

Reciprocal Trust Doctrine: Practical Tips for Successful Planning in the New Environment

Handout materials are available for download or printing on the **HANDOUT TAB** on the gotowebinar console. If the tab is not open click on that tab to open it and view the materials.



ChronicIllnessPlanning.org

Reciprocal Trust Doctrine: Practical Tips for Successful Planning in the New Environment

By: Martin M. Shenkman, Esq.,
Jonathan G. Blattmachr, Esq., Robert
S. Keebler, CPA and Alan S.
Gassman, Esq.



**A KEY ESTATE
PLANNING GUIDE**

Law Easy

Some Webinar Pointers

- All programs hosted by Shenkman Law are free and we focus on providing colleagues with practical and actionable planning ideas. Our goal is to help you, our colleagues, with your practice.
- The PowerPoint is available for download from the web console during the program.
- A recording of this program and the materials will be posted to www.shenkmanlaw.com/webinars within about a week of the program. There is a growing library of 150+ webinar recordings there.
- There is a growing library of 200+ video planning clips on www.laweasy.com.
- If you have questions, please email the panel. All emails are listed near the end of the slide deck.

Thank you to our sponsors

- InterActive Legal
 - **Teresa Bush**
 - *Director of Education and Support Services*
 - (321) 252-0100
 - sales@interactivelegal.com



InterActive Legal

Thank you to our sponsors



Andre Sears

National Business Development Officer

(888) 544-6775

expert@peaktrust.com

www.PeakTrust.com

General Disclaimer

- The information and/or the materials provided as part of this program are intended and provided solely for informational and educational purposes. None of the information and/or materials provided as part of this PowerPoint or ancillary materials are intended to be, nor should they be construed to be, the basis of any investment, legal, tax, or other professional advice. Under no circumstances should the audio, PowerPoint, or other materials be considered to be, or used as independent legal, tax, investment, or other professional advice. The discussions are general in nature and not person-specific. Laws vary by state and are subject to constant change. Economic developments could dramatically alter the illustrations or recommendations offered in the program or materials.

Introduction

**Are Changes
Coming before
2026?**

Will There Be A Sunset of the 2017 TCJA?

- With the Republican sweep, the 2026 sunset of the bonus exemption may happen, or not. But it is unlikely that any estate tax increases or restrictions will be enacted.
- The Tax Cuts and Jobs Act of 2017 (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) is scheduled to sunset as of December 31, 2025, as a matter of current law, potentially resulting in significant changes to the estate and gift tax laws. The Republicans have already announced the possibility of trying to extend the 2017 tax breaks.
- 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) to \$5 million inflation-adjusted, estimated to be approximately \$7,000,000 in 2026. But what happens to that planning now?

Planning Considerations

- While no negative tax changes are anticipated there is no assurance that the bonus exemption will be extended so planning should continue, but differently.
- For the ultra high net worth planning should continue and if access to trust assets is relevant then the reciprocal trust doctrine remains an issue to address.
- For all other clients, income tax planning, asset protection and possible estate taxes (now if the bonus exemption is not maintained or in the future if and when the political winds again shift) the reciprocal trust doctrine is an issue.
- The environment post-election may (MAY) be less pressured but planning must continue and the Reciprocal Trust Doctrine is a major consideration.

Reciprocal Trust Doctrine

**Significant Planning
Creates Additional Risk**

Clients May Consider Gifting Significant Portion of Net Worth

- 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, in order 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 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.

Effect of a Successful Reciprocal Trust Doctrine Challenge

- 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 previously, may potentially cause the trust to be included in the client's estate as well as reachable by their creditors.

Reciprocal Trust Doctrine

History of How it Evolved



Establishing the Reciprocal Trust Doctrine

- The concept of the reciprocal trust doctrine for tax purposes was first established in *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940).
- 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.
- 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.

Does Motive Matter?

- 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*, 395 U.S. 316 (1969) 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. The motive for creating the trusts was not relevant.

Avoiding the Same Economic Position Problem

- 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 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 some differences that might be meaningful to differentiate the economic positions of the parties after trust creation include: funding trusts with different assets, funding one trust with life insurance and the other materially different or no coverage, changing standards for distributions to each spouse under each trust, etc.

Taxpayer Loss Provides Guidance – Estate of Bruno Bischoff

- In Estate of Bruno Bischoff, 69 T.C. 32 (1977), 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.
- Even though the Bischoff's were not beneficiaries of each other's trusts, the reciprocal trust doctrine still ruined their planning.
- 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).

Taxpayer Victory Provides Guidance – Estate of Green

- While the facts in Estate of Green v. U. S., 68 F.3d 151 (6th Cir. 1995) were similar to Bischoff, a Sixth Circuit Court decision had a different result.
- 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.
- 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 effort to differentiate the trusts?

No Bright Line Rule

- There have been numerous taxpayer-friendly decisions regarding the reciprocal trust doctrine subsequent to Grace.
- 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.
- When feasible, integrate additional differences between trusts, similar to how practitioners have in the past added a second or even third mechanism to assure grantor trust status.

Reciprocal Trust Doctrine

**Deflecting Reciprocal
Trust Challenges**



Changing the Clients' Economic Position - 1

- 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, T.C. Memo. 1983-453 (1983) 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.

Changing the Clients' Economic Position - 2

- 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.
- But as discussed previously, 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 differences are incorporated that sufficed under a particular case.

Differentiating Beneficiary Status of Spouses - 1

- In Private Letter Ruling 9643013 (July 19, 1996) (not official precedent), husband created a trust for the benefit of his descendants. Wife created a similar trust. However, wife's trust was for the benefit of both 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 was 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.

Differentiating Beneficiary Status of Spouses - 2

- The IRS in Private Letter Ruling 200426008 (March 10, 2004) 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.

Is Differentiating Powers of Appointment Enough - 1

- Based on Levy and the two 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.

Is Differentiating Powers of Appointment Enough - 2

- 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.
- Many clients prefer the level of control naming each other as trustees provides. If so, consider noting 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.

Reciprocal Trust Doctrine

**Powers to Consider
Incorporating in Trusts**



Planning Considerations and Different Goals

- The following slides include a list of some of the differences to consider incorporating into trusts to provide significant differences.
- 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.
- Create significant economic differences in the positions the husband and wife 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.

Different Jurisdictions and Beneficiaries - 1

- 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.

Different Jurisdictions and Beneficiaries - 2

- 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.

Different Trustees

- 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 full-service institutions or purely administrative trustees, could provide a greater difference between the trusts.
- Naming the spouses as each other's trustees appears to have been viewed negatively by courts and the IRS.

Different Powers of Appointment - 1

- As in Levy and PLR 9643013, one trust might grant the beneficiary-spouse a power of appointment while the other trust does not.
- Consider advising 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.

Different Powers of Appointment - 2

- 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. Spouses should consider the breadth of the power granted and what the impact of an exercise might be after a divorce or other circumstance.
- 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 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.
- 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.

Provide a 5 and 5 Power in One Trust

- 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. In addition, including a 5 and 5 power may expose the withdrawable assets of the trust to the powerholder’s creditors.

Different Marital Saving Clause

- 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 spouse receives assets outright, the other spouse in a QTIP trust, etc.).

Different Powers Provided to Spouse in Trust

- 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.
- 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

Timing of Trusts

- Establish the trusts at different 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.
- 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.
- 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 gift 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.

Differentiate Assets Held in Each Trust

- For clients that have a varied portfolio of assets, such as marketable securities, privately held business interests, significant insurance policies, etc., consider recommending that the clients contribute different 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, 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.
- 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 of 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. Might the use of a DAPT, hybrid DAPT or SPAT negate that argument?

Differentiate Level of Funding

- 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.

Reciprocal Trust Doctrine

**Advise Clients of
Consequences of
Differences**



Communicate Differences with Clients

- As 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).
- 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.
- 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 economic impact of the distinctions between the trusts.

Impact of 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.

Impact of a 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.

Impact of Powers of Appointment

- 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 secretly 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.

Impact of Different Beneficiaries

- Modern trust drafting commonly incorporates several phases of the trust's "life cycle," where each phase has different governing provisions, i.e., different beneficiaries during the Grantor's life, after the Grantor's death, and after the death of both the Grantor and the Grantor's spouse.
- 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.

Impact of Loan Provisions - 1

- 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 individual given the power 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.

Impact of Loan Provisions - 2

- 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.

Reciprocal Trust Doctrine

**Using Financial Modeling
to Structure Plans**



Differentiating Trusts Based on Financial Need

- 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, it may be they would 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 effect there would be if a DAPT, hybrid DAPT or SPAT provision were used?

Reciprocal Trust Doctrine

Not Just for Trusts!



Applying Reciprocal Trust Doctrine to Outright Gifts

- While we have 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 v. Commissioner*, 282 F.3d 575 (8th Cir. 2002), 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, which increased the taxpayer's total gift tax cost.
- *Schuler* exemplifies 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.

Conclusion and Additional Information

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 sunset 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.
- Communication in the upcoming environment may assist in preventing clients from having “buyer’s remorse” when establishing trusts.

Additional information

- Martin M. Shenkman shenkman@shenkmanlaw.com
- Jonathan G. Blattmachr jblattmachr@pioneerllc.com
- Robert S. Keebler, CPA
Robert.Keebler@keeblerandassociates.com
- Alan S. Gassman, Esq.
agassman@gassmanpa.com
- Interactive Legal sales@interactivelegal.com
- Peak Trust Company experts@peaktrust.com