By Bruce D. Steiner & Martin M. Shenkman

Beware of the Reciprocal Trust Doctrine

If not set up properly, a popular strategy could backfire

Many clients are planning to make large gifts before the end of 2012, to take advantage of what may be a fleeting opportunity to do so without incurring any gift tax. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[1] temporarily increased the gift tax exemption from $1 million to $5 million in 2011 and $5.12 million in 2012.[2] The gift tax exemption is scheduled to revert to $1 million in 2013. Unless Congress acts in 2012 to continue the current exemption, the end of 2012 will likely bring a stampede of clients seeking to capitalize on it before it reverts to $1 million in 2013.

To take advantage of the increased gift tax exemption, married clients may want to set up reciprocal trusts, in which the husband gives up to $5.12 million to a trust for the benefit of his wife and issue, and the wife gives up to $5.12 million to a trust for the benefit of her husband and issue. However, when applying what's known as the reciprocal trust doctrine," courts often end up "uncrossing" the trusts. The doctrine states that if a husband creates a trust for his wife, and the wife creates a nearly identical trust for the husband, then the two trusts may be "un-crossed" and treated for tax purposes as if each spouse had created a trust for himself or herself.[3]

Here's how courts have ruled on attempts to set up reciprocal trusts and some advice on how to avoid the reciprocal trust doctrine.

Gift Splitting

The wealthiest clients can give $5.12 million (or $10.24 combined for a husband and wife) to (or more likely in trust for) their children and grandchildren.[4] However, high-net-worth clients may not be comfortable making such large transfers, because they might need the assets someday. If so, one or both of the spouses may create trusts in an asset protection jurisdiction, so that the transferor can remain a discretionary beneficiary.[5]

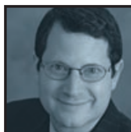
One possibility is for the client to create a trust for the benefit of his spouse and issue, give $10.24 million to that trust, and elect gift splitting.[6] This type of trust is essentially a credit shelter or bypass trust, except that it's created during life rather than at death. However, it's not clear that gift splitting is available for such a gift.[7] Gift splitting requires that the gift be to a person other than the donor's spouse.

A donor making modest gifts to a trust for the benefit of his spouse and issue may be willing to take the risk that gift splitting won't be allowed. However, a donor giving $10.24 million to such a trust shouldn't be willing to take that risk. If gift splitting isn't allowed, only $5.12 million of the gift will be covered by the donor's exemption, resulting in $1.792 million of gift tax at the 35 percent 2012 gift tax rate.

Reciprocal Trust Doctrine

The issue of reciprocal trusts first arose in *Lehman v. Commissioner*.[8] In *Lehman*, two brothers each created two trusts for the other. Each trust provided for income to the grantor's brother, gave the grantor's brother the right to withdraw $75,000 and provided that the remainder would go the grantor's issue. When the first brother died, the U.S. Court of Appeals for the Second Circuit uncrossed the trusts and held that the $150,000 that the decedent could have withdrawn from the trusts created by his brother was includible in the decedent's estate.[9]

As the doctrine evolved, there was a conflict among the lower courts as to whether the parties' motives were



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relevant. The Supreme Court resolved that issue in *United States v. Grace*.[10] In *Grace*, the decedent created a trust in which his wife received the income, the trustees had discretion to distribute principal to the wife and the wife had a testamentary special power of appointment (POA) in favor of her husband and the couple's issue. Two weeks later, the wife created a mirror image trust. The Supreme Court extended *Lehman*, holding that the reciprocal trust doctrine applies where the trusts are interrelated, "and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been if they had created trusts naming themselves as life beneficiaries."[11] The motive for creating the trusts wasn't relevant.

Post-*Grace* Rulings

The trend subsequent to *Grace* has been favorable for taxpayers. However, there's still a risk of the Internal Revenue Service and courts uncrossing reciprocal trusts. Importantly, there's never been a time in the history of the transfer tax system in which so many taxpayers were motivated to make such large gifts in trust as the remainder of 2012.

In *Estate of Bruno Bischoff*,[12] a husband created trusts for each of his four grandchildren, with his wife as trustee. The trustee was authorized to apply income and principal for the benefit of the beneficiary or to accumulate the income. Each trust ended when the grandchild reached age 21. The wife created identical trusts the next day, with identical assets and her husband as trustee. The Tax Court uncrossed the trusts and held that the retained powers were within Internal Revenue Code Sections 2036(a)(2) and 2038(a)(1), such that the value of the trusts each spouse created was includible in their respective estates.

Estate of Green v. United States[13] is similar to *Bischoff*. In *Green*, a husband and wife each created trusts for each of their grandchildren. Each trust ended when the grandchild reached age 21. Each was the trustee of the trust the other created, and the trustee had the power to distribute the income and principal or to accumulate the income. However, the Sixth Circuit rejected *Bischoff*, holding that

> 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. '[T]hat the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts, naming themselves as life beneficiaries.'[14]

Reciprocal transfers that are outright and not in trust can also be uncrossed.

In *Estate of Herbert Levy*,[15] a husband and wife each created a trust with identical assets, on the same day. Each was the trustee of the trust the other created. The couple's son was the residuary beneficiary of both trusts. However, the husband gave the wife the broadest possible special POA, exercisable during lifetime, in favor of anyone but herself, her creditors, her estate or the creditors of her estate. The wife didn't give the husband a similar power. The Tax Court, citing *Grace*, said that, as a result,

> decedent and his wife had markedly different interests in, and control over, the trusts created by each other. The reciprocal trust doctrine does not purport to reach transfers in trust which created different interests and which change 'the effective position of each party vis a vis the [transferred] property.'[16]

In Private Letter Ruling 9643013 (July 19, 1996), a husband created a trust for the benefit of his issue, and his wife created a trust for the benefit of her husband and issue. Each spouse was a trustee of the trust the other created, together with a co-trustee (the same person in each case), who had the sole power to make discretionary distributions. The husband had a special POA over the trust the wife created, exercisable during his lifetime prior to Jan. 1, 2022, or by his will, in favor of his wife's issue and their spouses. The wife didn't have a special POA over the trust the husband created. The IRS held that, in view of the differences between the trusts, they weren't reciprocal.

Mandating distributions severely limits the flexibility of the trust.

In PLR 200426008 (March 10, 2004), a husband and wife created insurance trusts. Each was the trustee of the other's trust. In the trust the husband created, the wife had a special POA and limited withdrawal powers after her son's death. Furthermore, there were limitations on the ability to make distributions to the husband out of the trust the wife created. The IRS, citing *Grace* and *Levy*, held that the trusts weren't reciprocal.

Reciprocal Powers

Sometimes it's the taxpayer who wants trusts to be treated as reciprocal. In *Matter of Spear*,[17] the decedent died on Jan. 5, 1988, leaving a will dated June 22, 1987. He left cash bequests to his three grandchildren and left his residuary estate in trust for two grandsons, Jeremy and Jonathan, with the principal payable in stages ending at age 50. If a grandson died before age 50, the balance of his trust was payable to his issue or, if none, to his brother, if living, or, if not, to his brother's issue. Jeremy and Jonathan were the trustees of each of their trusts. They were both in their 20s, and neither of them had any issue.

Three weeks before the decedent died, his brother died and left him more than $1 million.[18] In addition, earlier in 1988, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA)[19] was enacted. TAMRA made it clear that for a transfer in trust for a grandchild to qualify for the *Gallo* exclusion,[20] (that is, the exclusion of the $2 million per grandchild for certain transfers made before Jan. 1, 1990, to or in trust for a grandchild), the trust had to be included in the grandchild's estate. Although each grandson couldn't exercise the discretionary power of invasion in his own favor, the executors argued that the reciprocal invasion power invites a trade and is tantamount to a general POA. The court agreed, noting that it had the power to provide direction when tax decisions must be made and there's a conflict of interest and directed that the trustees were required to exercise that power and vest the trusts in themselves. As a result, the court directed that the funds continue to be held in trust subject to each grandson's having a general POA if he died before age 50.

Shortly after the decision in *Spear*, the IRS issued PLR 9235025 (May 29, 1992), which involved a testator who died on Aug. 8, 1990, leaving his residuary estate in separate trusts for his two children. Each child received the income of his trust and had a special testamentary POA exercisable in favor of the testator's children and grandchildren. Both children were the trustees of each of their trusts. One child died on April 6, 1991. The deceased child's executors sought a ruling that each child's power to distribute principal to the other for his "support, maintenance, comfort, emergencies and serious illness" constituted a general POA.[21] After concluding that the standard for distribution wasn't ascertainable, the IRS, citing *Grace* and *Spear*, uncrossed the trusts and held that the deceased child had a general POA over the principal of his trust, so it was includible in his estate.

Outright Reciprocal Transfers

While the discussion of reciprocal transfers mainly arises in the context of trusts, reciprocal transfers that are outright and not in trust can also be uncrossed. For example, in a situation in which each of two brothers made gifts both to his own children and to his brother's children, each brother's gifts to his nieces and nephews were treated as if made to his own children.[22] Similarly, in a situation in which a husband and wife made gifts to each other as custodians for their minor children under the Uniform Gifts to Minors Act, and the husband died, the property held by him as custodian for his minor

children was included in his estate.[23]

Avoiding Reciprocal Trust Doctrine

There's no clearly defined line or safe harbor as to what constitutes a sufficient difference between two trusts to avoid the reciprocal trust doctrine. Therefore, to avoid the reciprocal trust doctrine, the best approach is to make the trusts as different as is practicable under the circumstances. Here are some suggested methods for differentiating the trusts:

1. Draft the trusts pursuant to different plans. A separate memorandum or portions of a memorandum dealing with each trust separately may support this.

2. Don't put a husband and wife in the same economic position following the establishment of the two trusts. For example, a husband could create a trust for the benefit of his wife and issue, and a wife could create a trust for the benefit of her issue, in which her husband isn't a beneficiary. Or, one spouse could be a beneficiary of the trust he creates, if the trust is formed in an asset protection jurisdiction such as Alaska, Delaware, Nevada or South Dakota, and the other spouse could create a trust in which he isn't a beneficiary (that is, a trust that's not a domestic asset protection trust). Also, note that even if the trusts are uncrossed, it may be possible to avoid the consequences of the reciprocal trust doctrine by creating the trusts in an asset protection jurisdiction.[24]

3. Use different distribution standards in each trust. For example, one trust could limit distributions to an ascertainable standard, while the other could be fully discretionary. However, limiting distributions to an ascertainable standard reduces flexibility, may prevent decanting and may expose the trust assets to a beneficiary's creditors.

4. Use different trustees or co-trustees. If each spouse is a trustee of the trust the other spouse creates, add another trustee to one or both trusts. If adding another trustee to each trust, consider adding a different trustee for each trust and using different institutional trustees.

5. Give one spouse a noncumulative "5 and 5" power, but not the other. This power permits the holder to withdraw up to the greater of $5,000 or 5 percent of the trust principal each year. The amount the powerholder could have withdrawn at the time of death is includible in his estate. However, the lapse of the power, not in excess of the greater of $5,000 or 5 percent of the trust assets each year, isn't considered a release of the power includible in the powerholder's estate[25] or a taxable gift.[26] However, this power may expose assets of the trust to the powerholder's creditors.

6. As in *Levy* and PLR 9643013, give one spouse a special POA, but not the other. However, the absence of a POA reduces the flexibility of the trust. This might be viewed as particularly significant in light of the continued estate tax uncertainty.

Contributing different assets may not negate the application of the reciprocal trust doctrine.

7. Give one spouse the broadest possible special POA[27] and the other spouse a special POA exercisable only in favor of a narrower class of permissible appointees, such as issue or issue and their spouses.

8. Give one spouse a POA exercisable both during lifetime and by will and the other spouse a POA only by will.

9. In the case of insurance trusts, include a marital deduction savings clause in one trust, but not the other. A marital deduction savings clause provides that if any property is included in the grantor's estate because the grantor dies within three years after transferring a policy on his life to the trust,[28] some or all of the proceeds of the policy are held in a qualified terminable interest property trust[29] or are payable to the surviving spouse outright. Alternatively, if each trust has a marital deduction savings clause, the provisions of the two could be different.

10. Create different vesting provisions for each trust. For example, the two trusts could mandate distributions at different ages or, in a state that has repealed or allows a transferor to elect out of the rule against perpetuities, one trust could be a perpetual dynasty trust.

However, mandating distributions severely reduces the flexibility of the trust, throws the trust assets into the beneficiary's estate for estate tax purposes and exposes the assets to the beneficiary's creditors and spouses.

11. Instead of mandating distributions, give the beneficiaries control, or a different degree of control, at different ages. For example, the ages at which each child can become a trustee, have the right to remove and replace his co-trustee[30] and have a special POA could be different in each trust.

12. Vary the beneficiaries. For example, one spouse could create a trust for the spouse and issue, and the other spouse could create a trust just for the issue. Note that if, for example, a husband creates a trust for his wife and their first child, and the wife creates a trust for her husband and their second child, the gifts could still be viewed as reciprocal.[31]

13. Create the trusts at different times. In *Lueders' Estate v. Comm'r*,[32] a husband and wife each created a trust and gave the other the power to withdraw any or all of the trust assets.[33] Inasmuch as the trusts were created 15 months apart, the Third Circuit, in applying *Lehman*, held that there was no consideration or quid pro quo for the transfers. However, it should be noted that *Lueders* preceded *Grace*, in which, while the trusts were created two weeks apart, the Supreme Court held that the motive for creating the trusts wasn't relevant. If the difference in time is a factor post-*Grace*, a short time might be sufficient in light of *Holman v. Comm'r*,[34] in which a gift of partnership interests six days after the formation of the partnership wasn't a step transaction.

The closer we get to the end of 2012 and the possible end of the $5.12 million gift tax exemption, the more difficult it will be to interpose any meaningful time difference between the formation of the two trusts. Practitioners should also bear in mind that if the same transaction includes funding a limited liability company (LLC) then making gifts to the trusts that are to qualify for fractional interest or other discounts, they will be dealing with the challenge of two dating issues: the difference between the trusts and the maturation period of assets in the LLC prior to gift or sale.

14. Contribute different assets to each trust, either as to the nature or the value of the assets. However, if the purpose is to contribute $5.12 million to each trust, it may not be feasible to contribute assets of different value and, in any event, varying the value of the trust only serves to reduce the amount to which the reciprocal trust doctrine may apply. Contributing different assets may not negate the application of the reciprocal trust doctrine, since the assets in a trust may be susceptible to change over time. However, if one trust is funded with illiquid assets or assets subject to contractual restrictions on sale (for example, operating agreement restrictions on transfer of interests in an LLC), that may be viewed as a more meaningful difference in assets that may not be susceptible to ready modification.

In many instances, the richer spouse may have to give assets to the poorer spouse so that he will have sufficient assets to fund a $5.12 million trust. Query whether the IRS will argue that some time must elapse between the gift to the poorer spouse and the gift by the poorer spouse, to avoid the step transaction doctrine.[35]

Endnotes

1. Public Law 111-312.
2. The exempt amount is in the form of a credit rather than an exemption. For convenience, it's referred to as if it were an exemption. The exempt amount is indexed for inflation for 2012, and the indexed amount is $5.12 million.
3. For a detailed discussion of the reciprocal trust doctrine, *see* Marc Merric, "The Doctrine of Reciprocal Trusts," *Steve Leimberg's Asset Protection Newsletter* #1271, 1275, 1282, 1332 and 1339 (2008); Cheryl L. Hader, "Planning to Avoid the Reciprocal Trust Doctrine," 26 *Estate Planning* 358 (October 1999); Elena Marty-Nelson, "Taxing Reciprocal Trusts: Charting a Doctrine's Fall from Grace," 75 *No. Car. L. Rev.* 1781 (1997).
4. For convenience, it's assumed that the donor and his spouse haven't previously made any taxable gifts. Of course, many clients who can afford to make large gifts will have previously made $1 million of taxable gifts, to take advantage of the $1 million gift tax exempt amount in effect from 2002 through 2010. For convenience, we've ignored the gift tax annual exclusion.
5. A grantor can be a discretionary beneficiary of a trust in an asset protection jurisdiction without the trust being included in the grantor's estate. Private Letter Ruling 200944002 (July 15, 2009); David G. Shaftel, "IRS Letter Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts," 112 *J. Taxation* 213 (April 2010); *see* Revenue Ruling 2004-64, 2004-2 C.B. 7.
6. Internal Revenue Code Section 2513(a) allows a husband and wife to consent to treat gifts to third parties as if made one-half by each spouse. All statutory references are to the IRC of 1986, as amended, unless otherwise indicated.
7. Stanley L. Wang, T.C. Memo. 1972-143; Max Kass, T.C. Memo. 1957-227; Rev. Rul. 56-439, 1956-2 Cum. Bull. 605.
8. *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940).

9. The transfers were made before the enactment of the predecessor of IRC Section 2036, under which a transfer with a retained income interest is includible in the gross estate.
10. *United States v. Grace*, 395 U.S. 316 (1969).
11. *Ibid.* at p. 324.
12. *Estate of Bruno Bischoff*, 69 T.C. 32 (1977).
13. *Estate of Green v. U.S.*, 68 F.3d 151 (6th Cir. 1995).
14. *Ibid.* at p. 154.
15. *Estate of Herbert Levy*, T.C. Memo. 1983-453 (1983). *See also* LISI *Estate Planning Newsletter* # 1282 (April 24, 2008) *www.leimbergservices.com.*
16. *Ibid.*
17. *Matter of Spear*, 553 N.Y.S.2d 9 (Surr. Ct. N.Y. Co. 1990).
18. In New York, an executor can disclaim a bequest with court approval. New York Estates, Powers and Trusts Law Section 2-1.11(d)(5). The opinion doesn't discuss whether the decedent's executors sought court approval to disclaim the bequest from his brother, and if not, why.
19. P.L. 100-647.
20. Under Section 1433(b)(3) of the Tax Reform Act of 1968 (Pub. L. 99-514), there was an exclusion of $2 million per grandchild for certain transfers to or in trust for a grandchild. This is commonly referred to as the *Gallo* exclusion. The *Gallo* exclusion was only available for transfers made before Jan. 1, 1990.
21. The deceased's child's taxable estate, but for this trust, may have been less than the estate tax-exempt amount, so that it may have been advantageous to have the trust included in the child's estate, rather than being subject to generation-skipping transfer tax at the child's death.
22. *Estate of Schuler v. Comm'r*, 282 F.3d 575 (8th Cir. 2002); *Schultz v. U.S.*, 493 F.2d 1225 (4th Cir. 1974); PLR 8717003 (Jan. 17, 1987).
23. *Exchange Bank & Trust Co. v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1982).
24. PLR 200944002 (July 15, 2009); David G. Shaftel, "IRS Letter Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts," *supra* note 5; *see* Rev Rul 2004-64, *supra* note 5.
25. IRC Section 2041(b)(2).
26. IRC Section 2514(e).
27. Under IRC Section 2041(b)(1), a general power of appointment (POA) is one that's exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate.
28. Under IRC Section 2035(a)(2), life insurance proceeds are included in the gross estate if the decedent transferred the policy or relinquished an incident of ownership within three years of death.
29. Under IRC Section 2056(a)(7), qualified terminable interest property is eligible for the marital deduction if the spouse has an income interest for life.
30. A grantor can retain the power to remove and replace the trustees without adverse estate tax consequences, provided the replacement trustee isn't a related or subordinate party within the meaning of IRC Section 674(c). Rev. Rul. 95-58, 1995-2 Cum. Bull. 191. By corollary, a beneficiary can be given this power.
31. *Sather v. Comm'r*, 251 F.3d 1168 (8th Cir. 2001).
32. *Lueders' Estate v. Comm'r*, 164 F.2d 128 (3d Cir. 1947).
33. The trusts in *Lueders* were created in 1930 and 1931. Under IRC Section 2041(a)(1), a general POA created on or before Oct. 21, 1942 isn't included in the estate unless it's exercised by will, or in a manner such that if it were a transfer of property owned by the decedent, it would be includible under IRC Sections 2035 through 2038.
34. *Holman v. Comm'r*, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).
35. *Linton v. U.S.*, 630 F.3d 1211 (9th Cir. 2011); *Holman, ibid.*