Because you asked

The reciprocal trust doctrine

Estate planning for affluent families often involves irrevocable trusts of some kind. These trusts are powerful tools for safeguarding valuable assets for the benefit of loved ones, while also establishing the grantor's guidelines for how the beneficiaries should enjoy those assets. Often, multiple trusts are created to accomplish these goals, such as when a married couple creates two life insurance trusts, each for the benefit of the other spouse and their children. In these cases, individuals and their legal counsel must be careful to avoid triggering application of the "reciprocal trust doctrine," which could yield unintended consequences and potentially frustrate planning goals.

1. What is the reciprocal trust doctrine?
2. When does the reciprocal trust doctrine apply?
3. Can trusts be drafted to avoid the application of the reciprocal trust doctrine?
4. Does the reciprocal trust doctrine apply if the grantors are not beneficiaries of the trusts?

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1. What is the reciprocal trust doctrine?

The "reciprocal trust doctrine" is a judicially created doctrine that addresses perceived abuses when two transferors create trusts for each other, particularly in the context of estate and gift taxes. The Supreme Court has outlined two requirements for the doctrine to apply: the trusts 1) are "interrelated" and 2) leave each party in the same substantive economic position as they would have been in had they created trusts naming themselves as beneficiaries.[1] Trusts with substantially identical terms that were created at approximately the same time are interrelated. To illustrate the potential abuse targeted by this doctrine, consider the following examples.

Example 1

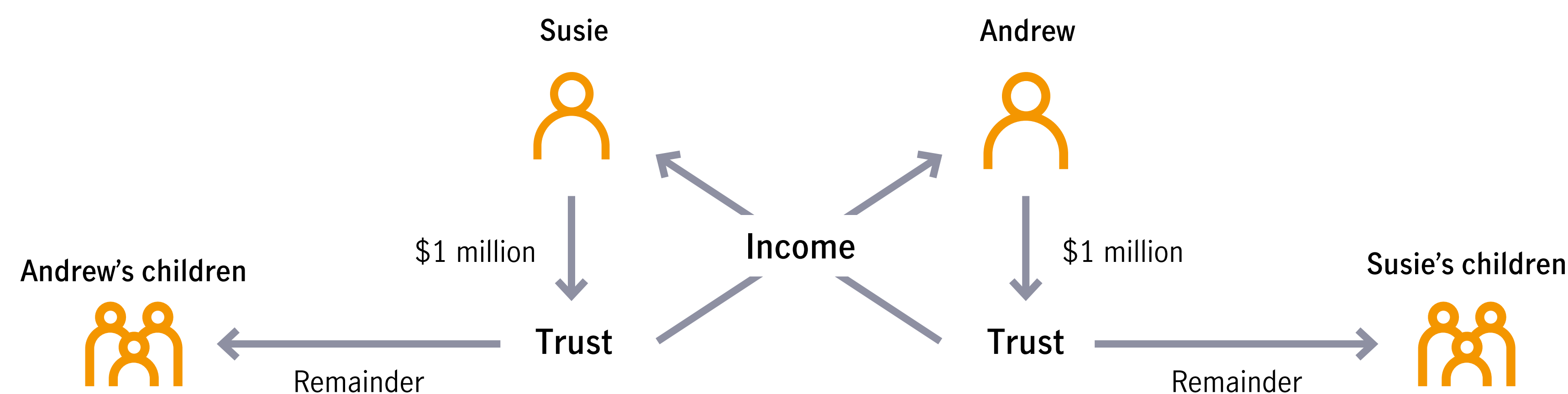
Susie transfers $1 million into a trust and retains the right to receive income for her life, with the remainder (corpus) passing to her children at her death. Even though Susie has transferred this money to a trust, the entire value of the trust will be included in Susie's estate due to her retained interest.

Example 2

Susie creates a trust and transfers $1 million to that trust with all income payable to Andrew, her brother, for his life and remainder to his children. At the same time, Andrew creates an identical trust for Susie's benefit and transfers $1 million into that trust, with all income payable to Susie for her life and remainder to her children (see below). Without application of the reciprocal trust doctrine, the transfers by Susie and Andrew would effectively allow each of them to retain the right to receive income on $1 million without having the trust property brought back in either of their taxable estates.

Compare the results of each example. If Susie creates the trust for herself and retains the right to income, the entire value of the trust is included in her estate at death. If Susie and Andrew create trusts for each other with the right to receive income, there is no inclusion under the literal language of the estate tax laws.

The facts in Example 2 closely resemble those of the 1939 case[2] that first set forth the reciprocal trust doctrine. The court in that case held that the economic substance of the transaction was the same as if each trust grantor had transferred the assets to a trust for **their own benefit,** with the remainder to **their own issue,** and that the reciprocation was a "mere trifle" lacking in practical or legal significance. Thus, the court disregarded the crossed reciprocation and held that each trust was to be treated as if it were created for the benefit of the grantor.



2. When does the reciprocal trust doctrine apply?

Where substantially similar or identical trusts are created at (or nearly at) the same time, the reciprocal trust doctrine can become an issue. Most commonly, this issue presents itself when doing irrevocable trust planning between spouses. For example, if a husband creates an irrevocable spousal access trust for the benefit of his wife and children (i.e., wife is a discretionary beneficiary of husband's trust) to own life insurance and his wife creates an identical trust for him, the reciprocal trust doctrine presents a real danger.

As illustrated in the previous examples, the doctrine is not limited to spouses and may apply even to outright transfers where no trust is used. In the *Sather v. Commissioner* case,[3] three brothers owned stock in the family business and each brother had three children. Each brother (and his spouse) made annual exclusion gifts of the stock to each of their respective children, and to each of their nieces and nephews. The result was 54 tax-free annual exclusion gifts from the parents to the children [6 donors (3 brothers and 3 wives) X 9 beneficiaries (all the children)) instead of 18 (2 donors (parents) X 3 beneficiaries (their own children) X 3 brothers]. The reciprocal trust doctrine was applied, causing 36 of these stock transfers to be taxable gifts, as they would if transferred directly from parent to child, resulting in a substantial gift tax liability.

3. Can trusts be drafted to avoid the application of the reciprocal trust doctrine?

As with most judicially created law, the answer is "it depends." Remember, the doctrine is triggered by substantially identical trusts being created at (or nearly at) the same time. Since its beginnings in 1939, the courts have refined, and occasionally confused, the definition of the doctrine. At its core, the doctrine applies to two or more trusts that are interrelated and leave each grantor in approximately the same economic position as they would have been in had each named themselves as the beneficiary. Thus, for trusts created at the same time, the more substantive differences there are between the trusts, and the more significant those differences are, the more unlikely a grantor will be left in the same economic position. For instance, grantors may consider differing provisions between the trusts of:

- **Current distributions –** one trust may be required to distribute all income, while the other either is required to distribute assets according to an ascertainable standard or has the discretion to distribute income or principal;
- **Different final distributions after the death of the current beneficiary –** one trust may divide the remaining assets among the descendants of the current beneficiary, while the other transfers all remaining assets to charity;
- **Beneficiary powers –** one trust may give its primary beneficiary a testamentary special power of appointment, while the other gives the beneficiary the power to name an additional charitable beneficiary;
- **Rights of collateral beneficiaries –** one trust may not give its beneficiaries the right to demand assets, while the other gives each beneficiary the power to withdraw each year an amount equal to $5,000 or 5% of the trust assets; and/or
- **Trustees –** the trusts may name different trustees or give the trustees different powers.

The reciprocal trust doctrine has been applied by the courts to "uncross" reciprocal trusts, resulting in substantially different tax consequences than the grantors of the trusts intended or expected. Whenever substantially similar trusts are created at the same time, it is prudent to consider the potential effects of the application of the reciprocal trust doctrine. Unfortunately, there is no silver bullet that can guarantee that two similar trusts created at the same time will escape application of the reciprocal trust doctrine. However, with a little attention and careful drafting, these risks can be reduced and planning can proceed.

4. Does the reciprocal trust doctrine apply if the grantors are not beneficiaries of the trusts?

Maybe. In *Estate of Bischoff v. Commissioner*, the Tax Court found the reciprocal trust doctrine applied to trusts created by grandparents for their grandchildren where each grandparent served as trustee for the trust created by the other, but neither grandparent had a beneficial interest in any trust.[4] The Tax Court concluded the retained fiduciary powers would lead to estate tax inclusion under §2036(a)(2) and so left each grandparent in the same economic position (being able to control the beneficial interest of the trust). The Sixth Circuit rejected this approach, finding that the reciprocal trust doctrine required a retained economic benefit.[5]

1. *United States v. Estate of Grace,* 395 U.S. 316 (1969).
2. *Lehman v. Commissioner,* 109 F.2d 99 (2d Cir. 1939).
3. *Sather v. Commissioner,* 251 F.3d 1168 (8th Cir. 2001).
4. *Estate of Bischoff v. Commissioner,* 69 T.C. 32 (1977).
5. *Estate of Green v. United States,* 68 F.3d 151 (6th Cir. 1995).

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Trusts should be drafted buy an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds. There can be costs associated with drafting a trust.

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