), and a couple of the leading treatises on asset protection take the position that any creditor can reach the deemed settlor's beneficial interest. In other words, with one caveat, there most likely is *no* asset protection for either the husband's or wife's beneficial interest if a court holds that the trusts are reciprocal. The one exception is a reciprocal trust that is also an asset protection trust ("APT") under a state that has passed a qualified disposition act or an offshore APT. In this case all three of the estate inclusion issues of IRC § 2036(a)(1) need to be analyzed to determine whether the trusts will be included in the settlor's estates.

TERMINOLOGY

Over the years, I have noticed how many planners have broadened the term "asset protection trust" ("APT"). For those of us who have been in the business since the term was first used, it has a very *specific* meaning – a self settled trust where a beneficiary's interest is protected under the governing state or nation law.

In recent years, I have seen where the term was used broadly to include typical third party trusts including discretionary dynasty trusts. With these trusts, the settlor is *not* a beneficiary.

For purposes of this article, I will use the narrow definition. An APT refers only to a self settled trust sited in a jurisdiction that protects a settlor/beneficiary's interest by statute or common law. The term domestic asset protection trust ("DAPT") refers only to a trust sited in a state that has adopted a qualified disposition statute. A qualified disposition statute is a statute that extends spendthrift protection to a self settled trust.

For more information on how a DAPT statute works see *Searching For Favorable DAPT Legislation: Tennessee Enters the Arena*, LISI Asset Protection Planning Newsletter #105, June 1, 2007. The term "offshore asset protection trust" ("OAPT") refers only to a trust sited in a nation that protects a self settled trust by statute or common law.[2]

RECIPROCAL TRUSTS

Assuming the trusts are not APTs, if a court holds the two trusts to be reciprocal, they are deemed to be self settled. Husband is deemed to be the settlor of the trust his wife created naming him as one of the beneficiaries, and wife is deemed to be the settlor of the trust her husband created naming her as one of the beneficiaries.

In the only case dealing with the creditor issue of reciprocal trusts, *Security Trust v. Sharp*[3], a Delaware chancery case, holds that creditors may reach the deemed settlor's interest in reciprocal trusts, under the theory that the trust is self settled. This case has been cited as the state of the law in a couple of the lead asset protection treatises.[4] It is also the position under the Restatement Third of Trusts.[5] Due to the common acceptance of this Delaware case as the state of the law, I would strongly suggest that most courts will follow it.

In all but the DAPT states, the general rule is that any creditor may reach the maximum amount that may be distributed to a settlor/beneficiary.[6] If this is the case, any creditor may reach the husband's or wife's beneficial interest in a reciprocal trust. If a creditor may reach a *settlor's* beneficial interest, it is included in the deemed settlor's estate.[7]

Conversely, if the reciprocal trusts are also APTs under a state qualified disposition statute, then whether there is a estate inclusion issue will require an analysis of all of the estate inclusion issues of IRC § 2036.[8] I will discuss these estate inclusion issues for DAPTs after discussing the amount of the inclusion for reciprocal trusts below.

WHAT IS THE AMOUNT INCLUDED IF RECIPROCAL BENEFICIARIES?

In the event the reciprocal trust doctrine applies and the reciprocal trusts are not DAPTs, the amount of the inclusion for each settlor was confirmed in *Grace*[9] that stated:

"Rather, we hold that the application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the *extent of mutual value*, leaves the settlors in the same economic position as they would have been if they had created trusts naming themselves as life beneficiaries." [Emphasis added].

This was also previously confirmed in *Estate of Cole v. Comm'r,* 140 F.2d 636 (8th Cir. 1944), where husband transferred 700 shares of stock to the trust he created naming his wife as one of the life beneficiaries and wife contributed 300 share of the same company to a trust naming husband as one of the life beneficiaries. The court held the value of the smaller trust, which was the 300 shares, at the death of each spouse was included in that spouse's estate.

Probably the most common incident where practitioners come across reciprocal trusts is with ILITs. Husband creates an ILIT naming his wife and children as beneficiaries, and the trustee of this ILIT obtains an insurance policy on the life of the husband. Wife does likewise. She creates an ILIT naming her husband and children as beneficiaries, the trustee of this ILIT obtains a life insurance on the life of the wife. Assume that husband dies and the death benefit is $2 million. At the time of his death, the cash surrender value of the insurance policy held by the trust the wife settled is $250,000. Under *Estate of Cole* the value of the wife's trust should be included in husband's estate when he dies, assuming he dies first, and the value of the wife's trust, at the time of her death will also be included in her estate.

SELF SETTLED ESTATE PLANNING TRUST ESTATE INCLUSION ISSUES

If one is able to draft around the doctrine of reciprocal trusts, husband and wife have access to the property gifted to both trusts. The amount that might be accessed depends upon the distribution standards as well as any savings clauses.[10]

Planning with trusts that have reciprocal beneficiaries generally requires both a husband and wife. Furthermore, to access trust assets, one must do so through the other spouse.

Is there a possibility that a trust could be designed where a settlor could also be a beneficiary of a trust and the trust property might be *excluded* from the estate? This type of trust has been referred to as a self settled estate planning trust (i.e. "rainy day trust™"[11]). A typical design for this type of trust has the following components.

- The settlor as well as his spouse and descendants are named as beneficiaries.
- An independent trustee is appointed within the meaning of IRC § 672(c).
- The settlor may remove the independent trustee without cause and appoint another independent trustee within the meaning of IRC § 672(c).
- The Trustee may make discretionary distributions (i.e., a common law discretionary trust[12]) of any amount of income or corpus to any beneficiary – including the settlor.

In essence, if such an estate planning tool works, the Settlor would be able to gift property away, and get back part of the trust property if ever needed, and still have the remaining trust property excluded from the settlor's estate. This type of a tool would also be "full loaf" planning. Also, it would not require the additional step of receiving distributed trust assets through a spouse.

GIFT TAX RULES

As explained by that esteemed estate planner **Richard Nenno** of the **Wilmington Trust Company**, whether a transfer to a self settled estate planning trust will be classified as a completed gift depends on whether or not a creditor may reach the beneficiary's interest in the trust.[13] Since whether a creditor can reach the settlor/beneficiary's assets is also an estate inclusion issue, it will be discussed in the upcoming Part VI.

ESTATE INCLUSION ISSUES AND THE ESTATE PLANNING OCTOPUS™[14]

The estate tax is broader than the gift tax. Just because the settlor completed a gift, possibly used all or part of his or her applicable exclusion, and even possibly paid some gift tax, does not mean the property is excluded from the settlor's estate.

As noted, in the Modular Approach to Estate Planning, one may view the estate tax similar to an octopus. The head of the octopus is IRC § 2033, which means that the client owns the asset. In order to get away from an octopus from devouring you, you must severe all eight arms. The eight arms are represented by IRC sections where generally the client does not own the property, but has retained some string of control over such property.

THREE TENTACLES TO IRC § 2036

The biggest and most deadly arm of this estate planning octopus is IRC § 2036. It is the biggest arm of the octopus for estate tax inclusion, because the arm breaks down into three tentacles, and one of the three tentacles further breaks down into three more sub-tentacles. All of these tentacles and sub-tentacles bring trust property back into the estate using different rules.

The three main tentacles are:

1. IRC § 2036(a)(1) – dealing with retained life interests;

2. IRC § 2036(a)(2) – which is generally concerned with the ability of a trustee to designate who receives what; and

3. IRC § 2036(b) – concerned with voting rights in closely held corporations.

By case law, IRC § 2036(a)(2) and IRC § 2038 have an external standard (i.e. ascertainable standard) exception to their application.[15]

The same is not true for IRC 2036(a)(1), there is no external or ascertainable standard exception. It is under IRC § 2036(a)(1) tentacle where three potential estate tax inclusion issues of a self-settled trust surface.

IRC § 2036(a)(1)'s Three Sub-Tentacles are:

1. retained life interest;

2. implied promise;[16] and

3. whether a creditor may reach the assets of a trust in satisfaction of a legal obligation.[17]

IRC § 2036(A)(1) – LIFE INTEREST RULE

In order to determine whether there is an estate inclusion issue under IRC § 2036(a)(1) for an APT, one must look to the common law classification of trusts to determine whether a beneficiary holds an enforceable right to a distribution.

Generally, in determining whether a beneficiary had an enforceable right to a distribution, there are primarily three classifications of trusts: (1) mandatory interest[18]; (2) support interest; and (3) a discretionary interest.

Mandatory Distribution Interest

Usually, a mandatory distribution standard requires that a fixed amount, percentage, or definition of income be paid out annually. For tax purposes, a QTIP, which requires all income to be paid to the surviving spouse, is a mandatory distribution. The same for the annuity or uni-trust interest in a GRAT or CRUT. Similarly, a $100,000 distribution to a certain beneficiary that is required to be made each year is a mandatory distribution.

If the settlor holds a mandatory distribution interest, there is an estate inclusion issue under IRC § 2036(a)(1).[19]

Support Distribution Interest

Under common law, the term support trust means that the distribution creates an enforceable right in a beneficiary based on a standard. Generally, a support trust is created with mandatory words such as "shall" or "must" combined with a standard that is capable of judicial interpretation. For example, Courts have determined the following language to create a support trust:

> "[T]he trustee shall pay…[to the settlor's] daughters such reasonable sums as shall be needed for their care, support, maintenance, and education" [emphasis added] was determined to be a support trust.[20]
>
> "[T]he Trustee shall use a sufficient amount of the income to provide for the grandchild's support, maintenance and education" [emphasis added] was held to be a support trust. [21]

If the settlor/beneficiary has an enforceable right to a distribution, again there is an estate inclusion issue.[22]

Discretionary Interest

It is only if a settlor hold a discretionary interest where he or she holds neither an enforceable right to a distribution nor a property interest that there is not an estate inclusion issue under the IRC § 2036(a)(2) tentacle. [23]

For purposes of this article, the term common law discretionary trust refers to a trust where a beneficiary has neither an enforceable right to compel a distribution nor a property interest, and no creditor may attach such interest.

At this point the author needs to clarify an area of confusion among some practitioners. Under common law, the term "purely discretionary trust" or "wholly discretionary trust" under common law did not require that the distribution interest not have any standards. Rather, in the hundreds of cases on point, almost all common law discretionary trusts contained a standard for making distributions.

However, as discussed in detail in my **LISI** Series on Spousal Access Trusts, the Restatement Third rewrites the definition of a common law discretionary trust creating an enforceable right in almost all discretionary trusts.

The *good* news, it does not appear that the courts are adopting the Restatement Third in this area of law.

The *bad* news is that there is nothing other than a state a statute codifying the Restatement Second that will prevent a judge from doing so.

Therefore, unless the trust is to be sited in a jurisdiction that has addressed this enforceable right issue[24], I would suggest the following distribution language:

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. When making distributions, my Trustee may, in its sole, absolute, and unfettered discretion may, but need not, consider a beneficiary's income or other resources that are available to the beneficiary outside of the trust and are known to the Trustee. The power to make a distribution in my Trustee's sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust."

The author is hopeful that the above language would create neither an enforceable right to a distribution nor a property right under even a Restatement Third analysis. This being the case, the first estate planning sub tentacle of IRC § 2036(a)(1) does not create an estate inclusion issue.

CONCLUSION

While it may be possible to design and operate a self-settled asset protection trust and avoid estate planning inclusion issues, the same does not appear to be true for reciprocal trusts that have reciprocal beneficiaries. The case of *Security Trust v. Sharp* as well as the Restatement Third takes the position that any creditor may reach a beneficiary's interest in a reciprocal trust. This being the case, the sub-tentacle that a creditor may reach the settlor/beneficiary's interest of the trust will pull the value of the smaller trust back into the deemed settlor's estate.

The exception to this statement would be a reciprocal trust that also was a DAPT, and in that case, one must be able to escape from the three estate planning sub tentacles of IRC § 2036(a)(1): (1) life interest rule; (2) implied promise; (3) or creditor can reach the settlor/beneficiary's interest.

A common law discretionary interest that creates neither an enforceable right to a distribution nor a property interest that no creditor may attach prevents the first sub tentacle of IRC § 2036(a)(1) from applying.

The second sub tentacle regarding an implied promise and the third sub tentacle of whether a creditor can reach the settlor/beneficiary's interest will be discussed in the upcoming series on self settled estate planning trusts.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

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CITES:

[1] The modular approach to estate planning is trademarked by Mark Merric.

[2] Some of the first common law asset protection trusts were Isle of Man, Jersey, and Guernsey (the last two being Channel Islands between England and France). These jurisdictions continue to protect a settlor/beneficiary's interest in trust by case law.

[3] *Security Trust v. Sharp,* 77A.2d 543 (Del. Ch. 1950).

[4] Elizabeth G. Deleery chapter titled *Trusts in Which A Settlor Retains an Interest,* in Duncan Osborne's and Elizabeth Schurig's treatise, *Asset Protection: Domestic and International Law and Tactics,* § 14:26; and Peter Spero, *Asset Protection: Legal Planning, Strategy & Forms,* P. 6.08, Self Settled Trusts.

[5] *Restatement (Third) of Trusts,* Section 58; comment f and Reporter Note's comment f.

[6] *Restatement (Second) of Trusts § 156(b); Restatement (Third) of Trusts § 60, comment f; Uniform Trust Code § 505.*

[7] Treas. Reg. § 20.2036-1(b)(2)

[8] As Richard Nenno notes in his chapter titled *Delaware Asset Protection Trusts,* in Duncan Osborne's and Elizabeth Schurig's treatise, *Asset Protection: Domestic and International Law and Tactics,* § 14A:134, the estate inclusion issues of IRC § 2038 are the same for a non-self settled trust. Therefore, they are not within the scope of this article.

[9] *U.S. v. Grace,* 395 U.S. 316 (1969).

[10] Limitations on distributions when someone uses a support trust will be discussed in detail in the upcoming series on Spousal Access Trusts.

[11] The term "Rainy Day Trust" is a service mark of Alaska Trust Company.

[12] The term common law discretionary trust refers to the Second Restatement where a beneficiary does not has neither an enforceable right to a distribution or a property interest. It does not refer to the new view of law articulated by the Restatement Third of Trusts.

[13] Richard Nenno's chapter titled *Delaware Asset Protection Trusts,* in Duncan Osborne's and Elizabeth Schurig's treatise, *Asset Protection: Domestic and International Law and Tactics,* § 14A:134. Richard Nenno provides an extensive paragraph of cites. A few of these cites follow: *Outwin v. Commr.,* 76 TC 153 (1981); Rev. Rul. 77-378; Rev. Rul. 76-103; and TAM 199917001.

[14] The "estate planning octopus" is trademarked by Mark Merric.

[15] *Estate of McTighe*, TC Memo 1977-410, *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Estate of Pardee*, 49 TC 140 (1967); PLR 9347014.

[16] Treas. Reg. § 20.2036-1(a)(1).

[17] Treas. Reg. § 20.2036-1(b)(2).

[18] For creditor purposes, the Restatement Second provided spendthrift protection to both mandatory and support trusts, and therefore does not make a distinction between these two types of trust. The Restatement Third and the Uniform Trust Code do not provide protection for a mandatory distribution that has become overdue, thereby reducing the asset protection under common law and creating a third classification for creditor purposes.

[19] *Estate of Uhl,* 241 F.2d 867 (7th Cir. 1957) as to the $100 mandatory income distribution that resulted in estate inclusion of the corpus necessary to produce the $100 payment.

[20] *In re Carlson's Trust*, 152 N.W.2d 434 (SD 1967).

[21] McElrath v. Citizens and Southern Nat. Bank, 189 S.E.2d 49 (GA. 1972).

[22] *Estate of Boardman v. Comm'r,* 20 T.C. 871 (1953); *Estate of John J. Toeller,* 165 F.2d 665 (7th Cir. 1946); and *Blunt v. Kelly,* 131 F.2d 632 (3rd Cir. 1941). For creditor purposes when a beneficiary has an enforceable right to a distribution, it is referred to as a "support trust."

[23] *Estate of Uhl*, 241 F2d 867 (7th Cir. 1957), as to the principal that was wholly in the discretion of the trustee "the settlor reserved no right to compel the trustee to pay him any sums . . . ." Both the *Estate of German,* 7 Cl. Ct. 641 (1985) and *Estate of Wells,* 475 F2d 1142 (Ct. of Claims 1964) are self settled discretionary trust cases where the court held in favor of the taxpayer, and it appears the Service did not attempt to argue that there was an enforceable right in a discretionary trust.

[24] There are three parts to codifying the discretionary asset protection provided by the Restatement Second: (1) defining a discretionary trust interest; (2) stating the legal effect of a discretionary interest (i.e. the beneficiary does not have an enforceable right or a property interest); and (3) providing a judicial review standard that does not create an enforceable right. South Dakota does this in SDCL § 55-1-23 through § 55-1-43. The proposed Michigan UTC does all of this. The Missouri UTC only covers the second issue, which is the most important of the three issues.