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# WRMarketplace

## An AALU/GAMA Washington Report

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***Topic: Case Study: The Reciprocal Trust Doctrine – A Trap for the Unwary***

**MARKET TREND:** The reciprocal trust doctrine can unwind legacy planning that involves mutually beneficial trusts; however, a careful and deliberate approach can shield transfers against application of the doctrine.

**SYNOPSIS:** In 2020, legacy planning for spouses and other related parties has focused largely on full use of their gift and estate tax exemptions due to the risk of prospective changes in the amounts of such exemptions. This type of planning often involves implementing mutually beneficial irrevocable trusts so that each party continues to have access to resources after the party gives assets away (e.g., spouses who each establish a spousal lifetime access trust ("SLAT") for the benefit of the other spouse). However, such trusts can sometimes contravene the reciprocal trust doctrine, which applies to interrelated trusts that have substantially identical terms and are part of the same transaction or plan. The doctrine treats each party who creates a trust in such a transaction (a "grantor") as having settled that trust for his or her own benefit, resulting in potential inclusion of the trust's assets in a grantor's estate at passing. Thus, a careful and deliberate approach is required to ensure the trusts' terms differ to the degree required to avoid application of the doctrine.

**TAKE AWAYS:** Mutually beneficial irrevocable trusts can be a powerful legacy planning strategy, so long as the trusts are structured to avoid the reciprocal trust doctrine. While the facts of each case are unique, best practices indicate that related grantors vary several factors among the respective trust agreements to reduce the risk of reciprocal trust treatment.

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Irrevocable trusts are a fundamental legacy planning tool that serve various planning purposes, such as providing liquidity for estate expenses and financial security for the grantor's family, including the lifetime support of a spouse (with the potential for indirect support of the grantor by his or her spouse). When spouses or other related parties (such as siblings) create trusts for each other, however, they must take extra care to avoid violation of the "reciprocal trust doctrine." The doctrine can undo the legacy planning benefits of the irrevocable trusts by unwinding the trusts and causing inclusion of the trust assets in the donor's estate, or by attributing gifts made by others to the grantor.

**REVIEWING THE RECIPROCAL TRUST DOCTRINE**

The reciprocal trust doctrine is a judicial concept that "uncrosses" transfers to two or more trusts when (i) the trusts are interrelated, and (ii) the arrangement, to the extent of mutual value, leaves the grantors in approximately the same economic position as they would have been had they created trusts naming themselves as life beneficiaries. The determination of whether trusts are "interrelated" depends on a variety of factors, including:

- When each trust was created (e.g., at the same or different points in time);
- The similarities or differences of the trusts' terms;
- Whether the trusts were created as part of the same transaction or plan;
- The identities of the beneficiaries and trustees; and,
- The relationship of the grantors to each other and/or the beneficiaries.

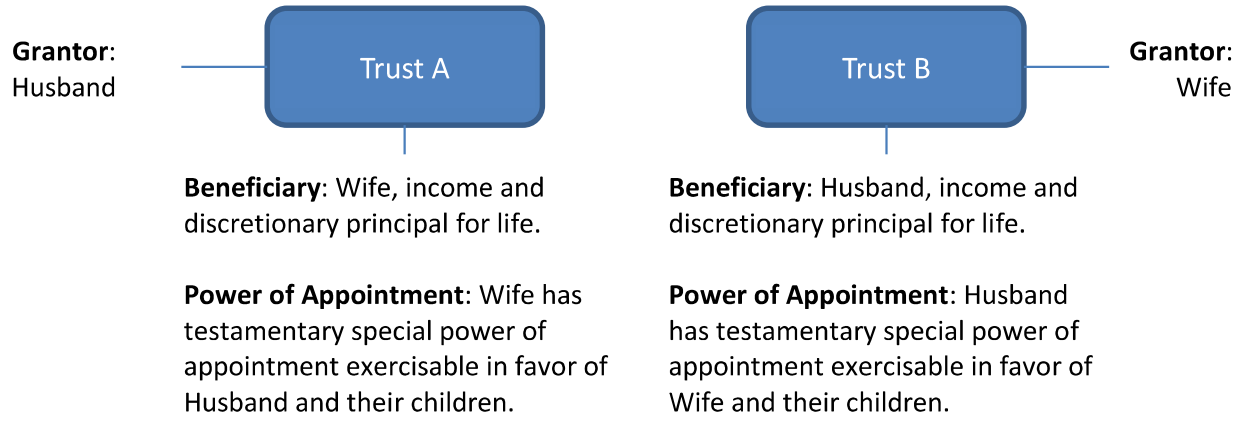
Once applied, the doctrine effectively treats each grantor of a related trust as having settled the trust for his or her own benefit or as having made additional gifts to his or her primary beneficiaries, resulting in potential inclusion of the trust's assets in the grantor's estate at passing or imposition of additional gift tax on lifetime gifts.

Application of the doctrine can be illustrated by the following case studies:

**CASE STUDY 1 – INTERRELATED TRUSTS**

A husband created a trust for the benefit of his wife, providing for the payment of income and discretionary distributions of principal to her for her lifetime as the trustees deemed advisable. The husband granted the wife a testamentary power of appointment exercisable in favor of the

husband and the couple's children following the wife's death. Two weeks later, at the husband's request, the wife executed a virtually identical trust for the husband's benefit during his life. The terms of the two trusts are illustrated by the following diagram.



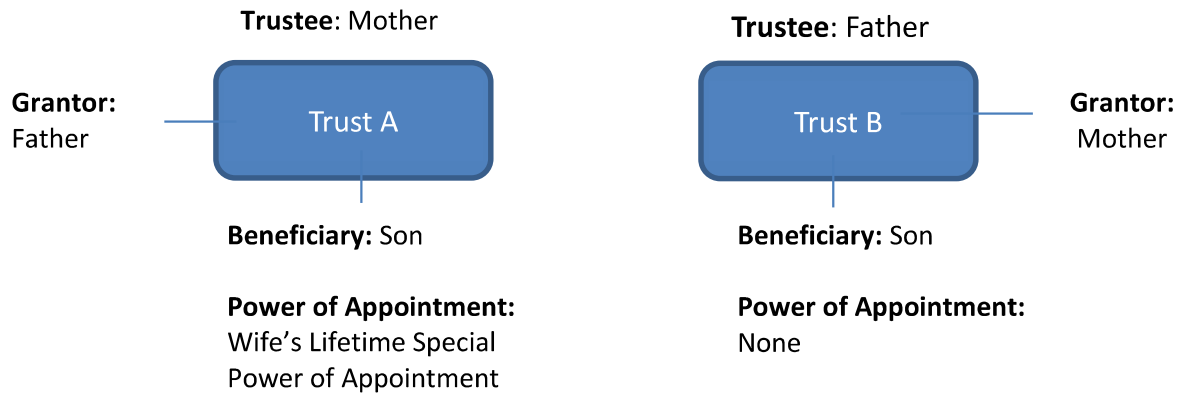

The wife predeceased the husband, and the trust created for her benefit terminated at her death. Following the husband's death, the IRS took the position that the trusts should be uncrossed with the result that the trust created for the husband by his wife (Trust B above) should be included in the husband's estate.

This case study illustrates the facts of *U.S. v. Grace*, 395 U.S. 316 (1969). There, consistent with the position taken by the IRS, the Supreme Court held that consideration or a quid pro quo did not have to be present for the reciprocal trust doctrine to apply. Rather, the application of the reciprocal trust doctrine required only that (i) the trusts are interrelated and (ii) that the arrangement, to the extent of mutual value, leaves the grantors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries. In finding that the trusts were interrelated, the Supreme Court focused on the facts that (i) the trusts had substantially identical terms, and (ii) the trusts were part of the same transaction or plan (i.e., created at substantially the same time).

*Grace* remains the leading case in analyzing the reciprocal trust doctrine, as illustrated by the discussion in *Matter of Jill Petrie St. Clair Trust Reformation*, 464 P.3d 326 (Kan. 2020). There, the Supreme Court of Kansas was presented with an action to reform a trust due to a scrivener's error resulting in concern that two trusts would be viewed as reciprocal trusts. In *Matter of Jill Petrie St. Clair Trust Reformation*, a husband executed a trust naming his wife as the income beneficiary during her life. Nine months later, his wife executed a trust with an identical distribution scheme, naming her husband as the income beneficiary during his life. The trusts were also funded with identical amounts. The court affirmed the reformation of the trust established by the wife, which granted her husband an annual withdrawal right and a special power of appointment.

**CASE STUDY 2 – "MARKEDLY DIFFERENT INTERESTS"**

A husband and his wife each created an irrevocable trust for the benefit of their son. The trusts were created on the same date and funded with identical assets. Each spouse served as trustee of the trust created by the other spouse. The only difference between the trusts was a lifetime special power of appointment granted to the wife in the trust created by the husband. The terms of the two trusts are illustrated by the following diagram.




The facts described in the case study above are those from *Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983). There, the Court noted that in order to determine whether the two trusts were interrelated, the terms of the trusts, the trust assets, the trustees, and the beneficiaries, as well as the date of creation and whether the trusts were created as part of a prearranged plan, had to be considered. In holding that the reciprocal trust doctrine did not apply to the trusts, the court noted that as a result of the special power of appointment, the decedent and his wife had "markedly different interests in, and control over, the trusts created by each other."

*Grace, Matter of Jill Petrie St. Clair Trust Reformation* and *Levy* (as well as related cases and rulings[1]) illustrate areas of concern when seeking to avoid application of the doctrine. No one factor is determinative, however. As noted in *Levy*, even a relatively small difference between trusts can be enough to prevent reciprocal trusts.

Where possible and consistent with a client's overall wishes, practitioners should consider the following suggestions in designing such trusts:

| **Best Practices to Avoid Application of the Reciprocal Trust Doctrine** | |
|---|---|
| **Timing** | |
| **Avoid**: Creating the trusts on the same date. | **Instead Consider**: Creating the trusts at different times and pursuant to different plans (e.g., if spouses are creating |

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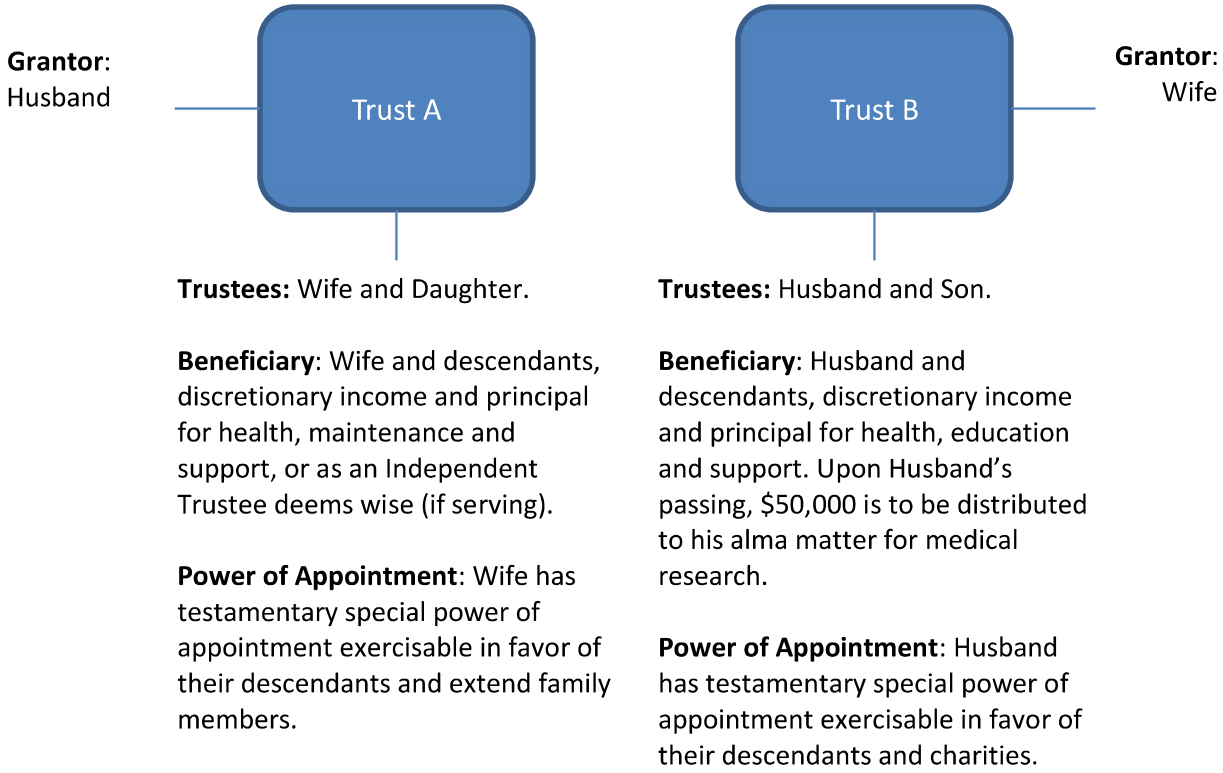
| | mutual trusts, create one trust now and the other sometime later as part of additional planning). |
| **Trustees** | |
| **Avoid**: Appointing the same trustees with the same powers under both trusts. | **Instead Consider**: Appointing different trustees and granting them different powers (e.g., the power to decant trust assets in only one trust) under the trusts or allowing beneficiaries of one trust to serve as co-trustees upon a specified event, but not under the other trust. |
| **Funding** | |
| **Avoid**: Funding the trusts with the same assets of equal value. | **Instead Consider**: Funding the trusts with different types of assets and/or different amounts (e.g., use one trust to acquire insurance on the grantor and fund the other trust with existing assets). |
| **Powers of Appointment** | |
| **Avoid**: Granting each spouse a power of appointment exercisable in favor of the same class of permissible appointees. | **Instead Consider**: Granting each spouse a power of appointment with different classes of permissible appointees (e.g., the power to appoint only to descendants versus the power to appoint to descendants or charities, or to extended family members in one trust but not in the other), or grant a power of appointment to another current beneficiary (such as an adult child of the donor). |
| **Distribution Standards** | |
| **Avoid**: Using the same standards for distributions under both trusts. | **Instead Consider**: Using different distribution standards, (e.g., require that one trust distribute all income annually with discretionary principal distributions while making all distributions discretionary in the other trust, and/or limit distributions in one trust to an ascertainable standard and use a broader standard in the other trust, etc.). |
| **Current Beneficiaries** | |
| **Avoid**: Naming the same current beneficiaries under both trusts. | **Instead Consider**: Varying the class of current beneficiaries (e.g., create a discretionary "pot trust" for the spouse and children in one trust and name the spouse as the only beneficiary in the other during his or her lifetime), or varying withdrawal rights between the trusts. |

| Remainder Beneficiaries | |
|---|---|
| **Avoid**: Naming the same remainder beneficiaries following the death of the beneficiary-spouse under both trusts. | **Instead Consider**: Varying the class of remainder beneficiaries following the death of the beneficiary-spouse (e.g., name the grantor's descendants as the remainder beneficiaries in one trust, and name the grantor's descendants and charity to some degree as remainder beneficiaries in the other. |

**CASE STUDY 3 – APPLICATION TO THOUGHTFUL TRUST DESIGN**

Husband and Wife have two children. Husband and Wife each create an irrevocable trust for the benefit of each other and their descendants. The trusts are created in separate calendar years with differing amounts and assets. Husband and one child serve as co-trustees of the trust created by Wife, and Wife and the other child serve as co-trustees of the trust created by Husband. The trusts employ different standards for distribution, classes of permissible appointees, and the trust created by Husband includes a charitable gift. The terms of the two trusts are illustrated by the following diagram.




The trusts in this example were created after giving careful thought to the clients' wishes and how the trusts might vary while still achieving their goals. Given the differences between the

two trusts, they are unlikely to be considered reciprocal trusts even if they are synchronized as part of the clients' overall legacy plan. Mutually beneficial trusts, if designed deliberately and with enough varying factors, may avoid classification as reciprocal trusts and provide the desired benefits and legacy planning outcomes to the grantors and beneficiaries.

**TAKE AWAYS:** Mutually beneficial irrevocable trusts can be a powerful legacy planning strategy, so long as the trusts are structured to avoid the reciprocal trust doctrine. While the facts of each case are unique, best practices indicate that related grantors vary several factors among the respective trust agreements to reduce the risk of reciprocal trust treatment.

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[1] *See e.g.*, *Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir. 1939); *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001); PLR 200426008 (March 10, 2004).