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Step-Transaction and Reciprocal Trust Doctrines: Planning Before 2026, or Earlier if Laws Change

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Introduction

The Tax Cuts and Jobs Act of 2017[1] is scheduled to sunset December 31, 2025, as a matter of current law, potentially resulting in significant changes to the estate and gift tax laws. One of the most relevant changes for estate planning practitioners is the reduction of the estate and gift tax exemption, which is slated to be reduced by half from $10 million inflation-adjusted ($13,610,000 in 2024[2]) to $5 million inflation-adjusted, estimated to be approximately $7,000,000 in 2026. Commentators have long been suggesting that practitioners advise their clients of the need to plan for the upcoming change.

A reduction in the estate tax exemption and other changes could happen before January 1, 2026, if there is sufficient political will in Washington DC following the 2024 elections. Senator Elizabeth Warren released proposed legislation, the American Housing and Economic Mobility Act of 2024 (the "AHEM Bill of 2024")[3] which would affect estate tax planning in dramatic ways:

- Reduce the estate and gift tax exclusion to $3,500,000.
- Increase federal estate tax rates to 55%, 60%, and 65%.
- Enact code section 2901, which treats all assets held in a traditional irrevocable grantor trust as includable in the grantor's gross estate, essentially ending the traditional estate planning use of grantor trusts.
- Limit valuation discounts where the taxpayer's family has control of an operating business or where a transfer is made of non-business assets, under proposed code section 2705(a) & (b).

While the Democratic Presidential nominee, Vice President Kamala Harris, has been more vague about her economic agenda, [4] VP Harris has expressed approval for some of the plans detailed in the AHEM Bill of 2024, particularly as it relates to making housing more affordable by raising the corporate tax rate.[5] The provisions in the AHEM Bill of 2024 are not new; the proposals have been on progressive wish lists for some time.

All of this is to say that clients may not have the entire calendar year of 2025 to complete their planning. Rather, depending upon how the November 2024 elections turn out, clients might need to complete their planning this year in order to hedge against a potential tax law change at the beginning of 2025, if Democrats are able to achieve control of the Presidency, the Senate, and the House of Representatives.

When planning in a time-compressed environment, practitioners will need to be cognizant of potential "pitfalls" that could undermine their clients' planning. The Step-Transaction Doctrine and the Reciprocal Trust Doctrine are often employed by the IRS to challenge clients' planning. In the waning months of 2024, there are steps that practitioners might recommend to their clients to take now in preparation for future planning, which could potentially mitigate the possibility of the IRS successfully raising either the step-transaction or reciprocal trust doctrines on audit. This article will explore various practical aspects of planning to limit both of these risks.

Further, practitioners should encourage clients to finalize their estate plans as soon as possible, well before any new Congress might be able to be seated in early January 2025. Though not a certainty, plans are more likely to be interpreted under the law in place at the time the plan was executed, rather than under a new law that might later be enacted.

Step-Transaction Doctrine

Substance Over Form

The concept of "substance over form" was established in the Supreme Court's 1935 *Gregory*[6] decision, which permits the IRS to ignore a transaction's legal form and examine its actual substance. The intent behind the *Gregory* decision was to prevent artificial structures from being designed to avoid paying taxes. Of course, estate tax planning is usually driven by the desire to avoid paying taxes. Mitigating or eliminating estate taxes is usually an essential purpose of the estate tax plan in the first place. The lesson of *Gregory* and its progeny is that practitioners must carefully structure each element of the plan, even if one of the purposes of certain elements is estate tax avoidance or mitigation.

Where a practitioner is not mindful of the "step-transaction" doctrine when putting together each component of an overall transaction, Courts may collapse arguably separate

steps of a plan into fewer steps and arrive at a different result than the client's intention and the practitioner's planning.

There is no universally accepted test to determine if the step-transaction doctrine should be applied to a particular transaction. However, Courts have relied on three concepts when evaluating whether the step-transaction doctrine should be applied: the mutual interdependence test, the end result test, and the binding commitment test. Each of these will be explored below.

Mutual Interdependence Test

There are multiple factors courts will consider when analyzing whether the step-transaction doctrine should be applied to a transaction. The first factor is often referred to as the "mutual interdependence test." Courts will review whether the steps in the plan must "lean" on each other to stand. If it is determined that subsequent steps must be taken to make the previous steps make sense, those steps might be considered to be interdependent. In other words, would clients have taken step 3 if the client knew that steps 4 and 5 would not also be completed? If not, then the planning may potentially have a step-transaction issue.

The Court in the *Linton*[7] case found that the taxpayers crafted a scheme that consisted of pre-arranged parts of a single tax plan. The Court considered steps to be interdependent and did not believe that the taxpayers would have undertaken the initial steps in the plan without knowing that the later integrated acts would also be taken. The ruling in *Linton* may be instructive to practitioners:

- Identify and evaluate each step of the plan separately.
- Consider whether each step of the plan is independently meaningful, even if no other steps are taken.
- For any steps that might appear to be interdependent upon other steps, a practitioner might consider whether the interdependent step might be eliminated or substituted with a different legal arrangement that could stand on its own.
- Determine whether and how to memorialize each step of a transaction separately.

A practitioner should consider ways for each step of an overall transaction to have independent significance. Perhaps the practitioner might assist the taxpayer with filing a gift and/or income tax return to separately report each step of the transaction, assure separate legal documentation is completed and signed as if each step were the last step, etc.

End Result Test

Courts also analyze what would happen if the plan stopped at an interim step. This is often referred to as the "end result test." For example, if you have a transaction that involves four separate steps, what would be the result if the plan were stopped mid-stream at step 2, without steps 3 and 4 being completed? Would the result be logical and desirable for the client? If the IRS shows that the various steps are really pre-arranged parts of a single plan intended from the beginning to result in a particular end result, courts may not look favorably on the planning completed. In such cases, a plan might be more vulnerable to challenge under the step-transaction doctrine.

When analyzing a transaction under the "end result" test, the practitioner should separately evaluate each step of the transaction and evaluate:

1. What is the purpose of this step?
2. How does taking this step affect the clients?
3. If this step were the last step, would the end-result be reasonable or desirable for the client?

To protect a plan against a challenge under the end-result test, practitioners may wish to document a logical, non-tax reason for each step throughout the planning process.

Binding Commitment Test

Courts will also review the contractual and other obligations established in the transaction documentation. Can the planning be stopped at any time and even skip certain steps, and still achieve the client's goals, or would stopping at any particular step cause an issue with the agreements signed at that point? If there is a binding commitment from the inception of the plan to undertake all the following steps until completion, then each step could potentially be considered a fait accompli.

The Court in *Penrod*[8] analyzed a business transaction in which the taxpayer sold interests in an entity that held McDonald's franchise restaurants and that received McDonald's stock as compensation. The taxpayer subsequently sold a portion of the McDonald's stock he received and used a portion of the funds to open a competing restaurant. The IRS argued that the steps of the business transaction, the sale of the McDonald's restaurants, the sale of the McDonald's stock received, and the subsequent establishment of a new restaurant chain should be collapsed into a singular transaction. The Court in *Penrod* analyzed the facts and noted that the deal for the Penrod interests to McDonald's was completed in March 1975, yet the sale of McDonald's stock did not take place until January 1976. In

addition, the Court determined through reviewing the facts that the taxpayer intended to retain the McDonald's stock when he acquired it.

In *Penrod*, timing mattered. The taxpayer held the McDonald's stock for almost a year before the sales transaction, so the court did not agree with the IRS that the steps should be collapsed.

Practitioners should consider the emphasis the *Penrod* Court placed on the timing of the actions that were taken. The *Penrod* decision appears to suggest that had there been less time between steps, the IRS challenge might have been more successful. Though there is no specific rule on what amount of time between steps would be sufficient, practitioners should emphasize to clients that it is likely better for the success of their plan for them to have more time between steps, in case they need to deflect against a step-transaction doctrine challenge. The *Penrod* rationale is why the risk of a step transaction challenge succeeding continues to grow as we get closer to year end and closer to the end of 2025 (depending on what law changes might occur).

Recent Court Case Exemplifies Step-Transaction Doctrine Risks

The Tax Court recently invoked the step-transaction doctrine against a taxpayer when the IRS challenged a plan in a case that has been widely discussed among estate tax commentators.[9] In *Smaldino*, the husband gave the wife interests in a family limited liability company (LLC), which she purportedly transferred to a trust for the benefit of the husband's children from a prior marriage the next day. The wife never signed any documentation as a member of an LLC, such as an operating agreement reflecting her ownership. The family did not address transfer restrictions that were incorporated into the LLC's operating agreement to permit the transfer to the wife.[10] She received no economic benefit from being a member, such as a distribution from the LLC. The LLC failed to issue a Schedule K-1 to the wife for the partial period of the year when she was a member of the LLC. The Court found that there was no economic significance of the initial transfer of the LLC interests by the husband to the wife. Because the husband's gift to the wife appeared to have been dependent upon the wife's agreement to transfer the asset to a trust for his children, the Court concluded that the wife was merely an intermediary who facilitated the ultimate transfer. For this reason, the Court collapsed the transactions and treated the transfer as having been made by the husband to the trust for his children.

This created a tax cost for the Smaldino family, as the husband had already exhausted his gift tax exemption. While the *Smaldino* case was a taxpayer loss, it was also instructive for practitioners on the actions, or steps, the Tax Court may scrutinize when analyzing clients' planning.

How Long of a Holding Period Is Sufficient?

While the *Smaldino* case found that the wife holding the LLC stock for one day was an insufficient period of time, in the *Holman*[11] case, the court found that holding stock for a mere six days, in one step along the planning path, was enough time for the tax plan to work.

In *Holman*, the parents transferred Dell stock to a family limited partnership ("FLP"). Approximately six days later, the parents gifted a portion of the partnership interests to a trust and argued that a discount on the value of the FLP interests should be applied, so the value would be less than the value of the underlying stock value. The IRS applied the step-transaction doctrine, arguing that the parents really made direct gifts of Dell stock to their children's trust. This argument is based on claiming the FLP was a fiction and should be considered a steppingstone on the path from the parents to the trust. In that case, not only would the FLP be ignored, but the reduction in value from the discount the parents claimed would be as well.

The IRS's reasoning in their attack was that the step-transaction doctrine provides that if a series of steps in a transaction are so integrated and interdependent, economic reality may be better reflected by collapsing the various steps into a single step. The court, in a resounding taxpayer victory, determined that during the six-day time period that the FLP held the Dell stock from the time stock was contributed to the FLP, until the date the parents gifted FLP interests to the trust, created an economic risk. The Court's reasoning was that due to the volatility of a publicly traded stock, the value of the stock interests could change significantly during that six-day period.

While few commentators might suggest that a six-day holding period is ideal when planning a transaction, the lessons of the *Holman* case are valuable. The facts and circumstances of a particular transaction will affect the inherent step-transaction risk. For example, is six days (or a "reasonably longer period," whatever that might be) for a transfer of rental property sufficient? What if it is a commercial rental property and the primary or sole tenant is a public traded company that could have financial issues putting the lease and property in jeopardy? Facts may matter and the guidance is sparse. Practitioners may wish to assess a client's assets and discuss with clients which assets are candidates for use in estate planning transactions.

No Bright Line Rules

While the Court in *Smaldino* stated that the steps taken by the Smaldino family were insufficient to prevent the collapse of the planning steps, the Court did not state which actions would have been sufficient to cause the transaction to be respected. Meanwhile,

the *Holman* case found that a six-day waiting period was sufficient. Unfortunately, there is no definitive "bright line" rule regarding what would prevent the application of the step-transaction doctrine.[12] Practitioners may wish to caution clients that there is no way to ensure insulation from the step-transaction doctrine and provide clients with examples of good practices and actions the clients could take to reduce the risk of the IRS successfully arguing for the collapse of the steps in the clients' transactions.

Hypothetical to Illustrate Factors in Implementation of Planning by the End of 2025

While practitioners may not have a specific formula they could follow when implementing planning to avoid the step-transaction doctrine, practitioners may use some of the concepts from *Smaldino* to advise clients on structuring their planning. The following is a hypothetical plan implemented before the end of 2025 addressing some of the Court's concerns in *Smaldino*.

Example: The wife in the hypothetical is a neurosurgeon, and she wants to protect her assets from malpractice claims and move value out of her estate before the estate tax exemption is reduced by half. Her husband is a schoolteacher and has few assets in his name and a low risk profile for asset protection considerations. Wife gifts $7 million in cash to her husband at the end of October 2024. The following day, the husband deposits the gift into an account that he has in his sole name, which held the husband's personal investment assets.

The husband then hires a new investment advisor who creates a new financial plan and investment policy statement and reallocates the asset allocation of the marketable securities husband received from his wife, and he directed the purchase of investments with any cash he received or had on hand prior to the gift. The husband withdraws funds periodically from this new account and treats the funds as his own, using those funds for living expenses, vacations, purchasing tangible goods, etc. More than six months later, in the new 2025 tax year, the husband hires an estate planning attorney who creates a trust for which the husband will be the settlor, and to benefit the wife and descendants pursuant to a plan the attorney developed with the husband. The husband funds the initial $100,000 gift to the trust from funds he inherited many years ago. Then the husband has his financial planner create new financial forecasts and determines through that analysis the amount of money that husband might reasonably gift to the new trust. The financial advisor's analysis suggests $5 million could be gifted, and the following month the husband makes that gift.

Comparing *Smaldino* and the Hypothetical

There is no assurance that the IRS or a creditor will not successfully challenge the foregoing hypothetical planning under the step-transaction doctrine, creating a situation where the

wife really funded the trust to benefit herself, causing the trust to be considered the equivalent of a self-settled trust. If the trust is established in a state that does not permit self-settled trusts, that re-classification could cause the assets to be considered inside the wife's estate (cf. Rev. Rul. 76-103). Not only would this result undermine the couple's estate planning goals, but it would also potentially make the assets reachable by her creditors, thereby defeating her asset protection goals. Even if the trust were established in one of the approximately 20 trust-friendly jurisdictions that permit self-settled trusts, unless the planning followed that states' statutory requirements to establish a self-settled trust,[13] the clients' planning goals may be undermined. Nonetheless, practitioners might consider using self-settled trust jurisdictions for SLATs to provide a possible backstop for a SLAT plan. If the IRS or a creditor were successful in arguing that the trusts were reciprocal, the supposed result of that would be un-crossing the trusts so that husband would be deemed to have created the trust of which he is the beneficiary, and similarly for the wife. If both SLATs had situs in a self-settled trust jurisdiction, that un-crossing may result in two self-settled trusts, each of which might, if qualification as a self-settled trust were feasible, retain estate tax exclusion and creditor protection.

However, due to the additional steps taken by the husband and wife in the hypothetical, the practitioner has several better arguments to advance when arguing that the husband's funding of the trust was not part of the same integrated plan of the wife's gift to him. Some of the factors that might help support the hypothetical plan include:

1. The husband treated the gifted funds as his own in several ways. He reallocated investments, withdrew and used funds from the gifted money, and commingled the money with an old account of his own. In contrast to the *Linton* case discussed above, if the husband chose to keep the assets in his own name at this point, it would have still achieved several objectives of the wife and husband. For example, the wife was concerned with asset protection, so having assets out of her name and in her husband's name provided a measure of insulation. In addition, the husband did not have significant funds in his name before this gift. It could be argued that providing the husband with greater assets in his own name provided him with peace of mind and could help marital unity.

2. The husband hired his own investment advisor to advise him on the funds and the nature of the funds changed dramatically from a cash gift to an investment portfolio.

3. The amount the wife gave the husband did not correlate directly to the amount husband gave the trust.

4. The husband did not merely re-gift the funds his wife gave, but he had an independent analysis completed to arrive at the amount that he might gift to a trust for his wife. The amount of the gift husband made to the trust was less than the amount he received from his wife.
5. Several months passed from wife's gift to husband's funding of the trust. Consider *Holman*'s waiting period in comparison. The longer the assets are held in each "step," the stronger an argument there may be to deflect the step-transaction doctrine.
6. The husband's gift was in a separate tax year from wife's gift.

Planning Considerations to Address the Step-Transaction Doctrine.

While the hypothetical above included several "good fact" points regarding the step-transaction doctrine, below is a more in-depth discussion of the nuances and concepts that practitioners may wish to consider when crafting planning for clients.

1. The greater the time span between each step or phase of a plan, the more likely that each planning step may stand independently on its own. However, as exemplified by *Holman*, what is considered sufficient time is based on the facts and circumstances of each particular transaction. Considering this, time alone should not be the sole factor practitioners address when crafting a plan.
2. Ideally, there should be several, and if possible, significant, economic implications for each step of the plan. If one spouse transfers assets to the other spouse, while the second spouse holds the asset, there should be a meaningful risk of economic consequences during that period of ownership. As in *Holman*, if the assets are interests in publicly traded companies, the simple action of holding the asset for a period of time creates volatility. If an action such as reporting an earnings date happens during the period the second spouse has ownership, it can inject additional volatility. However, for privately held entity interests, it is not as simple as holding the asset for a period of time. For example, if interests in an LLC are transferred, a distribution might be made from the entity while that recipient holds the interests (although in some cases there could be income tax consequences of doing so). If the asset is a vacation home, if there are expected capital improvements or repairs that are intended to be made soon, having those actions taken while the second spouse is the owner may potentially show significant economic implications.
3. The recipient of a transfer should exercise control, to the extent feasible, over the asset received. For marketable securities, this may be choosing to change the asset

allocation or rebalance the portfolio. For an entity, such as an LLC, it may be taking significant administrative actions for that entity, such as signing an agreement with a third-party (e.g. a new lease with a tenant in the case of rental property), agreeing to sell assets held in the entity, signing a lease with a tenant, etc.

4. To the extent feasible, each step in the plan should be able to stand on its own as the final step of the plan. There should ideally be no requirement or even need to proceed to later steps.

5. Carefully adhere to all the legal formalities the plan would seem to suggest are necessary. For example, interests in an entity, such as an LLC, are transferred from one person to another and then to a trust. The LLC should have a new operating agreement that could be amended and restated, and signed at each transfer, confirming the new owner after that particular step. This is not always feasible if there are multiple independent parties, e.g., a mere joinder agreement might be used. But in such a situation the existence of such independent third parties may lend more credibility to the planning steps. If there are any restrictions or covenants in the operating agreement prohibiting transfers, a document should be signed confirming those restrictions were either waived by the members for each of these transactions, or otherwise adhered to. If there are any mortgages or third-party agreements involved, confirm if the transfers are permitted under those documents, and if there are any steps that need to be taken to approve the transactions with those third parties, ensure they are followed.

6. Carefully adhere to all the tax formalities the plan would seem to suggest are necessary. Consider a transaction where interests in an entity, such as an LLC, are transferred from one person to another, then to another entity, and finally to a trust. The LLC, assuming that it is taxed as a partnership for income tax purposes, should issue a K-1 to each owner accurately reflecting the number of days each owned an interest in that LLC during the year. (Even if the entity is a complete passthrough so no tax returns for it need be filed, it may be best to file whatever is feasible and permissible to enhance the appearance of respecting the entity.) This point was exemplified in the recent *Sorensen*[14] decision, where the taxpayer's defined value mechanism was not respected due to the legal documents failing to adhere to the terms outlined in the gift the taxpayer made. If the clients do not adhere to the formalities of the transaction they implemented, the IRS or a creditor will likely not need to do so either.

How Far Should Clients Go?

Many of the actions taken by the husband and wife in the hypothetical above may be more aggressive than some clients would be comfortable taking. For example, unlike the hypothetical, few clients would be willing to have each spouse engage independent financial advisors and/or attorneys. Many clients will not have "old and cold" separate financial accounts to use as a receptacle of gifted assets. Many clients might become overwhelmed by the details and steps the planning suggested entails. Clients might feel overburdened with the administrative hassles that could come from following the steps in the hypothetical, even if those steps could potentially save their plan from an attack based on the step transaction doctrine.

Clients may not appreciate how the possibility of an inquiry based on the step-transaction doctrine necessitates intricate steps at each stage of planning to deflect or refute a challenge to the greatest extent possible. Practitioners should be specific when advising clients about the purpose behind each recommendation and the potential risks of "short-circuiting" certain administrative actions.

It is likely that many clients, even after understanding the practitioner's cautions, will nonetheless choose not to take all the actions recommended. However, even if practitioners feel clients would not be willing to take certain actions, practitioners could consider advising clients of the options they have and the steps they may take and allow the client to determine which steps they are comfortable committing to. There is a spectrum between the *Smaldino* case and the facts of the hypothetical, and most clients' planning will fall onto that continuum. Providing clients with sufficient information to make an informed decision regarding steps they wish to take when implementing their planning is both protective for the practitioner and beneficial for the client, as they may choose to take actions or administer the planning in a manner that provides them with a greater chance of success.

In addition, practitioners may wish to communicate to clients that less favorable scenarios may potentially succeed. For example, in 2020 and 2021, when most taxpayers and advisors feared imminent, significant, and detrimental changes to the estate tax laws, many taxpayers implemented plans where time between steps was non-existent, or nearly so. Those plans were based on the premise that the government could change the tax laws any day, so it might be better to get a plan implemented as fast as possible since any risk of a quickly done plan might outweigh the risk of not getting the planning completed before a change in the tax laws. A comparable situation may present itself as January 1, 2026, gets closer, or if the Democrats sweep and harsh tax legislation is quickly enacted.

Reciprocal Trust Doctrine[15]

Significant Gifting Can Create Significant Concerns

As the gift and estate tax exemption is slated to be reduced from $10 million inflation-adjusted to $5 million inflation-adjusted at the end of 2025, clients are (or should) be considering whether to make gifts of a significant portion of their wealth in order to use and secure the additional exemption they currently have. However, to be comfortable making such significant gifts, the trusts that are created may include the spouses as beneficiaries of each other's trusts (i.e., the husband will be a beneficiary of the wife's trust and vice versa). Practitioners representing such clients should be wary of the reciprocal trust doctrine when spouses seek to create similar trusts for one another. It is also important to note at the outset that the although the reciprocal trust doctrine is almost always discussed in the context of spouses creating trusts for each other the doctrine has been applied to siblings and there is no reason it cannot be applied in other contexts and relationships as well. For purposes of the discussions following, even if the typical context of spouses is used, read it more broadly to apply to other contexts as well.

In a successful reciprocal trust doctrine challenge, the courts may "un-cross" trusts where spouses create nearly identical trusts for each other. In this situation, the trusts would then be treated for tax purposes as if each spouse had created their own trust. This would create a situation where the trust is now a self-settled trust, which, as discussed above, may potentially cause the trust to be included in the client's estate as well as reachable by their creditors.

Establishment of the Reciprocal Trust Doctrine

The concept of the reciprocal trust doctrine for tax purposes was first established in *Lehman v. Commissioner.*[16] In *Lehman*, brothers each created two trusts for each other, so there were four trusts created in total. The trusts were identical, providing income to the grantor's brother, giving the grantor's brother the right to withdraw $75,000 if exercised before December 31, 1935, and providing that the remainder would go to the grantor's issue. When the first brother died, the Court uncrossed all the trusts, holding that each of the brothers only created trusts in consideration for the other brother also creating trusts for them. The Court held that the $150,000 that the decedent could have withdrawn from the two trusts created by his brother was includible in the decedent's estate.[17] While *Lehman* included trusts created by two brothers, the reciprocal trust doctrine is typically considered in planning when spouses are creating trusts for each other. The reciprocal trust doctrine potentially applies where each party's transfer of property appears to have been induced by the other party also transferring property to a trust for their benefit.[18]

In *Lehman,* the Court appeared to consider the party's motives in the analysis. For several decades, courts were inconsistent on whether the party's motives were relevant to the reciprocal trust doctrine. The United States Supreme Court in *United States v. Grace*[19] determined that motive was not relevant. In *Grace,* the decedent established a trust where his spouse received all income, trustees had discretionary distribution powers to the spouse for principal, and the spouse had a testamentary power of appointment, which could be exercised in favor of the decedent and their descendants. Two weeks after the decedent created this trust, his spouse created an identical trust where the decedent was a beneficiary. The Supreme Court held that the reciprocal trust doctrine applies where the trusts are interrelated and leave both settlors in about the same economic position they would have been if they simply created trusts for themselves.[20] The motive for creating the trusts was no longer relevant.

The concept that the parties (spouses or otherwise) were left in about the same economic position after the creation of the trusts as they were in before, should be a fundamental principle to consider in planning to avoid the reciprocal trust doctrine. Many of the differences commentators suggest, or practitioners indicate they use, may have little impact on changing the economic position of the parties after trust creation. While such differences might still be worthwhile integrating into the plan to differentiate each trust, that should not detract practitioners from also focusing on differentiating the economic position of each party (e.g., spouse) from what it was before the plan, to what it becomes after the plan. From that perspective, whether or not case law supports it, some differences that might be meaningful to differentiate the economic positions of the parties after trust creation might include: funding each trust with different assets, funding one trust with life insurance and the other materially different or no coverage, changing standards for and opportunities for distributions to each spouse under each trust, etc.

After *Grace*, there have been numerous taxpayer-friendly decisions regarding the reciprocal trust doctrine. However, there are still inconsistencies between the courts when applying the reciprocal trust doctrine, and there is no bright-line rule that would assuredly avoid application of the doctrine. That is important for practitioners to bear in mind. When feasible, integrating additional differences between trusts, similar to how practitioners had in the past, added a second or even third mechanism to assure grantor trust status, may be worthwhile.

For example, in *Estate of Bruno Bischoff*,[21] the husband created trusts for each of his four grandchildren. His wife was named as the trustee. The trustee could distribute income and principal for the benefit of the beneficiary. Any income that was not distributed would be added to the trust principal. All the trusts terminated when the beneficiary reached age

21. The day after the husband created his trusts, the wife created four additional trusts for each grandchild, with identical terms and the husband serving as trustee. The Tax Court uncrossed the trusts. The effect was that both husband and wife had created trusts in which they were also the trustees. Due to this, the Tax Court held that the retained powers ran afoul of Internal Revenue Code Sections 2036(a)(2) and 2038(a)(1), causing the assets in the trusts to be includible in each spouse's estate. A few take home messages from *Bischoff* might be use independent and ideally institutional trustees for one if not both trusts, endeavor to avoid making trusts identical, and consider avoiding the spouse/settlors being named trustees (recognizing that this is the default that many clients want).

A Sixth Circuit Court decision had a different result than *Bischoff*. The fact pattern in *Estate of Green v. United States*[22] was similar to *Bischoff*. In *Green*, the husband and wife each created trusts for their grandchildren. The trusts terminated when the beneficiary reached the age of 21. Husband and wife were trustees of each other's trusts and had the discretion to distribute income and principal or accumulate income. However, the Sixth Circuit rejected *Bischoff*, holding that the powers provided to each of the husband and the wife were not sufficient to be considered a retained economic benefit to satisfy *Grace*'s holding of leaving the settlors in approximately the same economic position as if they had created the trusts themselves.[23] A conclusion some might draw from *Green* is that drafting a similar plan to this case might thus be supportable. But even if there is case law upholding a particular plan, why not make the extra efforts to differentiate the trusts. The discussion in Green about the retained benefits and same economic positions should also be instructive as to the factors that practitioners might consider when evaluating the plan, as discussed above in the comments on the *Grace* case.

Deflecting the Reciprocal Trust Doctrine

There have been several decisions that provide guidance on the kinds of differences practitioners might incorporate into trust documents when endeavoring to deflect a reciprocal trust doctrine challenge. Consider that, under *Grace*, the Court determined that the reciprocal trust doctrine applies when the parties are left in "approximately the same economic position."

The Court in *Estate of Herbert Levy*[24] determined that due to the differences in the powers of appointment the spouses provided each other, it created significant economic differences, and the reciprocal trust doctrine did not apply. The husband and wife in *Levy* each created trusts with identical assets. The trusts were created on the same day. Each was the trustee of the other's trust. Their son was the residuary beneficiary of both trusts. However, the husband gave the wife the broadest possible lifetime special power of

appointment. It was exercisable in favor of anyone but herself, her creditors, her estate, or the creditors of her estate. The wife's trust did not give the husband a similar power. The Tax Court, citing *Grace*, said that as a result, the husband and wife had significant differences and control over the trusts they each created, stating that the reciprocal trust doctrine did not apply in that situation.[25] But as discussed above, the mere fact that a case seems to have found that the reciprocal trust doctrine wasn't violated, is not necessarily a reason at the planning stage not to incorporate additional differences in the trusts and plan. Also, consider that in *Levy* the Court considered the terms of each trust document, the assets or principal of each trust, who were the trustees, who were named as beneficiaries, the dates that each trust was created, and whether there was a prearranged plan. Thus, a broad perspective may be prudent even if different mechanisms are used in each trust that sufficed under a particular case.

After *Levy*, several private letter rulings (PLRs) were provided by the IRS reinforcing the decision in *Levy*. In PLR 9643013,[26] the husband created a trust for the benefit of his descendants. The wife created a similar trust. However, the wife's trust was for the benefit of both the husband and her descendants. Each spouse was a trustee of each other's trust. An independent co-trustee was named, but the same individual was named in both trusts. The independent trustee had the sole power to make discretionary distributions. The husband had a lifetime power of appointment in the wife's trust, exercisable during his lifetime prior to January 1, 2022. The husband also had a testamentary power of appointment, exercisable via will, and could appoint assets to his wife's descendants or their spouses. The wife did not have a power of appointment over the trust the husband created. The Internal Revenue Service held that in view of the differences between the trusts, they were not reciprocal. It is interesting to note that in this PLR, the husband was a beneficiary of the wife's trust and also had a power of appointment over the assets. It is unclear whether the IRS would have taken a different position if the powers were separated, i.e., if husband were a beneficiary of wife's trust, but the wife was given a lifetime and testamentary power of appointment over the assets in the husband's trust. Thus, perhaps one lesson of PLR 9643013 is to endeavor to evaluate the interplay of the various provisions in each trust.

The IRS in PLR 200426008[27] held that trusts created by a husband and wife were not reciprocal. The husband and wife both created life insurance trusts. Each was the trustee of each other's trust. The wife was given a power of appointment and limited withdrawal powers after her son's death in the husband's trust. While the husband and the wife were beneficiaries of each other's trusts, there were limitations on the ability to make distributions to the husband in the trust the wife created. The IRS, citing *Grace* and *Levy*, held that the trusts were not reciprocal.

Based on *Levy* and the above PLRs, practitioners may consider incorporating a lifetime power of appointment in one spouse's trust and not the other to create what appears to be a substantive economic difference between the two trusts. However, caution should be exercised if the practitioner chooses to rely on a power of appointment as the only difference between trusts. In *Levy*, the trusts did not have reciprocal beneficiaries; the husband was not a beneficiary of the wife's trust, and vice versa. Would the *Levy* court have come to a different conclusion if there were reciprocal beneficiaries? In PLR 9643013, while there was a beneficiary spouse, it was only in one trust, and the same spouse that was a beneficiary was also provided with powers of appointment, further differentiating the economic situations between spouses. In PLR 200426008, there were different distribution standards between the husband and wife. Each of these decisions is instructive on some differences that can be incorporated to create a better position to deflect a reciprocal trust doctrine challenge.

A review of the above authorities might also suggest a possible benefit of using a different corporate, professional, or institutional trustee on each of the trusts, rather than naming each spouse for the other's trust. As noted above, many clients prefer this level of control. If so, then practitioners accommodating that request might note in a letter or email to the clients that they were informed of possible benefits of using different institutional trustees on each trust but despite what might be an increased risk of failing a reciprocal trust challenge the clients opted for naming each other as trustees.

Powers to Consider Incorporating When Addressing the Reciprocal Trust Doctrine

Like the step-transaction doctrine discussed above, there is no bright line rule on what differences between trusts suffice to deflect the reciprocal trust doctrine. This creates a difficult situation for practitioners when determining what differences to incorporate between two trusts. One approach to consider is incorporating as many differences as is practicable under the clients' unique circumstances. But, from a practical perspective, each difference that is incorporated into the plan and drafting may create additional cost and complexity. Also, the differences often have material economic consequences (which, it might be said, is why they were used). But the consequences of differences can be quite real, and not what the client later find to be what they might have selected with hindsight. For example, wife creates a SLAT for her husband and vice versa. But the wife's SLAT does not name the husband as a beneficiary during the wife's lifetime. In contrast, the wife is a current beneficiary of the husband's trust. The husband is incapacitated and the lucrative income stream from his work endeavors evaporate, and he has no disability income replacement insurance. The husband may then wish with hindsight that he had been named as a beneficiary of the trust his wife created during her lifetime. That difference that

was willingly integrated into the plan to deflect a reciprocal trust challenge may now create financial hardships that are not desired. Differences can have real and adverse consequences that the clients need to understand. Practitioners might consider noting in a letter, memorandum or email forwarding draft trusts to the client that some of the differences have real economic consequences, and that the clients, if they sign the trusts, will by doing so confirm that they have read and understood the trust terms, including the economic impact of the distinctions between the trusts.

Below are several options practitioners might consider when determining what differences to incorporate between two trusts that might be susceptible to a reciprocal trust challenge. There is no suggestion whatsoever that all or even most of these differences are necessary. As stated above there is no bright line test of which differences are necessary or which combination of differences might assure success:

1. Have different plans created for each trust. Showing that there were different goals and that the clients' intent for creating each trust were not the same may assist in creating a narrative when arguing that the trusts were not reciprocal. Consider drafting different memoranda for each trust, if that is not feasible, at least reference each trust in different portions of a memorandum and outline the different goals of each trust separately.

2. Create significant economic differences in the positions the spouses will be in after the establishment and funding of the trusts. For example, as in PLR 9643013, one spouse could create a trust for the benefit of their spouse and issue, and the other spouse could create a trust for the benefit of only their issue.

3. Another option would be to have the trusts established in a jurisdiction that permits self-settled domestic asset protection trusts ("DAPTs") so that one spouse can be named as a beneficiary of their own trust, which would then be a DAPT, and the other spouse is not a beneficiary of their own trust. This would create greater access to the trust funds for one spouse than the other spouse has. A hybrid-DAPT where the settlor spouse can be added back as a beneficiary to a trust may also be viewed, like the DAPT, as a material difference from a more "traditional" SLAT. Further a special power of appointment trust ("SPAT") might similarly be a material difference from a SLAT. Using a combination of one SLAT, DAPT, hybrid-DAPT, SPAT for one trust, and a different one of these techniques for the second trust, might alone be a substantially and material difference.

4. Incorporate different distribution standards in each trust. One trust could limit distributions to the spouse/beneficiary to an ascertainable standard, i.e., a health,

education, maintenance, and support ("HEMS") standard, while the other trust (created by the other spouse) could incorporate a fully discretionary distribution standard (with an independent trustee). However, practitioners may wish to discuss with clients the fact that limiting distributions to a HEMS standard reduces flexibility for distributions, may prevent decanting depending on state law where the trust is established, and may potentially expose the trust assets to a beneficiary's creditors.

5. Appoint different trustees or co-trustees in each trust. While many clients may wish to be named as trustees of each other's trust, practitioners may wish to caution clients of potential risks. If the clients still wish to be each other's trustees, discuss whether they would be willing to add different independent co-trustees to each trust. If the clients are amenable, naming different institutional trustees, either banks or purely administrative trustees, could provide a greater difference between the trusts. As discussed in the review of authorities above, naming the spouses as each other's trustees appears to have been viewed negatively by courts and the IRS.
6. As in *Levy* and PLR 9643013, one trust might grant the beneficiary-spouse a power of appointment while the other trust does not. Practitioners should advise clients in writing that the beneficiary-spouse who does not have a power of appointment might have less flexibility in dealing with the assets in the trust. In other words, the assets in a trust without a special power of appointment could only pass based on the terms written in the trust. Clients may not be able to appoint assets in a different manner if circumstances change. Considering the continued estate tax uncertainty and proposals for significant changes to the estate taxation system, such inflexibility could be viewed as a significant detriment. Also, consider the impact of when the powerholder spouse can exercise the power granted, and whether that exercise might reduce or negate differences in distribution provisions. Also, spouses should consider the breadth of the power granted and what the impact of an exercise might be after a divorce or other circumstance.
7. If the clients are not comfortable completely eliminating the power of appointment in one trust, consider giving one spouse the broadest possible limited power of appointment permitted under law without causing estate tax inclusion[28] and the other spouse a narrower power of appointment, in which they can only appoint assets to a specific class of individuals, such as the settlor's descendants or spouses of the settlor's descendants.
8. As an additional difference between the powers of appointment in each trust, consider providing one spouse with both a lifetime and testamentary power of appointment and the other spouse with only a testamentary power of appointment.

9. Grant one spouse a noncumulative “5 and 5” power. This power permits the holder to withdraw up to the greater of $5,000 or 5 percent of the trust principal each year. This would provide one spouse with the power to access assets held in the trust that the other spouse does not have, potentially creating a significant economic difference between spouses due to the creation of the trusts. The 5 and 5 power has several detriments, however. For example, the amount the powerholder can withdraw at the time of death is included in their estate (although allowing the power to be exercised only on one day during the year may obviate this issue). The lapse of the power, not in excess of the greater of $5,000 or 5 percent of the trust assets each year, is not considered a taxable gift.[29] In addition, including a 5 and 5 power may expose the withdrawable assets of the trust to the powerholder’s creditors. The clients should also consider the impact of the exercise of the withdrawal right. For example, if the settlor spouse is disabled shortly after the trust is completed, and the powerholder spouse exercises the 5 and 5 power for decades, that could shift substantial wealth in a manner not anticipated. If the powerholder spouse had children from a prior marriage, over sufficient years, the continued exercise of a 5 and 5 power could shift the intended dispositive plan to favor those other children.

10. Include a marital deduction savings clause in one trust but not the other. This clause would provide that if any property held in the trust is included in the settlor’s estate on their death, those assets pass to a sub-trust designed to have the marital deduction apply. Alternatively, if both trusts have a marital deduction savings clause, the provisions in each could be different (one outright the other a QTIP, etc.).

11. Provide spousal beneficiaries with different degrees of control over the trust at different ages in each trust. For example, vary whether each becomes a trustee or co-trustee of the trust. Provide one spouse but not the other with the authority to remove and replace the trustee or co-trustee of the trust. Provide one spouse with a lifetime power of appointment in only one trust.

12. Establish the trusts at separate times, preferably in different calendar years and, if true, be able to establish through testimony, that there was no discussion with the spouse who was the beneficiary of the first trust that he or she would create a trust for the other. In *Lueders’ Estate v. Commissioner*,[30] a husband and wife each created a trust and gave the other the power to withdraw any or all the trust assets. The Third Circuit, in applying *Lehman*, held that as the trusts were established 15 months apart, there was no consideration or quid pro quo for the transfers. However, practitioners should note that the *Lueders’* decision was made

before *Grace*, where the Supreme Court determined that the motive for creating the trusts was not relevant. Consider *Holman,* where a 6-day holding period of Dell stock was considered sufficient for deflecting the step-transaction doctrine. Even though a longer time between settling trusts may be preferable optically, establishing trusts in quick succession may not necessarily be considered fatal. This point is especially relevant the closer we get to the end of 2025. Practitioners may wish to advise clients to establish one trust now, before the end of 2024, so any additional trusts can be established in 2025. However, for clients that wait until later in 2025, it may become difficult, if not impossible, to include a meaningful time difference between the establishment of the trusts. Nonetheless, if there is no choice but to establish two trusts in 2025 use whatever time there is to differentiate between the creation dates if feasible. There is with timing, as with other factors, no bright line test and the 15 months' in *Lueders* is not necessarily a minimum time difference. Practitioners should also consider that transactions may include several dates as part of a single transaction. If the transaction includes clients funding an LLC, then subsequently, the clients gifting LLC interests to trusts that are to qualify for fractional interest or other discounts, there will be several dates to consider: the difference between the trusts and the period of time the assets are held in the LLC prior to gift or sale.

13. For clients that have a varied portfolio of assets, such as marketable securities, privately held business interests, significant insurance policies, etc., practitioners may wish to recommend that the clients contribute diverse types of assets to each trust. Where one trust is funded with non-liquid assets such as entity interests or assets subject to contractual restrictions on transfer, perhaps the other trust may be funded with cash, marketable securities and/or one or more insurance policies. Even if contributing different asset profiles alone may not entirely deflect a reciprocal trust doctrine challenge, the trustee of each trust would quite likely administer the trust assets in ways that would meaningfully differentiate each trust from the other. By way of example, a trustee managing a trust with nonvoting ownership interests in a closely held business would have different responsibilities relative to the trust assets than a trustee who had to manage marketable securities or pay premiums on a life insurance policy owned by the trust. It may also be that under the *Grace* standard, the parties could be deemed to be in different economic positions after the plan than before. Before the plan either spouse may have benefited from access to all the marital assets. After the trusts are funded, each spouse arguably only has access to the assets in the trust they are a beneficiary of,

not the trust that they were the settlor of and not a beneficiary of. Might the use of a DAPT, hybrid DAPT or SPAT negate that argument?

14. Clients may consider contributing different amounts to each trust, i.e., one spouse gifts $10 million to their trust, and the other contributes $13.6 million. However, if the intention of the clients is to use the entirety of their gift and estate tax exemption before it is reduced at the end of 2025, this may not be feasible. In addition, courts may potentially argue that the reciprocal trust doctrine would still apply to the lesser amount given, i.e., in the example above the reciprocal trust doctrine would apply to the first $10 million that was given to both trusts.
15. Clients can consider having one of the spouses create a special power of appointment trust (SPAT) rather than one for the other spouse. This is a trust created for other members of the family (e.g., descendants) with a prohibition for the trustee, even after a so-called "decanting," to ever make a discretionary distribution to either spouse. However, the grantor will have named one or more persons who are not beneficiaries who can in a non-fiduciary capacity direct the trustee to distribute trust assets to someone (e.g., a descendant of the mother of the grantor's spouse) whom the grantor wishes to benefit.[31]

Advising Clients of Risks Due to Differences Incorporated

The powers, distribution standard and other provisions discussed above may create significant economic differences between the trusts and may have real economic impact on the clients. Many of the differences may have an impact on the financial security of each spouse. In an intact marriage, that can be an issue, but in a blended family situation, it may be an even greater concern. With a greater potential for divorce, more stress in the marriage, different children or beneficiaries named, etc., the risks of the differences having an unintended and undesired consequence could be worrisome to the clients.

Practitioners may wish to communicate to clients the fact that these powers will affect their access to the trusts and that each spouse may have a different level of access. Consider the potential impact of the following powers:

1. Different distribution standards. If one trust only permits distributions based on a HEMS standard, and the other trust is fully discretionary, it will potentially create a significant difference in access to trust funds between spouses. This is somewhat difficult to quantify due to the ambiguity of the HEMS standard. What is considered sufficient distributions for support, and what would be considered too much? Consider the following example: Husband creates a trust for wife in which the trustee can distribute, subject to a HEMs standard, funds to pay for the costs of

maintaining wife's current standard of living, such as for her home, food, travel, etc. The trustee of the SLAT that husband created for the wife may be able to pay for vacations at a level consistent with the wife's standard of living. However, if the trust distributes $2 million to the wife to buy a yacht (or tries to purchase the yacht to be held in the trust), that might be considered beyond the ascertainable HEMS standard. Meanwhile, the husband is a beneficiary of a SLAT wife created for his benefit that has a fully discretionary distribution standard with an independent trustee. The trust benefiting the husband can have the $2 million distributed to purchase the yacht without an issue, or alternatively have the trust purchase the yacht. The economic consequences of different distribution standards can be material.

2. 5 and 5 power. If only one spouse's trust has a 5 and 5 power incorporated, the beneficiary-spouse with the 5 and 5 power will have greater access to the trust assets. While it might be a meaningful difference between the trusts, it also means that over time, the spouse with the 5 and 5 power will be able to withdraw significantly more assets from the trust. For example, consider a trust with $10 million in assets that has a 5 and 5 power. That spouse could withdraw, no questions asked, 5% of the principal, or $500,000 a year, every year, year in and year out. The other spouse would not have access to a similar cash stream. That is a difference that has real economic consequences. What if there is stress in the marriage? What if there is a consideration of divorce? One spouse would be able to withdraw $500,000 from a trust every year, but the other spouse would not have the right to withdraw anything.

3. Differences in powers of appointment. While in a nuclear family, differences in powers of appointment may be significant, but not worrisome. But consider the divorce rate, especially for older clients. If there is a blended family in which each spouse has children from a previous marriage, the differences in powers of appointment could have the potential to create significant issues. Consider a situation where one spouse is not granted a power of appointment, and the other spouse is granted a broad limited power of appointment (i.e., to anyone other than the spouse, spouse's creditors, spouse's estate, and creditors of the spouse's estate). After the trusts are formed, the spouse who has a power of appointment secretively goes to a new lawyer and signs a new will, exercising that power of appointment, so all those trust assets pass only to that spouse's children from a prior marriage. The family would not know about this change until that spouse dies. The exercise of that power of appointment may completely upend the intended dispositive scheme that the clients had agreed to.

4. Different beneficiaries named in each of the trusts. Modern trust drafting commonly incorporates several phases of the trust's "life cycle," where each phase has different governing provisions. For example, there could be trust provisions that govern during the settlor's lifetime that provide for specified distribution standards to the beneficiaries, a "lifetime trust." During that period of time the trust may be treated as a "grantor trust" for income tax purposes (assuming it was structured that way). After the settlor dies, if the spouse is alive, assets may pass to a "family trust" for the benefit of the spouse and all descendants. The family trust will also have specified beneficiaries and distribution standards. On the death of the last spouse, the assets may pass in further trust to children or other named beneficiaries. To differentiate the trusts, the wife might be named a beneficiary of the family trust after the husband's death. However, in the trust the wife creates for the husband and beneficiaries, the husband might not be named as a beneficiary of the family trust or the lifetime trust. If the wife were to predecease the husband, or if they were to get divorced, the husband would lose access to all assets held in the trusts. That could be a real economic hardship for the husband and force him to spend assets in his own name. If this is a blended family, that may reduce or even eliminate what the husband's children from a prior marriage might receive on his passing.

5. Power to Loan Assets from the Trust. If an individual is given the power, in a non-fiduciary capacity, to loan money to the settlor, that may provide the settlor the ability to access trust assets if needed. Practitioners will often incorporate the power to loan assets to cause the trust to be considered a "grantor trust." Consider the potential impact if one spouse's trust includes the power to loan assets and the other does not. For example, the trust that the husband creates to benefit the wife has incorporated a loan power into his trust. The husband's trust provides his bowling buddy with the power to loan him trust funds. The bowling partner chooses to loan the husband most of the funds in the trust at the minimum interest rate permitted by law at a time when rates are relatively low. The husband invests the funds outside the trust and effectively transfers growth from the trust to his personal name. This would give the husband the ability to shift that value to anyone he chooses, such as his children from a prior marriage, in contradiction to the trust provisions and the party's plan. Taking the example further, consider a blended family situation. When the husband dies and assets pass to all the children under the terms of the trust, the main asset of the trust is a loan to husband. However, husband has given away all his assets to his own children before death. In this situation, the wife's children would inherit a partial interest in a note owed to them and their stepfather's trust and have to collect it against an estate with inadequate

assets. They have inherited in large part a lawsuit. So even the ubiquitous loan provision can have unintended consequences to a SLAT plan. Despite the powerful impact a loan provision can have this particular power does not receive much attention in the context of differentiating trusts.

Financial Structuring to Reduce the Reciprocol Trust Risk

Over the years a great amount of emphasis has been placed on differences in the trust documents to reduce the reciprocal trust risk. However, in some family situations it may be possible to reduce the risk by having spouses create smaller trusts for each other with the remaining exemption transferred simply to a dynasty trust for children and grandchildren (i.e., a trust that excludes either spouse as being a beneficiary).

For example, if everyone agrees based on a financial forecast that the wife should not need more than $200,000 per year to live on, and she has a maximum 15-year life expectancy, the husband could gift $3,000,000 into a trust for his wife, with the remaining exemption amount being gifted in a dynasty trust for the family. If the IRS successfully imposes the reciprocal trust doctrine, they could only impose it to the extent of $3,000,000, not the remaining exemption that was gifted to the non-SLAT dynasty trust.

If the above approach is pursued, consider what if DAPT, hybrid DAPT or SPAT provision were used?

Reciprocal Trust Doctrine is Not Just for Trusts!

While the analysis above has concentrated on transactions involving trusts, it is important to note that the reciprocal trust doctrine can potentially apply to outright gifts as well. In *Estate of Schuler*,[32] the taxpayer made outright gifts of entity interests to his brother's children, and his brother also made outright gifts of entity interests in the same entities to the taxpayer's children. By making gifts to additional family members, each brother applied for several more annual gift exclusions, reducing the total gift tax cost. The court in *Schuler* uncrossed the gifts, with the net result being each brother made the gifts to their own children rather than their nieces and nephews. This reduced the number of individuals that the annual gift exclusion applied to increase the taxpayer's total gift tax cost.

A similar fact pattern was found in *Schultz v. U.S.*,[33] where both brothers made gifts of stock to their nieces and nephews, in addition to their own children. The Court in *Schultz* uncrossed the gifts and found the brothers made the gifts to their own children, disallowing the annual gift exclusions that were applied and assessing additional gift tax.

Both *Schuler* and *Schultz* exemplify that practitioners may wish to caution clients when those clients are considering outright gifts to extended family. Courts will scrutinize these

gifts, and the specter of the reciprocal trust doctrine is not avoided even if the gifts are not made to trusts.

An Additional Warning: Be Intentional When Creating Grantor Trust Status for Spousal Trusts

Generally, when a settlor names a spouse as a beneficiary of a trust, the trust will automatically be a grantor trust.[34] Where a trust is a grantor trust, the income of the trust will be attributed to the spouse who created the trust, not the spouse who is the trust beneficiary. The attribution of the income to the grantor trust may continue even if the spouses divorce.

By being more intentional about how a settlor might include their spouse as a beneficiary, a practitioner might be able to avoid grantor trust status if non-grantor trust status is intended or preferable.

On the other hand, where a spouse is a beneficiary but may only receive distributions if an adverse party consents, the fact that the spouse is a beneficiary should not, in and of itself, cause the trust to be considered a grantor trust for income tax purposes.

Practitioners may consider whether to draft trusts so that distributions may only be made to the spouse with the consent of an adverse party. In general, practitioners should make it so that grantor trust provisions are intentional and may wish to consider whether to close off any other opportunities for the trust to be taxed as a grantor trust:

1. Specify that the Trustee has no power to lend any principal or income to the grantor for less than adequate consideration. Practitioners should caution clients that even if the trust does not specifically permit such loans and is not otherwise a grantor trust, where a loan between the settlor and the trust is not sufficiently secured and does not carry an adequate interest rate, the trust may nonetheless be considered to be a grantor trust.
2. Include a requirement that an adverse party consent to the use of trust income or principal to pay premiums of life insurance on the life of the grantor or the grantor's spouse.
3. Provide that no person in a non-fiduciary capacity shall have the power:
4. to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and any trust hereunder are significant from the viewpoint of voting control,

5. to control the investment of any trust assets either by directing investments or reinvestment or by vetoing proposed investments or reinvestment, to the extent that the trust assets consist of stocks or securities of a corporation in which the holdings of the Grantor and the trust are significant from the viewpoint of voting control.
6. Ensure that no one who is related or subordinate to the settlor may participate in a disposition in respect of the beneficial enjoyment of the principal or income of the trust, other than as the same may be exercised in a non-fiduciary capacity as a special power of appointment.[35]

Once all of the elements that would otherwise have made the trust a grantor trust have been eliminated, the practitioner may then add a separate provision that would permit the grantor or other non-adverse party[36] to "reacquire any trust assets or any portion thereof by substituting other property of an equivalent value."[37] This provision would make the trust a grantor trust until the settlor renounces the substitution power. By choosing to turn grantor trust status on in a more deliberate and intentional way, it should be easier for the client to turn off grantor trust status if that becomes desirable later, perhaps in the event of a divorce.

Additionally, the practitioner might wish to include a provision that the beneficiary spouse will lose beneficiary status in the event of a divorce or legal separation. Such a provision might define the settlor's spouse as "the person (if any) to whom that individual is married at any given time." Further, the trust agreement might clarify that the settlor's spouse will be treated as though they died when the settlor and spouse "became legally separated or divorced or their marriage was annulled."

Conclusion

Similar to the crush of planning that was completed at the end of 2012, 2020, and 2021, the results of the upcoming election in November 2024 and the reduction of the estate and gift tax exemption at the sunsetting of the TCJA provisions on December 31, 2025, have the potential to create a tsunami of work for practitioners. Clients, when wanting to complete planning on an urgent basis, may not understand the nuance of the step-transaction doctrine or the reciprocal trust doctrine. They will not appreciate the potential pitfalls that are created when implementing planning on a tight deadline. Often, clients will simply say they want to "get it done." However, if issues arise due to completing planning in a compressed manner, clients will likely respond negatively to the practitioner.

Practitioners should be cautious when approaching planning in the upcoming environment. Practitioners may wish to proactively communicate with clients, address potential issues that are identified with the planning, and provide clients with options for

reducing exposure to the step-transaction doctrine and reciprocal trust doctrine, if those options exist. Discuss with clients the potentially far-reaching economic implications of the differences that may be built into trusts that are established. Communication in the upcoming environment may assist practitioners in preventing clients from having "buyer's remorse" when establishing trusts.

If the Democrats are able to gain sufficient traction to enact estate tax restrictions clients may storm estate planners trying to get planning done. If the time to complete steps is limited practitioners may consider explaining the risks and the impossibility of quantifying the risks, and let clients make the decision as to whether to proceed and how. This may become similar to the compressed planning completed at the end of 2012. Practitioners might consider communicating to clients the potential step-transaction, reciprocal trust doctrine, and other risks and corroborating that the client has opted to proceed despite the risks. Many clients will likely proceed even in the face of these types of tax risks if the only other option is not planning at all. For practitioners, documenting that should there later be a problem may be prudent.

[1] Officially titled the "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law (United States) 115–97.

[2] The IRS publication of tax brackets in 2024 is provided here: **https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2024** Accessed August 30, 2024.

[3] The final text of Senator Warren's bill can be accessed here: **https://www.warren.senate.gov/imo/media/doc/final_text_-_ahem_2024.pdf** Accessed August 30, 2024.

[4] An analysis of Vice President Harris's proposals is provided by the New York Times here: **https://www.nytimes.com/2024/08/22/us/politics/kamala-harris-tax-plan.html** Accessed August 30, 2024.

[5] Kamala Harris proposes raising corporate tax rate to 28%, Reuters.com, **https://www.reuters.com/world/us/harris-calls-raising-us-corporate-tax-rate-28-percent-2024-08-19/** (visited September 7, 2024).

[6] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[7] *Linton v. US*, 638 F. Supp. 2d, 1277 (W.D. Wash. 2009).

[8] *Penrod v. Comr*. 88 T.C. 1415 (1987)

[9] *Smaldino v. Comr.*, T.C. Memo. 2021-127 (November 10, 2021).

[10] The Court in *Smaldino* specifically stated "*The record does not suggest that petitioner, in his dual roles as trustee of the Smaldino Family Trust and as manager of the LLC, gave express or implied consent for the admission of Mrs. Smaldino as a member in disregard of the operating agreement's restrictions. To the contrary, the record shows that on April 15, 2013—a day after he purportedly transferred the LLC member interests to Mrs. Smaldino—petitioner executed an amendment to the LLC operating agreement (providing for guaranteed payments to himself)…*"

[11] *Thomas Holman*, 130 TC No. 12, 5/27/08

[12] For an extreme case on the application of the step-transaction doctrine, see *De Goldschmidt-Rothschild v. Commissioner,* 168 F. 2d 975 (2d Cir. 1948)

[13] Several states require an affidavit of solvency for every transfer of assets to a self-settled domestic asset protection trust ("DAPT"). In addition, the state may require specific provisions incorporated into the trust document to qualify as a DAPT. Perhaps this step should not only be limited to DAPT transfers.

[14] *Sorensen v. Commissioner*, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered Aug. 22, 2022).

[15] Bruce D. Steiner, Esq., and Martin M. Shenkman, Esq. "*Beware the Reciprocal Trust Doctrine*," Trusts and Estates Magazine, pages 14-20 (April 2012).

[16] *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940).

[17] The transfers were made before the enactment of the predecessor of IRC Section 2036. Due to this, the retained income interest was not includible in the decedent's gross estate.

[18] The Court in *Lehman* stated the following regarding the trusts the brother's created, "*The decisive point is that the decedent by transfer of his share to the brother or for the brother's use or according to the brother's direction caused the brother to make a transfer of property in trust under which the decedent had the right to withdraw $150,000 from principal.*"

[19] *United States v. Grace*, 395 U.S. 316 (1969).

[20] The Supreme Court in *Grace* stated on page 324, "*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.*"

[21] *Estate of Bruno Bischoff*, 69 T.C. 32 (1977).

[22] *Estate of Green v. U. S.*, 68 F.3d 151 (6th Cir. 1995).

[23] The court in *Green* stated on page 154, "*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.*'"

[24] *Estate of Herbert Levy*, T.C. Memo. 1983-453 (1983)

[25] The *Levy* Court stated, on page 325, "*In contrast, Herbert Levy had no power of appointment over the income or the corpus of the Ilse Levy Trust. He was merely its trustee. 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 create different interests and which change "the effective position of each party visavis the [transferred] property * * *."* Note that, according to the court, the IRS conceded that, if the power of appointment granted to the spouse was enforceable, there should be no estate tax inclusion.

[26] Private Letter Ruling 9643013 (July 19, 1996) (not official precedent).

[27] Private Letter Ruling 200426008 (March 10, 2004)(not official precedent).

[28] A power of appointment is not a general power of appointment so long as the individual cannot appoint assets to themselves, their creditors, their estate, or the creditors of their estate. IRC Section 2041(b)(1)

[29] IRC Section 2514(e).

[30] *Lueders' Estate v. Comm'r*, 164 F.2d 128 (3d Cir. 1947).

[31] See O'Connor, Gans & Blattmachr, "SPATs: A Flexible Alternative to DAPTs," Estate Planning (Feb. 2019).

[32] *Estate of Schuler v. Commissioner*, 282 F.3d 575 (8th Cir. 2002).

[33] *Schultz v. U.S.,* 493 F.2d 1225 (4th Cir. 1974).

[34] See IRC Sect. 677(a)(1).

[35] IRC Code Sec. 674(a)

[36] As that term is defined in IRC Code 672(b).

[37] IRC Sect. 675(4)(C).