Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1271

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From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: Can Husband Create Irrevocable Trust For Benefit of His Wife and Visa Versa?

Can Husband Create Irrevocable Trust For Benefit of His Wife and Visa Versa?

The Doctrine of Reciprocal Trusts – Part I

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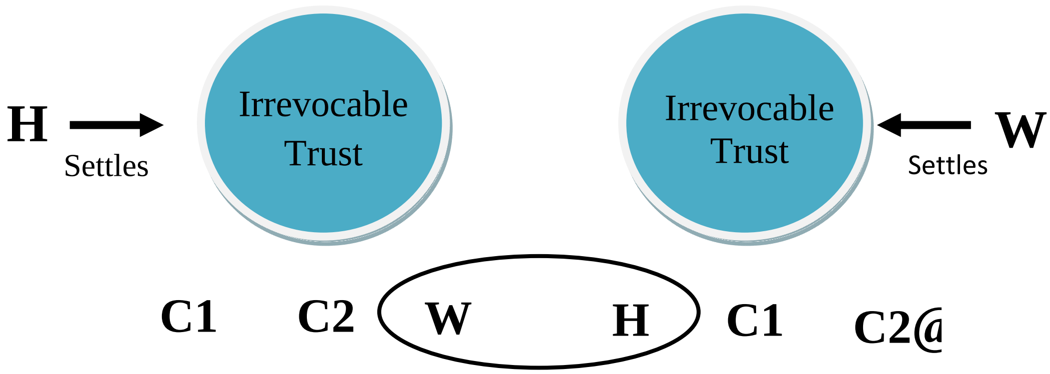
This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.™ [1]

EXECUTIVE SUMMARY:

Suppose a husband creates an irrevocable trust and names the couple's children and the grantor's wife as beneficiaries. Assume at some later date, the wife creates an irrevocable trust and names their children and her husband as the beneficiaries. Suppose that, should either husband or wife need the property gifted to the trusts, depending on the distribution terms, all or part of the trust property may be distributed back to them or, if the property is not needed by husband or wife, it then would pass pursuant to the terms of the trust, free from estate tax. Is this type of estate planning too good to be true?

Many estate planners take the position that this result *is* too good to be true and claim such planning violates the doctrine of reciprocal trusts. Conversely, other estate planners claim that one may draft *out* of the pitfalls of the doctrine of reciprocal trusts. This series of **LISI** commentaries analyzes almost all of the cases and private letter rulings on reciprocal trusts since *Estate of Grace*, discusses some methods that planners have articulated that might possibly avoid reciprocal trust problems, and furthermore comments on how grey this planning area may well be.



Reciprocal Beneficiaries

FACTS:

I. HISTORY OF RECIPROCAL BENEFICIARIES

The idea of using reciprocal beneficiaries to avoid estate tax and still have access to the gifted property is not new. In fact, it was utilized shortly after the estate tax was passed in the twentieth century. The concept is relatively straight forward: if each spouse creates a trust where the *other* spouse retains a beneficial interest before a large estate develops, for many clients, the estate tax could be completely avoided. All couples or even brothers and sisters would merely create reciprocal trusts for the benefit of each other and their descendants. Naturally, the Internal Revenue Service did not allow such tactics to go unchecked and began to assert the case law doctrine of "reciprocal trusts."

The First Case

The first reported case regarding reciprocal trusts reached the Second Circuit Court in 1940. In *Lehman v. Commr.*,[2] there were two brothers, and each brother settled a trust for the other brother and his descendants. The court listed the following three stipulations when determining that the trusts *were* reciprocal and therefore would result in estate tax inclusion:

1. the parties were left in the same economic position they were before the trusts were established because each brother created a trust for the other brother and his descendants;

2. there was a similarity of trust provisions (i.e. the trusts were interrelated); and

3. there was a quid pro quo (i.e consideration) for each brother to create a trust for the other brother.

The last stipulation required by the Second Circuit made it particularly troublesome for the Service to win in reciprocal trust cases. The Service would have to prove *intent* of the parties to prove that there was an agreement in which one party created a trust as consideration for the other party creating a trust, in other words a "quid pro quo."

SPLIT BETWEEN CIRCUITS:

The Court of Claims followed the Second Circuit in requiring a "quid pro quo" for the doctrine of reciprocal trusts to apply. However, the Seventh Circuit and the Third Circuit had only *two* requirements: (1) the parties were left in the same economic position; and (2) the trusts were interrelated. [3]

While these cases did not provide a precise definition for the term "interrelated," in general terms, it meant some combination of the following factors were present:

1. The trusts were created at approximately the same period of time (i.e. part of the same plan);
2. The trusts had substantially identical terms;
3. The trusts had the same trustee; and
4. The trusts were funded with the same assets.[4]

SPLIT RESOLVED – *U.S. V. GRACE*

To resolve the conflict between circuits, the Supreme Court held in *U.S. v. Grace* [5] that the trusts only need to be (1) interrelated and (2) creation of the trusts put them in the same economic position (reciprocal beneficiaries).

The Supreme Court held the Service did <u>*not*</u> have to prove that there was a quid pro quo when the trusts were created. In *Grace*, the following factors were specifically mentioned indicating that the trusts were interrelated:

1. Created at the same time (i.e. pursuant to a plan); and
2. Substantially identical terms.

Many estate planners misconstrue the notion of "trust creation at the same time". These planners will have husband settle an irrevocable trust in the current year, and in the next year the wife will settle an irrevocable trust. As explained in the case law, the *real* factor is whether the trusts were created pursuant to the same *plan*.

A distance in time such as a couple of years provides some evidence that the trusts were not part of the same plan.

However, if prior to the husband settling the first trust, the estate planner created one of those beautiful Viso diagrams showing that both trusts would be formed as part of the same estate plan, then the fact that the trusts were created one to two years apart would probably have little bearing. The factor of creating the trusts as part of the same plan would be met.

After *Grace*, many planners began to speculate: were there now only *two* factors to show that the trusts were interrelated? The third factor from prior case law regarding the same trustee was not discussed in the Supreme Court's opinion. However, identical trustees were present in *Grace*.

On the other hand, the fourth factor from prior case law was missing - the husband and wife did not fund the trusts with the same assets as in *Grace.* While *Grace* holds that only *two* factors are needed to prove the trusts are interrelated, subsequent case law appears to allow *other* factors to also conclude that trusts are interrelated.

II. RECIPROCAL TRUST (BENEFICIARY) CASES AFTER *GRACE*

It should be noted, that there have not been many reciprocal *beneficiary* cases since *Grace*. Most of the cases that have followed *Grace* appear to be the Service seeking an expansion of the reciprocal trust doctrine into the area of reciprocal trustees and reciprocal gifts. However, there are two to three cases that have exemplified reciprocal beneficiary cases since *Grace.*

In *Krause,*[6] the Seventh Circuit followed *Grace* and held that trusts with reciprocal beneficiaries were interrelated because

(1) the trusts were created on the same day (i.e. part of the same plan);

(2) the trusts contained substantially identical provisions; and

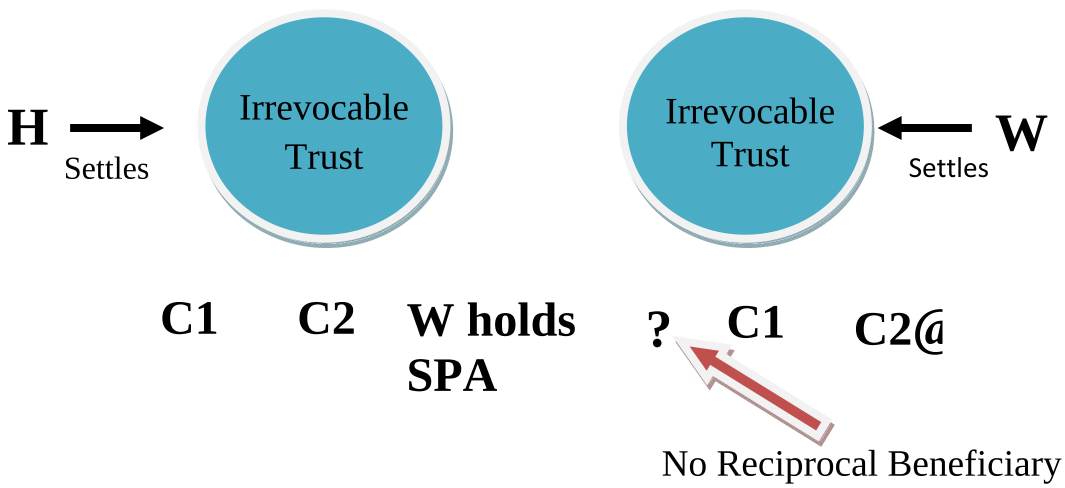
(3) the trusts named the same trustee.

The first two determinative factors from *Grace* are met in *Krause.* However, *Krause* listed the third factor from prior case law of identical trustees, as a *further* reason to hold that the trusts were reciprocal.

The second case since *Grace* was *Exchange Bank & Trust.*[7] When listing the factors to meet "interrelated" prong, the Court of Appeals *expanded* the literal language of *Grace*, stating that the reciprocal trust doctrine was in essence a "substance over form" argument. This would imply that the doctrine of reciprocal trusts could well be applied *outside* of the two *Grace* requirements needed to prove that the trusts were interrelated.

Furthermore, the *Exchange Bank & Trust Cour* [8] referred to the fourth factor under prior case law, to determine whether the trusts were interrelated: where the same asset was contributed to both trusts.

The third case, *Estate of Lev*[9], is frequently cited as authority that one might easily break the interrelated factors by merely including a special power of appointment in *one* trust, but not in the *other* trust. By doing so, some estate planners claim that the trusts are not substantially identical.



I disagree with the statement that a special power of appointment - by itself - would sufficiently distinguish the trusts so that the trusts were not substantially identical.

However, there is a much greater error that many planners make when relying on *Levy*. As will be discussed in detail in the third **LISI** installment, *Levy* was not a reciprocal beneficiary case. Only the *wife* could bring assets back into the family unit through a special power of appointment. There was no reciprocal provision for the *husband* to do the same. In this respect, the first prong of *Grace* was broken, the husband and wife were *not* in the same economic position.

III. SYNTHESIS OF THE ABOVE CASES

Grace provides the following two prong test where both of the following tests must be met for the doctrine of reciprocal trusts to apply:

(1) The settlers must be left in the same economic position (e.g., reciprocal beneficiaries); and

(2) The trusts must be interrelated.

When determining whether the trusts are interrelated, cases subsequent to *Grace* still appear to use the following same four factors as articulated by the cases prior to *Grace*:

(1) created under the same estate plan;

(2) substantially identical terms;

(3) the same trustee is appointed on both trusts; or

(4) the trusts are funded with the same assets.

Before *Grace,* it was uncertain if one factor might carry more weight than another, however, under *Grace* the first two factors when combined proved to be fatal.

COMMENT:

Planners may prevent the doctrine of reciprocal trusts from applying by breaking *either* one of the two prongs articulated in *Grace:* (1) the settlers are left in the same economic position and (2) the trusts are interrelated.

However, if planners want clients to have the ability to have all of the assets distributed back to the family unit, breaking the first prong reciprocal beneficiaries would only accomplish half of the planner's goal. The assets from one trust would be available to be distributed back to the family unit, but the same would not be true for the assets of the second trust. Therefore, the more aggressive estate planners seek to find ways to break the *second* prong - interrelated trusts.

In our next installment of this series, I'll discuss how the doctrine of reciprocal trusts has possibly been expanded to include reciprocal trustees and moreover to include reciprocal gifts.

I'll then discuss the four factors of interrelated trusts. When this **LISI** series is concluded, we will have discussed almost all the reciprocal trust cases since *Grace* as well as the PLRs, and then you, as an estate planner, can decide how "grey is grey" when you attempt – if you dare - to draft around the doctrine of reciprocal 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] 109 F.2d 99 (2nd Cir. 1940).

[3] *McLain v. Jarecki*, 232 F.2d 211 (7th Cir. 1956); *Newberry's Estate v. Commr.*, 201 F. 2d 874 (3rd Cir. 1953); *In re Lueder's Estate*, 164 F. 2d 128 (3rd Cir. 1947); *Moreno's Estate*, 260 F.2d 389 (8th Cir. 1958).

[4] *Id*.

[5] 395 U.S. 316 (1969).

[6] 497 F.2d 1109 (7th Cir. 1974); 57 TC 890 (1972).

[7] *Exchange Bank & Trust v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1982).

[8] Please note that some authors consider this solely a reciprocal trustee case, which will be defined and discussed on the next installment of the Doctrine of Reciprocal Trusts LISI. On the other hand, the Sixth Circuit classified it as a reciprocal beneficiary case, because the settlors could discharge a legal obligation with the crossed trusts. *Estate of Green*, 68 F.3d 151 (6th Cir. 1995).

[9] T.C. Memo 1983-453.