WRMarketplace

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TOPIC: Reciprocal Trusts – A Refresher

Irrevocable trusts are core legacy planning tools that serve a multitude of 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 indirect support of the grantor through spousal distributions). When spouses or other related parties create trusts for the benefit of each other, however, they must proceed cautiously to avoid violation of the so-called "reciprocal trust doctrine," which can defeat 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 attributing gifts made by others to the grantor.

WHAT IS THE RECIPROCAL TRUST DOCTRINE?

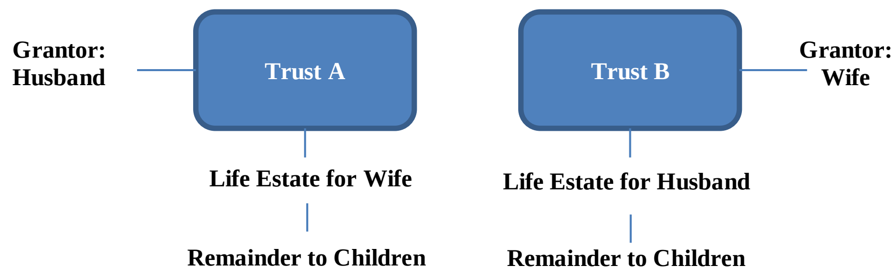
The reciprocal trust doctrine is a judicial concept that "uncrosses" transfers to interrelated trusts. Application of the reciprocal trust doctrine requires that (i) the trusts be interrelated and (ii) that the arrangement, to the extent of mutual value, leaves the grantors in approximately the same economic position as they would have been had they created trusts naming themselves as life beneficiaries. The determination of whether trusts are "interrelated" is factually-based and involves an analysis of a variety of factors, including:

- When the trusts were created (e.g., at the same or different points in time),
- The similarity or dissimilarity 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.

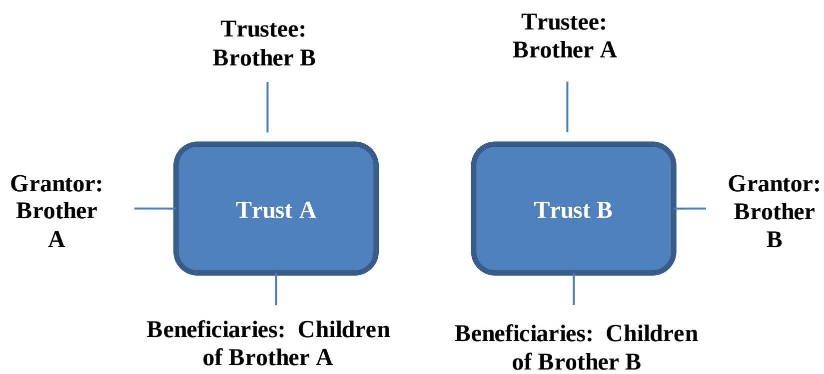
Once applied, the doctrine effectively treats each grantor of a related trust as having settled the trust for his or her own benefit or as having made additional gifts to his or her primary beneficiaries, resulting in potential inclusion of the trust's assets in the grantor's estate at passing or imposition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

A variety of interrelated planning situations may trigger application of the reciprocal trust doctrine, including when related parties (e.g., spouses, siblings, business partners, etc.):

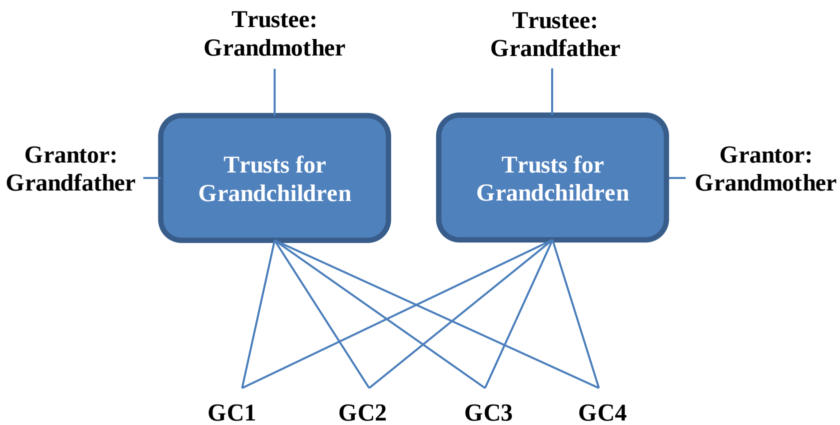
- Create identical trusts naming each other as beneficiaries, such as mutual gift trusts, irrevocable life insurance trusts (**ILITs**), or SLATs.[1]



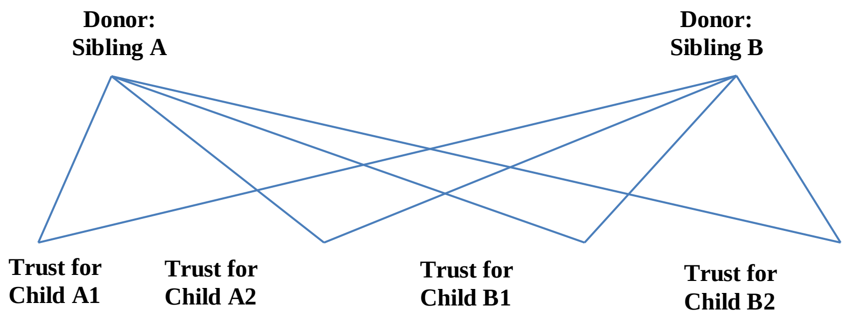
- Create identical trusts for their own children but name the other party as the trustee of the trust.



- Create separate trusts for the same beneficiaries and name each other as the trustee (for example, where a grandfather and grandmother create separate identical trusts for the benefit of their four grandchildren, naming the other grandparent as the trustee).[2]



- In the case of siblings, make annual exclusions gifts to trusts for their own children and also to trusts for their nieces and nephews.[3]



HOW CAN RELATED GRANTORS LIMIT EXPOSURE?

Potential ways for related grantors to limit exposure to the reciprocal trust doctrine when creating mutually-beneficial trusts include:

Limiting Exposure to the Reciprocal Trust Doctrine
• Create the trusts at <u>different times</u> and pursuant to different plans (e.g., if spouses are creating mutual trusts, create one trust now and the other some time later as part of additional planning undertaken by the spouses).
• Appoint <u>different trustees</u> and grant them <u>different powers</u> under the trusts.
• Allow beneficiaries of one trust to serve as co-trustees upon a specified event but not under the other trust.
• Fund the trusts with <u>different types of assets</u> and/or different amounts (e.g., use one trust to acquire insurance on the grantor and fund the other trust with existing assets).

Limiting Exposure to the Reciprocal Trust Doctrine

- Grant each spouse a <u>power of appointment</u> but use different classes of permissible appointees (e.g., the power to appoint only to descendants versus the power to appoint to descendants or charities) or grant a power of appointment to another current beneficiary (such as an adult child of the donor).
- Use <u>different distribution standards</u>, (e.g., (1) require that one trust distribute all income annually with discretionary principal distributions while making all distributions discretionary in the other trust, (2) limit distributions in one trust to an ascertainable standard and use a broader standard in the other trust, etc.).
- <u>Vary the beneficiaries</u> (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).
- Name <u>different remainder beneficiaries</u> following the death of the beneficiary-spouse.
- Grant the beneficiary-spouse a <u>five or five withdrawal right</u> in one trust but not the other.
- Include a <u>marital deduction trust</u> in one trust but not the other.

PUTTING IT ALL TOGETHER – MEET HARRY AND SALLY

To illustrate how to potentially limit exposure to the reciprocal trust doctrine, consider Harry and Sally, now in their late 50s, who have been married for 35 years and reside in Colorado. They have three children and four grandchildren. Harry and Sally are owners of a chain of sporting goods stores located throughout Colorado, Idaho, and Utah. All three children are actively involved in the family business. Harry and Sally would like to set up a legacy plan that will allow them to benefit from the business for their lifetimes while transferring future appreciation on to their descendants and ensuring the business enterprise continues for future generations.

To achieve the above goals and effectively use the current high gift tax exemption, Harry and Sally decide to transfer a large part of the family business to mutually-beneficial SLATs. Use of identical SLATs however, likely will expose the trusts to the reciprocal trust doctrine and result in inclusion of trust assets in the estate of a spouse at passing. To limit the application of the doctrine, rather than naming each other as trustees, they will appoint third party trustees. As illustrated by the following chart, they will also vary the terms of their SLATs.

Trust Provisions	Sally's SLAT	Harry's SLAT
Beneficiaries	Harry and the children	Sally and all descendants
Assets Transferred to Trust	Interests in the family business	Interests in the family business and cash to fund acquisition of a life insurance policy on Harry (Harry will make annual exclusion gifts to the trust to fund future premiums)
Distributions During Harry or Sally's lifetime	All income to Harry. Income and principal to Harry and the children for health, education, maintenance and support (**HEMS**), in the trustee's discretion. An independent trustee may make principal distributions for any purpose.	Income and principal to Sally and descendants for HEMS in the trustee's discretion. An independent trustee may make principal distributions for any purpose.
Withdrawal Rights	Harry will have a noncumulative right to withdraw 5% of the value of the trust estate each year	Sally may withdraw the greater of $5,000 or 5% of the value of the trust estate from the annual contributions to the trust. Each descendant also may withdraw a pro-rata share of annual contributions to the trust, not in excess of the available annual gift tax exclusion amount
Testamentary Powers of Appointment	At passing, Harry may appoint the trust assets to Harry and Sally's descendants	At passing, Sally may appoint the trust assets to anyone she selects other than herself, her estate, her creditors, or her estate creditors

TAKE AWAYS

Mutually-beneficial trusts can effectively serve the legacy planning needs of related parties, both currently and post-tax reform, so long as they do not run afoul of the reciprocal trust doctrine. While application of the doctrine is factually based, best practices recommend that related grantors who create mutually-beneficial irrevocable trusts vary the terms of the trusts, and, when possible, the timing of trust execution and funding, to reduce the risk of reciprocal trust treatment.

NOTES

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

[1] See, *U.S. v. Grace*, 395 U.S. 316 (1969); *Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir. 1939).
[2] See, *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977).
[3] See, *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001).