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Subject: Attempting to Draft Out of the Doctrine of Reciprocal Trusts

Attempting to Draft Around the Substantially Identical Factor of Reciprocal Trusts

The Doctrine of Reciprocal Trusts – Part IV

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

Executive Summary:

My first LISI delineated the two prong test under the U.S. Supreme Court decision in *Grace*.[2] The second installment focused on how the reciprocal trust doctrine had expanded to reciprocal trustees and reciprocal gifts, where a life interest or economic interest may no longer be a requirement under the reciprocal trust doctrine.

In the third installment of the reciprocal trust doctrine, I discussed the *Estate of Levy* as well as PLR 9643013. Our concern with both of these fact patterns was that neither one was a reciprocal beneficiary fact pattern. Both fact patterns allowed one spouse to bring back trust assets into the family unit from one trust, but not from both. They were half a loaf solutions. Since *Grace* and until 2004, we had little authority regarding how to possibly break the reciprocal trust doctrine when there were reciprocal beneficiaries. Then the golden PLR 200426008 arrived. The Service ruled positively on a true reciprocal beneficiary case where the estate planner had drafted around the substantially identical trust factor of the interrelated prong of *Grace*.

In this fourth installment of this LISI series, I will discuss whether PLR 200426008 is truly 24 carrot gold or is it merely fool's gold. Unfortunately, many of the drafting differences in this PLR appear to be immaterial differences that the Service may have missed. Conversely, on the positive side, it may be possible to draft around the substantially identical factor of the interrelated prong by making several significant drafting differences between the trusts.

I. A True Reciprocal Beneficiary Fact Pattern - PLR 200426008

As previously mentioned, PLR 200426008 is a true full loaf planning structure where both husband and wife have access to trust assets that have been gifted away. At first glance, it also appears that there might be reciprocal trustee issues.

Structure

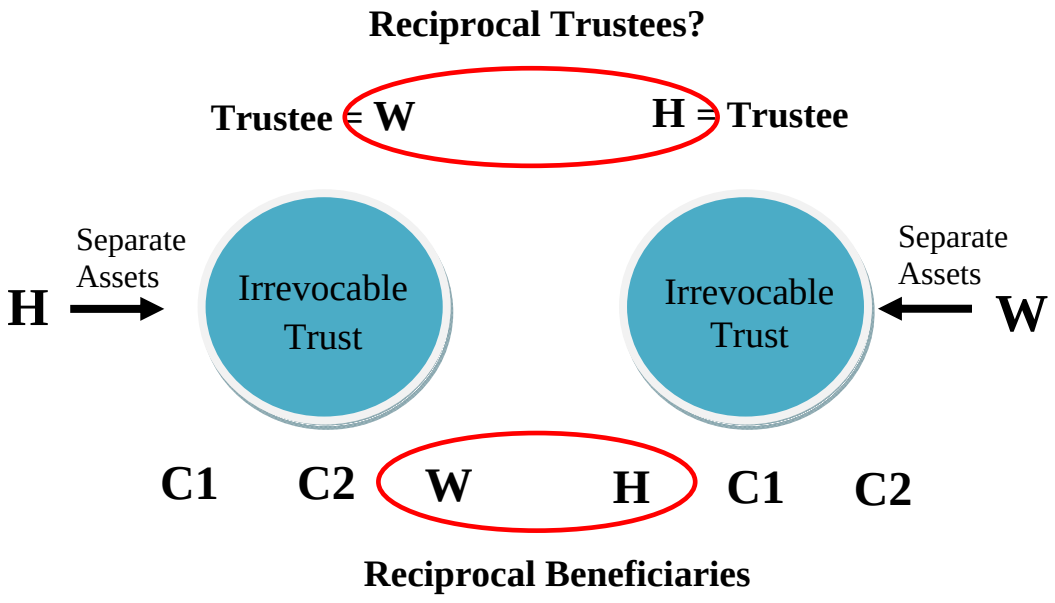
Some of the facts under PLR 200426008 are as follows:

(1) Pursuant to the same plan, husband and wife each create a trust for the benefit of their son;

(2) The husband is appointed the trustee of the trust settled by the wife, and the wife is appointed as trustee of the trust settled by the husband;

(3) The husband is a beneficiary of the trust settled by the wife, and the wife is a beneficiary of the trust settled by the husband;

(4) Husband and wife both contributed separate property.



Reciprocal Trustees

As noted in our second installment of this LISI series, it appears that in order for the reciprocal trustees doctrine to apply, husband and wife must contribute the same assets. Therefore, it may be possible that the Service did not address the reciprocal trustee issue, because it did not apply.

Reciprocal Beneficiaries

The PLR notes that since it found that the trusts were not interrelated under the second prong of the *Grace* test, it was not necessary to discuss whether husband and wife were in the same economic position under the first prong of the *Grace* test. Since I find this analysis as helpful, I will discuss this issue. While it may be uncertain whether the reciprocal trustee doctrine applied, because husband and wife each gifted separate property, there is no question that the same economic position prong of the *Grace* test has been met. The husband is a beneficiary of the trust settled by the wife, and the wife is a beneficiary of the trust settled by the husband. Further, in her capacity as trustee wife may make distributions to herself as a beneficiary of the trust settled by the husband. The same is true for the husband. Not only were husband and wife left in the same economic position, but they even had control in making distributions as a trustee to themselves.[3]

Immaterial Differences in Breaking the Substantially Identical Factor?

Through the incredibly artful drafting of these trusts, the drafting attorney was able to point to five differences between the trusts. Unfortunately, upon further review of these five differences, all of them appear to be quite minor differences and one of the differences may well be nothing more than a red herring. First, in the unlikely event that the son predeceases mom, mom is granted the following three powers:

(1) a 5x5 power;

With first marriages, it is not uncommon to grant a 5 x 5 power. I would find that this is a minor difference between the trust, most likely not being able to break the substantially identical factor.[4]

(2) an inter vivos SPA; and

In the unlikely event that son predeceases mom, she also receives a special power of appointment to appoint the trust property to husband's child, husband's descendents, or their spouses. The child is also mom's child and he is the only child of both mom and dad. When comparing the powers granted under the PLR SPA to the *Levy* SPA, the PLR SPA powers appear to be cosmetic. In *Levy*¸ husband and wife were not reciprocal beneficiaries. The *Levy* SPA gave the wife the power to appoint trust assets to the husband. Further, the *Levy* SPA gave the wife the ability to stop a corporate reorganization by gifting her shares as well as the shares subject to an SPA to a third person. The PLR SPA powers only allow mom the ability to redirect trust property to her grandchildren (and their spouses) should she not wish for it to be held

equally for them in trust. Since the PLR SPA is only effective in the unlikely event that son predeceases mom, and the powers granted under the SPA merely allow a reallocation between possibly favored grandchildren, I do not find this difference to be material.

(3) a testamentary SPA.

Again, in the unlikely event that son predeceases mom, mom receives a testamentary SPA identical to the inter vivos one discussed in (2) above with the exception that mom may also appoint the property to charity. In this respect, the third purported difference appears to be nothing more than a knock off of the second difference. Again, I do not find the economic rights of adding a charity as a possible recipient as anything close to the powers granted under the SPA in *Levy*, where the SPA allowed property to come back into the family unit. Therefore, it appears that this difference is also immaterial.

The fourth and fifth differences are concerned with marital trust savings clauses. A marital trust savings clause is a savings clause where upon the death of the first spouse, if an inter vivos irrevocable trust is inadvertently included in the settlor's estate, the assets included in the settlor's estate are placed into the marital trust (which is generally the QTIP) so that the estate tax may be deferred to the death of the second spouse. Similar to the first three minor differences in trust drafting, the fourth and fifth differences are also effective only upon an unlikely event. Here, the unlikely event is that the inter vivos trusts will have been inadvertently drafted and result in some estate inclusion issue.

Both the trust settled by the husband and the trust settled by the wife have marital trust savings clauses. However, the powers granted to husband and wife under these marital trusts savings clauses differ. The fourth difference is under the wife's marital trust, where she is given a 5 x 5 power and a testamentary special power of appointment. The husband's marital savings trust clause does not provide for these powers. Both the 5 x 5 power as well as the testamentary SPA were previously discussed in differences one and three above. In this respect, the fourth proclaimed difference appears to be nothing more than a restatement of the first and third difference. For the same reasons stated above, I would find these differences to be immaterial.

The fifth purported difference is that the marital trust savings clause provided for under the trust settled by the wife does not allow the husband to be a beneficiary for three years. Further, the husband may not be a beneficiary at all if he is above a certain income level. The purpose of a marital trust savings clause is to preserve the tax deferral until the second spouse's death if an inter vivos irrevocable trust is brought back into the settlor's estate. In order to accomplish this objective, the QTIP created under the marital trust savings clause must qualify for the marital deduction under IRC § 2056(b)(7). However, under the PLR's facts, the QTIP fails to qualify from inception, because the husband does not receive income annually for three years, and possibly forever if his income is above a certain level. In this respect, it appears that the fifth purported difference has no other purpose than to serve as a red herring in an attempt to argue that the trusts are not substantially identical.

Synthesis

All of the differences between the trusts depend on either the unlikely event that the son predeceases mom or that the trust had other estate inclusion issues that brought part or all of the trust assets back into the settlor's estate. The 5 x 5 power, by itself does not appear to be material. The SPAs under the PLR do not have the economic effect or control effect that the SPA in Levy did. Furthermore, the only difference between the inter vivos SPA and the testamentary SPA is that the wife may appoint the trust property to charity under the testamentary SPA. The fourth difference appears to be nothing more than a restatement of the 5 x 5 power and the testamentary SPA. Likewise, the fifth difference appears to be nothing more than a red herring. Considering these differences, one might conclude that the only real differences are a 5 x 5 power and an SPA that does not begin to approach the powers granted under the SPA in *Levy*. Both of these differences appear to be immaterial either alone or combined. Moreover, since they depend on unlikely events, these differences appear to be even more immaterial. Therefore, some planners may well disagree with the Service's favorable ruling and find that these trusts actually are substantially identical. Conversely, some planners may take the position that very little drafting is needed to break the substantially identical factor, and agree with the Service position.

II. Drafting Reciprocal Trusts With Fundamental Differences

Due to limited case authority and the fact that a PLR may not be relied on as authority[5], it is hard for anyone to be certain how different the trusts settled by husband and wife need to be to break the substantially identical trust factor under the interrelated prong of the *Grace* test. I would suggest rather than putting much credence in PLR 200426008, that should the drafter wish to attempt to break the substantially identical factor, the trusts should be drafted with fundamental differences. In addition to the differences in PLR 200426008, planners should consider the following other possible drafting deviations:

Different Types of Estate Planning Trusts

When drafting a trust settled by the husband, the trust may be an IDIT. On the other hand, the trust settled by the wife might be a GRAT. These type of trusts function as substantially different types of trusts for estate planning purposes. Further, due to the several pages it takes to define the annuity interest, the trusts look substantially different at first glance.

On the other hand, if the trust settled by the husband is an irrevocable trust (i.e. non-grantor trust), and the trust settled by the wife is an IDIT, the only difference may be a paragraph that provides the wife with the power to substitute property of equivalent value. In this respect, this may not be sufficient to convince the court that the trusts are not identical.

Different Vesting Options

One trust might be a dynasty trust and the other trust might provide for distribution of the trust assets to the beneficiaries based on an age vesting schedule. The drafting for a dynasty trust typically takes a few pages and is considerably different than the paragraph used for age vesting.

Different Distribution Options

One trust might be a purely discretionary trust, and the other trust might be a support trusts based on ascertainable standards (health, education, maintenance, and support). The support trust would give the beneficiary an enforceable right to force a distribution based on the ascertainable standard. Yet, with a common law purely discretionary trust a beneficiary would not have an enforceable right to a distribution.

Different Beneficiaries Other Than Husband and Wife

Using different beneficiaries for each trust other than husband and wife may not suit the settlors objectives. For example, if husband creates a trust for wife, C1, and C2, but wife only creates a trust for husband and C1, then C2 may well not receive as much as C1 upon the death of both husband and wife. Also, if Husband creates a trust for wife and C1, and wife creates a trust for husband and C2, the service may argue that this puts the parties in the same economic position not only as to husband and wife, but also as to the children. The Service could apply the reciprocal gift analysis under *Sather*[6] and *Schuler*[7] discussed in my second installment of this series, LISI Estate Planning Newsletter 1275. Conversely, if it would fit the settlors' goals and there are three or more children, husband could settle a trust for wife, C1 and C2. Wife could settle a trust for husband, C1, C2, and C3.

Other Differences in One Trust, But Not the Other

One trust might have a marital savings clause, and the other one does not have such a provision. Further, one trust might provide that if the children beneficiaries predecease the parent, then the surviving spouse beneficiary would receive a 5 x 5 power. Since some estate planners are of the opinion that a mere SPA might break the substantially identical factor, in the event that this is a first marriage and there are not any conflicts of interest, one trust may provide a SPA. The SPA should be drafted broadly as in *Levy* so that the spouse may appoint the trust property to anyone other than to herself, her creditors, her estate, or the creditors of her estate.

Greater Number of Factors the Better

I would suggest if one is of the opinion that meticulous drafting may break this factor, the more significant contrasts the better. For example, the author would hope that that the following differences would be sufficient:

Husband settles:	**Wife Settles:**
1. IDIT	1. GRAT
2. Pure discretionary distribution standard	2. Distributions shall be made pursuant to an ascertainable standard

3. Dynasty trust	3. Age vesting
4. Marital savings clause	4. None
5. 5 x 5 power if children beneficiaries predecease parent	5. None
6. SPA	6. None
7.. Different beneficiaries	7. Different beneficiaries

III. Do Not Forget the Other Design Issues

Just because the drafter may be able to break the substantially identical factor of the interrelated prong of the *Grace* test does not necessarily mean that the drafter has hit a home run. It is true that the U.S. Supreme Court only focused on the two factors when determining whether the trusts were interrelated: (1) created at the same time (i.e. pursuant to the same estate plan); and (2) whether the trusts were identical. However, as discussed in my previous LISIs, other courts have also considered whether the trusts had the same trustee as well as whether the same assets were contributed to the trust. Additionally, one must also consider the doctrine of reciprocal trustees articulated by the Tax Court and Court of Appeals since *Grace*. Therefore, I would also suggest the following additional estate planning design differences if a drafter wishes to draft around the doctrine of reciprocal trusts.

1. Do not have either spouse serve as a trustee of either trust;

2. Use a different trustee for each trust; and

3. Contribute separate assets to the trusts.

As previously noted in my prior LISI, it is very difficult to break the factor that the trusts were created pursuant to the same estate plan. It is true that the trusts may be established one to two years apart. However, any estate planning diagrams or memorandums documenting that the trusts were established as an overall plan may well negate the fact that the trusts were created at the different times.

Conclusion

There are many opinions regarding the doctrine of reciprocal trusts, and this is an area where many authorities may reasonably disagree. Many drafters will conclude that case and PLR authority is too sparse to provide adequate guidance. They also may well note that to error on the conservative side they would have to include a substantial number of drafting differences, many which they would prefer not to do. Therefore, these conservative drafters may well prefer to draft simply with one spousal access trust. For example, husband settles a trust for the benefit of wife and children. However, if wife settles a trust, then only the children will be a beneficiary, not the husband. This approach centers around drafting the trusts so that they break the second prong of the *Grace* test, the settlors are not left in the same economic position.[8] As noted in part III of this series, this is a half of loaf approach. Trust property from only one trust may be brought back into the family unit.

Some of the more daring estate planners will attempt to break the reciprocal trust doctrine by designing around the interrelated factor. There is little authority on just how one breaks the substantially identical factor of the interrelated test since *Grace*. Many planners will be a little reluctant to rely on one PLR that appears to not have any substantial differences in it. Conversely, if the trusts contain real substantial differences as detailed in this LISI, many planners may conclude that the substantially identical factor should be broken. More aggressive planners may well note that *Grace* states that the drafter need only make the trusts so that they are not substantially identical. These planners may conclude that drafting trusts with fundamental differences is overkill and not necessary.

Finally, the truly thrill seekers of the estate planning community might state the following, "So what if you have created reciprocal trusts. All that means is that they are treated as self-settled. It does not mean that they are automatically included in the settlors' estates." When applied to a domestic asset protection trust, these thrill seekers could be correct. Depending upon a number of factors a domestic asset protection trust might not be included in the settlor's estate. However, the same is probably not true for reciprocal trusts. Hence the subject of my next LISI in this series – Reciprocal Trusts and Domestic Asset Protection Trusts – Estate Inclusion Issues.

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

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

[3] It should be noted that distributions were limited to "any amounts of income or principal as is necessary or advisable for their health, education, maintenance, or support," and that the son's needs needed to be satisfied before any distributions were made to a parent.

[4] Most of the reciprocal trust cases with reciprocal beneficiaries prior to *Grace* contained identical terms. However, in *Estate of Carter*, 311 TC 1148 (1959) the court noted, "The trust agreements contained identical provisions with respect to many of the powers of the trustee, the treatment of income received by the trust, and the property the trust funds might be invested." In this Tax Court case, the court does not seem too concerned that the trust terms need to be substantially identical. However, this case was decided before *Grace.*

[5] IRC § 6110(k)(3).

[6] 251 F.3d 1168 (8th Cir. 2001).

[7] 282 F.3d 575 (8th Cir. 2002).

[8] When using this approach, please remember to address any possible reciprocal trustee issues.