

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1275

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From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: Expansion of the Reciprocal Trust Doctrine

Expansion of the Reciprocal Trust Doctrine to Reciprocal Trustees and Reciprocal Gifts

The Doctrine of Reciprocal Trusts – Part II

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law 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*. 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/HotofthePress.htm>).

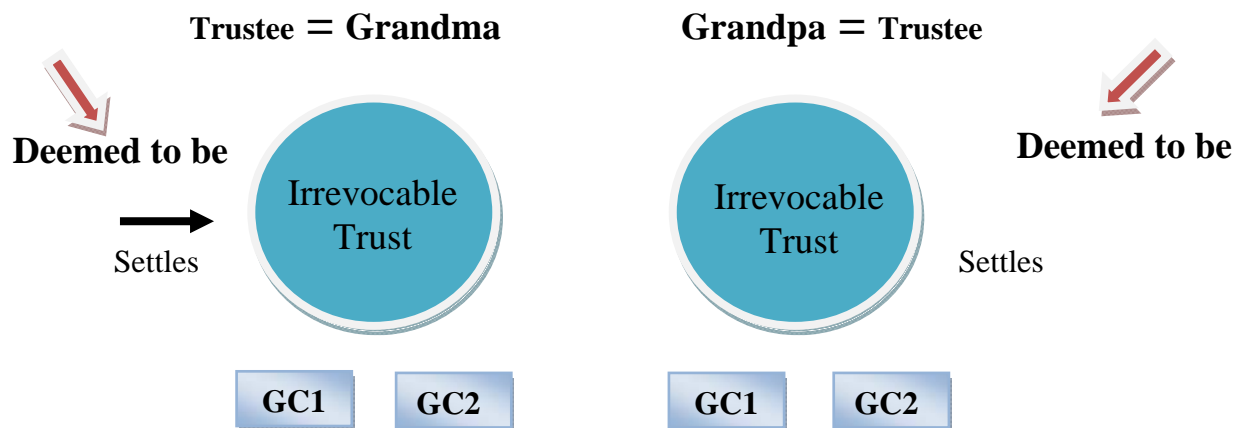
EXECUTIVE SUMMARY:

My last **LISI** ([Estate Planning Newsletter # 1271](#)) delineated the two prong test under the U.S. Supreme Court decision in *Grace*^[2] that must be met to invoke the doctrine of reciprocal trusts: (1) the trusts leave the settlers in the same economic position; and (2) the trusts are interrelated. Some planners would instantly look at the factors in determining whether the trusts are interrelated and focus primarily on drafting around the “substantially identical terms” factor. However, before addressing the drafting issues and whether a planner may break the second prong of the *Grace* test, an estate planner should review how the doctrine of reciprocal trusts has expanded into the areas of reciprocal trustees and reciprocal gifts, which affects the first prong of *Grace*. An estate planner must know what being “left in the same economic position” means.

The holding from *Grace* states,

“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.”

Estate of Bischoff^[3] Using the above diagram, in Bischoff, the Service was successful with the reciprocal trustee argument, resulting in grandpa being deemed as the settlor of the trust that grandma settled, and grandma being deemed as the settlor of the trust that grandpa settled (see diagram below). Bischoff also had the same partnership interests in a business transferred to the trusts.



As noted in the previous [LISI](#), the holding that trusts are reciprocal, does not automatically result in the equivalent value of each trust being included in the deemed settlor’s estate.

Rather, the second step in determining whether there is a basis for estate inclusion must be analyzed. *In Bischoff*, after application of the reciprocal trust doctrine, grandpa can now make discretionary distributions from a trust he was deemed to have settled, and the same is true for grandma. Under IRC § 2036(a)(2), if the settlor can make the decision of who receives a distribution and it is not limited by an external (e.g. ascertainable)^[4] standard, the trust is included in the settlor’s estate. Under IRC § 2038, if the settlor can alter the timing or manner or enjoyment of a beneficial interest^[5], the trust is included in the settlor’s estate.

This was the final holding in *Bischoff* – the trust settled by grandma was brought back into grandpa’s estate and the trust settled by grandpa was brought back into grandma’s estate, even though neither grandpa or grandma held a life interest in either trust.

Exchange Bank & Trust v. U.S.^[6]

In *Exchange Bank & Trust v. U.S.*, the Court of Appeals followed the *Bischoff* rationale in holding that

“Nowhere in Grace can we find the requirement that the transferors retain a substantial economic interest in order for the reciprocal trust doctrine to apply.”

In other words, the Circuit Court of Appeals endorsed the concept that reciprocal beneficiaries were *not* required for application of the reciprocal trust doctrine.

It should be noted that *Exchange Bank* dealt with transfers to Uniform Gift to Minor Accounts. However, such cases are properly analyzed as trust cases with the Custodian deemed the trustee. Also, the settlors transferred the same property into the UGMA accounts, and interest in Fishhawk Ranch, Inc. that was later exchanged for Continental Oil shares.

Estate of Green^[7]

In *Estate of Green*, grandma transferred property to trust for grandchild 1, and grandpa transferred property in trust to grandchild 2. Grandpa was the appointed trustee of the trust that grandma settled, and grandma was appointed trustee of the trust that grandpa settled. The Sixth Circuit court disagreed with the holding in *Estate of Bischoff* that *Grace* did not require that the settlors held an economic benefit. It held

“the settlor/trustee retained fiduciary powers to reinvest income and time distribution of trust income and corpus until the beneficiaries reach 21 years of age do not constitute a retained economic benefit that satisfies the core mandate of Grace ‘that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been had they created trusts naming themselves as life beneficiaries.’” Citing *Grace*.

The case does not mention whether the settlors in *Green* contributed the same assets.

The Service Has Not Conceded the Reciprocal Trustee Issue

Since *Green*, it is uncertain how diligent the Service will pursue a reciprocal trustee issue. Reciprocal trustees were present in *Estate of Levy*, PLR 9643013, and PLR 200426008. However, the Service did not discuss the issue. In *Levy*, the facts and whether the trusts were reciprocal were stipulated by the parties. Under the stipulation, the outcome of the case depended on whether an SPA was valid under New Jersey law. Therefore, the Tax Court did not address the reciprocal trustee issue. The *Levy* case will be discussed in detail in the next installment of this LISI series. Therefore, the *Levy* case as well the above two PLRs may be distinguished from a pure reciprocal trustee case.

In PLR 9643013, the Service may not have discussed the issue for two reasons. First, this PLR may be distinguished from a true reciprocal trustee case, because there were independent distribution trustees, and husband and wife were merely management trustees. Separate assets were contributed to the trusts. In order for a reciprocal trustee doctrine to apply, it appears that one would need to retain control as trustee over the same type of assets transferred. When separate assets are contributed, this would not be possible.

In PLR 200426008, husband and wife contributed separate assets. Therefore, it appears that the doctrine of reciprocal trustees did not apply. On the other hand, in PLRs 200748008, 200748011, 200748012, 200748013, and 200748016, the Service still considered the issue of reciprocal

trustees. However, that time the Service noted it did not apply to the facts under these PLRs because the husband and wife were not trustees of trusts that each one settled. While these PLRs do not provide any discussion of the reciprocal trustee issue, because it did not remotely apply, they do confirm that the Service has not abandoned the reciprocal trustee theory.

What if the distribution standard was limited by an ascertainable standard? Bischoff dealt with a discretionary distribution standard not limited by an ascertainable standard. Therefore, once the doctrine of reciprocal trustees applied, the equivalent value of each trust was included in each settlor's estate. In *Exchange Bank*, the equivalent value of each UGMA account was included in the parent's estate. The *Exchange Bank* Court noted that a parent had an obligation of support for a minor child, and therefore, all courts had held when a parent creates an UGMA (or UTMA) account and appoints himself or herself as custodian such UGMA (or UTMA) is included in the parent's estate. Fortunately, should the beneficiary of the UGMA (or UTMA) live past the age of majority, there is no inclusion issue in the parent's estate.^[8]

Some planners have suggested a planning technique where the husband creates a trust for his wife and children and the wife does the same for the husband. The distribution standards in both trusts are limited to an ascertainable standard. As previously stated, when a parent creates a trust for the support of his child who is a minor and the parent passes away before the age of the child's majority, there the trust is included in the parent's estate. A similar estate inclusion issues arises when a husband or wife creates an inter vivos trust for the benefit of his or her spouse, because both a husband and his wife have a support obligation for their spouse^[9] Therefore, extreme care in drafting the distribution standard needs to be observed to avoid this estate inclusion issue that is independent of the reciprocal trustee issue estate inclusion.

Synthesis

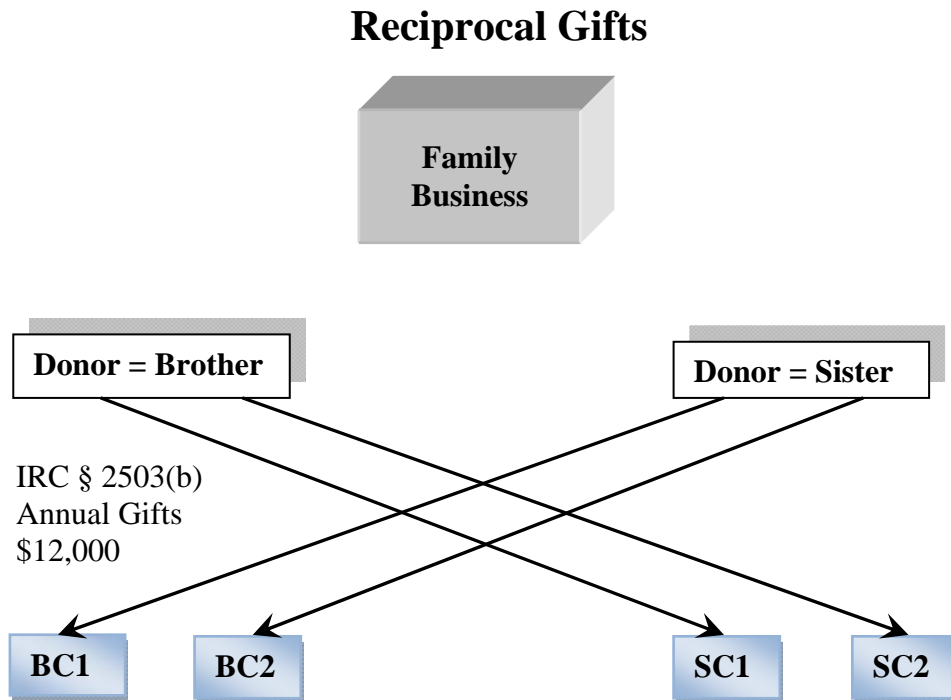
While the Sixth Circuit in the *Estate of Green* held that the reciprocal trust doctrine should only apply where the settlors retained some type of life or economic interest in the trust, the Tax Court, the Court of Appeals, and Eight Circuit (discussed in the following reciprocal gift cases) apparently have completely deleted the "life interest" or economic interest from the Supreme Court decision in *Grace*. Further, in the 2007 PLRs, the Service has continued to articulate the concept of reciprocal trustees.

II. Reciprocal Annual Gifts Under IRC §2503(b)

At first, one might wonder why a discussion of reciprocal gifts is included in a reciprocal trust article. The justifying reason is that it shows the trend of the courts to continue to expand the concept of reciprocal trusts by not requiring that the donor retain a life interest to meet the first prong of the *Grace* test.

In the reciprocal gift cases, brothers and sisters wished to transfer the family business to the next generation. Rather than using applicable exclusions and making gifts of business interests to irrevocable trusts, GRATs, or IDITs under a comprehensive estate plan, the brothers and/or

sisters used the simplistic approach of making annual IRC § 2503(b) gifts to their children, and their sibling's children as diagrammed below.



Sather v. Commr.^[10]

In Sather, the Eighth Circuit (quoting language from Exchange Bank) held that the reciprocal trust doctrine was “a variation of the substance over form concept.” Later in the opinion, the Sather Court stated,

“We do not believe that the Supreme Court [referring to Grace] meant to limit the doctrine to cases involving life estate trusts, or even to cases where the donor retains an economic interest, but used the language in the specific facts of the case.”

After Sather, the Eight Circuit, similar to the Tax Court in Bischoff and the Court of Appeals in Exchange Bank, completely deleted any notion that the donor retains a life interest. In essence, the Eighth Circuit held that it was wrong for four brothers as part of a planning process to make gifts to the sibling's children and avail themselves of the annual exclusions. This conclusion was justified under the “reciprocal trust doctrine.”

It should be noted that one brother did not even have children hence there was no possibility of reciprocity, which the court found as immaterial.

Estate of Schuler^[11]

In Estate of Schuler, a case involving two brothers who had made reciprocal gifts as part of a planning process, the Eighth Circuit again reached the same conclusion. The annual gifts were not permitted based on its on definition of expanding the reciprocal trust standard. The Schuler Court stated,

“The application of the reciprocal trust doctrine is not limited only to identifying the true transferor or transferee, but also applies to determining the nature of the property transferred.”

CONCLUSION:

Since Grace, the doctrine of reciprocal trusts has been expanded to include both reciprocal trustees and reciprocal gifts. Under the Service’s position with both reciprocal trustees and reciprocal gifts, there is no requirement that the donor (e.g., settlor) retain a life interest under the first prong of Grace.

As applied to the reciprocal trustee doctrine, the Seventh Circuit has rejected the Tax Court position and the Court of Appeals position that a life or economic interest was not required.

Since the issue of reciprocal trustees is unsettled, I would suggest taking the conservative road, and simply not appointing reciprocal trustees, rather than trying to draft out of the issue with the distribution language.

TO BE CONTINUED...

The next installment of this series discusses how some estate planners have attempted to break the interrelated prong of the identical trust factor by including a special power of appointment in one trust, but not the other and citing to the case Estate of Levy^[12]

As discussed in this upcoming installment Levy may be one of the most frequently miscited cases.

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] *U.S. v. Grace*, 395 U.S. 316 (1969).
- [3] 69 T.C. 32 (1977).
- [4] Most practitioners use the term “ascertainable standard” from IRC § 2041 interchangeably with the term “external standard” created by case law under IRC § 2036 and § 2038 as well as the grantor trust term of “reasonably definite standard.” The case cites for the external standard are *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Hurd v. Comm’r*, 160 F.2d 610 (1st Cir. 1947).
- [5] Treas. Reg. 20.2038-1(a)
- [6] 694 F.2d 1261 (Fed Cir. 1982).
- [7] *Estate of Green*, 68 F.3d 151 (6th Cir. 1995).
- [8] Rev. Rul. 79-154; *Townsend v. Thompson*, 50-2 USTC P 10,780 (W.D. Ark. 1950).
- [9] *Commr. V. Dwight’s Estate*, 205 F.2d 298 (2nd Cir. 1953); *First Ntl. Bank of Montgomery v. U.S.*, 211 F. Supp. 403 (D. Ala. 1962); and *Est. of Stephen L. Richards*, TC Memo 1965-263.
- [10] 251 F.3d 1168 (8th Cir. 2001).
- [11] 282 F.3d 575 (8th Cir. 2002).
- [12] T.C. Memo 1983-453.