Understanding and Avoiding the Reciprocal Trust Doctrine

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When implementing a plan involving the transfer of assets to more than one trust with overlapping donors and beneficiaries, prospective donors and their advisers should be mindful of the possible application, and implications, of the so-called "reciprocal trust doctrine." In its simplest form, if A creates a trust for the benefit of B, and B creates a substantially identical trust for the benefit of A, the reciprocal trust doctrine enables a court (generally at the urging of the IRS) to "uncross" the trusts whereupon A and B will each be treated as the donor of the trust for his or her own benefit.

Depending upon the terms of the trusts' governing instruments, the uncrossing of these trusts can have catastrophic transfer tax implications that will undermine an otherwise carefully crafted plan. Consequently, it is important to have at least a general understanding of the doctrine, to recognize situations in which it may arise, and to have a strategy to avoid its application.

The Doctrine

The reciprocal trust doctrine was first articulated in 1940 by the Second Circuit Court of Appeals in *Lehman v. Commissioner*.[1] In *Lehman*, two brothers created identical trusts for the benefit of one another and their descendants. Upon the death of the first brother to die, the Court uncrossed the trusts and ruled that the property that the deceased brother could have withdrawn from the trust created for the deceased brother's benefit was includable in the deceased brother's estate. In making its ruling, the Court found that the brothers had essentially engaged in a quid pro quo whereby the brothers were considered to have paid one another to create a trust for their own benefit. In sum, the Court held that "a person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another."[2]

The *quid pro quo* reasoning described in *Lehman* was met with inconsistent application by the courts until the United States Supreme Court addressed the issue in 1969 in a case styled as *United States v. Grace.*[3] In *Grace*, a decedent transferred assets to a trust appointing himself, his nephew, and an unrelated person as trustees. The terms of the governing instrument directed the trustees to pay to the decedent's wife all of the trust's income, granted the trustees discretion to distribute principal to decedent's wife, and granted to the decedent's wife a testamentary power to appoint the remaining trust property among the decedent and their children. Fifteen days later, the decedent's wife created a trust for her husband's benefit that was substantially identical to the trust created for her by her husband and funded the trust with assets that had been transferred to her by her husband in the preceding years. Recognizing the general difficulties of applying the *quid pro quo* standard, the Court ruled that the value of the assets of the trust created by the decedent's wife were includable in the decedents' estate as a result of the reciprocal trust doctrine, and stated:

> *[W]e hold that application of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo for the other. Such a 'consideration' requirement necessarily involves a difficult inquiry into the subjective intent of the settlors. Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.*[4]

Consequently, the *Grace* standard appears to require (i) interrelatedness and (ii) an arrangement that, to the extent of mutual value, leaves the settlors in approximately the same position. If both of these elements are met, a court may conclude that the deemed-donor possesses beneficial interests or powers over the trust property that results in estate inclusion, resulting in an unexpected estate tax liability.

There is no safe harbor in the Treasury Regulations or other guidance that provides clean comfort to donors or their advisers regarding exactly what facts will, or will not, trigger application of the reciprocal trust doctrine in all circumstances. Rather, taxpayers and practitioners are left to analyze the case law and private letter rulings following *Grace* to predict what position the IRS may take based upon the specific facts of the situation.

Increased Importance in Recent Years

Although the reciprocal trust doctrine has existed for more than eighty years, the stakes have increased in recent years due to developments in transfer taxation and the increased use of certain planning techniques. One feature of the 2017 Tax Cuts and Jobs Act ("TCJA") is the substantial, albeit temporary, increase of the estate, gift and generation-skipping transfer tax exemption amount. The exemption amount, which is $11.7 million per person in 2021, was a "mere" $5.5 million per person prior to the enactment of the TCJA and, as recently as 2001, was less than $1 million per person. Under current law, the exemption is scheduled to revert to pre-TCJA levels (adjusted for inflation) in 2026, but Congress and the Biden Administration have signaled that changes to the transfer tax regime are on the horizon, possibly as soon as this year. Consequently, the window of opportunity to transfer a tremendous amount of wealth transfer-tax-free that has existed for the past few years may soon close for a period of time, if it hasn't closed already.[5]

It often makes sense from a tax-planning perspective for a wealthy individual to utilize his or her transfer tax exemption during his or her lifetime by making completed gifts of property. Making such gifts not only removes the gifted assets from the donor's taxable estate, but it also prevents the future appreciation of such assets from accumulating while under the donor's ownership. Lifetime gifting is especially effective during periods of inflated transfer tax exemptions because donors can leverage the system to a much greater extent. Especially when faced with a potentially declining exemption amount, prospective donors may desire to take action for tax-planning purposes, but may not have fully come to terms with the implications of gifting a substantial portion of their personal wealth. Donors may be uncertain about their own future needs and should be very reluctant to part with assets that could leave them with less assets than they require or desire in the future. Heroic gifting for tax-planning purposes that leaves the donor strapped for cash during his or her golden years is the epitome of allowing the "tax tail to wag the dog."

So-called "spousal lifetime access trusts," or "SLATs", are a popular planning technique that has helped some donors resolve these concerns, at least in part. A common example of SLAT planning involves Spouse 1 making a gift of assets equal to Spouse 1's remaining exemption amount to a trust for the benefit of Spouse 2 and their descendants, and Spouse 2 making a gift of assets equal to Spouse 2's remaining exemption amount to a trust for the benefit of Spouse 1 and their descendants. If the SLATs are designed correctly, contributions to the SLATs will effectively utilize the spouses' transfer tax exemptions and none of the trust property will be included in either spouse's taxable estate. SLAT planning may seem simple enough, and it has been quite popular during recent years as a result of the inflated transfer tax exemption amount. Such planning, however, can be complicated or undermined entirely by the reciprocal trust doctrine because the uncrossing of the SLATs may result in the spouses being treated as donors of trusts with respect to which they possess powers or rights that result in estate inclusion.

To be clear, the reciprocal trust doctrine can arise in myriad situations, but SLATs tend to be one of the more obvious situations in which the doctrine may be invoked.

Avoiding Application of the Doctrine

Although no safe harbor or other authority precisely sets forth steps to avoid application of the reciprocal trust doctrine, a variety of factors derived from court decisions, private letter rulings, and scholarly articles have become widely recognized as important considerations to avoid application of the reciprocal trust doctrine when making multiple transfers with overlapping parties.

Timing: As mentioned above, application of the reciprocal trust doctrine requires an element of interrelatedness. Separating gifts by a meaningful period of time should strengthen the argument that the gifts are not interrelated. Unfortunately, it is not clear exactly what period of time would be meaningful in this regard, although *Grace* indicates fifteen days is likely not sufficient. As a general rule, the longer the period of time the stronger the argument will be, and of course there should be no prearranged agreement obligating the second donor to make the second transfer.

Beneficiaries: One of the seemingly best ways to undermine a potential argument that trusts are interrelated or that the donors' economic positions have not changed is to ensure that the trusts have different beneficiaries. For example, one trust could be created for the benefit of the grantor's spouse and descendants (i.e. a SLAT described above), while the other trust could be for

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the benefit of the grantor's descendants only. Alternatively, other family members, loved ones or charities could be included among the class of only one trust's current beneficiaries. Similarly, the identities of the remainder beneficiaries could be different among the trusts. Any distinctions that cause the trusts to be dissimilar or that create a disparity in the economic positions of the donors should be helpful.

Powers of Appointment: Another method of differentiating the terms of the trusts in a manner that distinguishes the economic interests of the relevant parties is to grant powers of appointment to beneficiaries of one trust but not the other, or to alter the scope of the power or the time that such power may be exercised. For example, in the SLAT context, it may be sufficient to grant to one spouse a broad limited power of appointment exercisable during life or upon such spouse's death in favor of any person other than either spouse, either spouses' estate, either spouses' creditors or the creditors of either spouses' estate, and to grant to the other spouse a limited power of appointment exercisable only at death and in favor of only such spouse's descendants.

Distribution Standards: Yet another way to create separation with respect to economic positions is to alter the standards for distribution. For example, one spouse may be eligible to receive only income for such spouse's health, education, maintenance and support, while the other spouse may be eligible for discretionary distributions of both income and principal.

Withdrawal Rights: Similar in concept to providing different distribution standards, the trusts could provide beneficiaries with different withdrawal rights. Indeed, if withdrawal rights are included at all, such rights must be different or there will be a strong argument that the donors' economic positions are unchanged. Consequently, consider granting withdrawal rights to only one beneficiary but not to the other.

Assets: Contributing different assets to the trusts may also serve to substantially alter the donors' economic interests. Even if similar values are contributed to the trusts, contributing marketable securities to one trust and illiquid, closely-held business interests to the other will clearly alter the donor's interests.

Trustees and Other Fiduciaries: Another way to distinguish the trusts is to name different trustees or other trust fiduciaries. Similarly, one trust could create the role of distribution adviser or a distribution committee to direct the trustee with respect to distribution decisions and/or investment adviser to direct the trustee with respect to trust investments.

Design the Trusts to Qualify as Asset Protection Trusts: Consider designing the trusts so that, even if they were uncrossed, each trust would constitute an asset protection trust under Delaware's Qualified Dispositions in Trust Act that is not includable in the donor's estate.[6] Doing so may obviate both asset protection related issues and tax-related issues that could arise if the trusts were to be treated as self-settled for creditor rights purposes.

Conclusion

Donors and their advisers should remain vigilant to avoid the application of reciprocal trust doctrine and should understand the potential implications if the doctrine were successfully invoked. Failing to prepare accordingly may have substantial adverse tax implications that will undermine an otherwise well-designed plan.

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Notes:

1- 109 F.2d 99 (2d Cir. 1940).

2- *Id.* at 100, citing Scott on Trusts § 156.3 (1st ed. 1939).

3 -395 U.S. 316 (1969).

4- *Id.* at 324.

5- Some commentators have speculated that Congress may attempt to make any reduction in the transfer tax exemption retroactive to the date of introduction of the legislation as opposed to a date on or after the date that the legislation passes. Notably, Senator Bernie Sanders formally proposed the "For the 99.5% Act" on March 25, 2021, which would reduce the estate, gift and generation skipping tax exemption to $3.5 million in the case of estates and $1 million in the case of gifts, but the effective date for such reductions is December 31, 2021 in the current draft.

6-12 *Del. C.* §§ 3570 et seq.