by Terri Getman, J.D.*, CLU, ChFC, RICP, AEP (Distinguished)

Will There Be an Estate Tax Problem If A Couple Establishes Reciprocal ILITS?

Situation: Today, moderately wealthy couples are increasingly worried about the future lower Federal exemption amount. To keep the life insurance proceeds outside their estate, we often suggest that their life insurance be owned by an irrevocable life insurance trust (ILIT). Many of those clients purchase life insurance because of the long-term care or chronic illness riders. We often find that these couples want to include provisions in their ILITs that make the trust assets "accessible" while removing the policy proceeds from their estates – so called Spousal Limited Access Trusts or SLATs.

Arguably, it's possible to give the non-insured spouse a limited beneficial interest and the children the ultimate remainder beneficiaries, while still excluding the policy from the couple's estate. However, the law regarding the use of SLATs as well as the choice of long-term care rider is still developing, so there is a tax risk of estate inclusion. Clients must consider the tax risks, along with what should happen in the event of divorce or premature death of the noninsured spouse. Furthermore, a question that inevitably comes up is, "If one spouse can do this, can both spouses create trusts with substantially similar provisions?" Specifically, can the wife and children be the beneficiaries of a trust with the husband as the insured, while the husband and the children are the beneficiaries of a trust with the wife as the insured? This *Counselor's Corner* sheds light on this question.

Solution: When two trusts are interrelated and leave the grantors in about the same economic position as if they had made themselves life beneficiaries of the trusts they created, the grantors of the trusts are switched and each grantor is regarded as creating a trust under which s/he retained a life interest for himself. This results in the inclusion of the trust in each grantor's estate under IRC § 2036. This theory is known as the reciprocal trust doctrine.

Early History of the Doctrine

The reciprocal trust doctrine was developed over the years as a result of IRS challenges and subsequent court cases. Since it developed from a number of different factual situations and is not defined in any statute, it is an unsettled area that depends upon the facts and circumstances of each case. A review of some of the major cases is helpful to better understand how the doctrine has been applied.

The 1940 case, *Lehman v. Commissioner*,[1] is the first one reported on the subject. It involved two brothers who established trusts for the benefit of each other and the other's children. The court stated that three circumstances were present that made the trusts reciprocal and, therefore, would not avoid estate tax. Those three were:

- Quid pro quo consideration occurred between the individuals involved (each trust was created as a quid pro quo for the other).
- The individuals were in the same economic position before and after the establishment of the trusts.
- The trust provisions were interrelated, meaning similar in terms.

For the Education of Financial Advisors & Financial Professionals. Not for use with the General Public.

The application of the reciprocal trust doctrine initially turned on whether there was a finding of quid pro quo consideration passed between the parties. It was not too many years later that courts in different jurisdictions began articulating the doctrine differently. Some courts followed the rationale of the Second Circuit *Lehman* case, but others eliminated the requirement for a *quid pro quo* and attempted to clarify the meaning of "interrelated" by defining it as combinations of the following:

- Trusts that are created as part of a plan.
- Trusts with substantially similar terms.
- Trusts with the same trustee.
- Trusts funded with the same assets.

As a result of these different cases, whether trusts were deemed to be reciprocal depended upon where one lived. It became incumbent on the Supreme Court to bring some sense of uniformity to the matter.

The Supreme Court Speaks

The case that reached the Supreme Court was *U. S. v. Grace*.[2] The Court in *Grace* held that the reciprocal trust doctrine is not dependent upon a finding that each trust is created as a quid pro quo for the other. The Court held that there were only two factors that needed to be present to find reciprocity of trusts:

- The trusts were interrelated (pursuant to the same plan).
- The parties were in the same economic position before and after the establishment of the trusts.

Trusts were deemed interrelated if they were created pursuant to a plan and had substantially the same terms. While trusts were presumed to be interrelated if they were created at the same time, creating trusts with a time interval between them does not necessarily mean that they are not reciprocal. The key to the interrelationship test, the Court stated, is whether the trusts were created pursuant to a plan. The time interval is simply evidence one way or the other.

Subsequent to *Grace*

Subsequent to *Grace*, legal advisors began to speculate on how they might prevent the doctrine from applying by breaking one of the two factors. Most of the focus by legal advisors has been on drafting trusts in hopes to sever the interrelated prong of the test because, generally, most families want the ability to have the assets distributed back to the family unit.

One Tax Court case that shed some light on the interrelated prong is *Estate of Levy*.[3] The trusts In *Levy* were drafted so that a special power of appointment was given to Mrs. Levy who was the grantor of the second trust, but that trust did not grant a reciprocal power back to Mr. Levy. Because of this, it was maintained that the husband and wife were in different economic positions relative to each other before and after the establishment of the trusts and thus outside the holding of *Grace*.

Mr. and Mrs. Levy each owned the same number of shares of their company stock. Each trust also owned an equal number of shares. When the trust shares subject to her power of appointment were added to her individual holdings, Mrs. Levy had greater control over the company than her husband. They no longer had the equal voting rights that they had before the trusts were put in place.

The Court considered, “[the] terms [of the trusts], corpus, and beneficiaries, as well as their date of creation and their relation, if any, to a prearranged plan.” In arriving at the conclusion that the trusts were not reciprocal, the court, citing *Grace*, stated, “…the decedent and his wife had markedly different interests in, and control over, the trusts created by each other. The reciprocal trust doctrine does not purport to reach transfers in trust which create different interests and which change ‘the effective position of each party *vis a vis* the [transferred] property . . .’” The insertion of a special power of appointment in one trust and not the other does not, in and of itself, lead to the conclusion that the interests of the parties are different. It was the particular facts of *Levy* that gave that result.

Reciprocal Trust Expanded - Reciprocal Gifts

The reciprocity doctrine is not confined to those situations that utilize trusts. Some of the same principles apply to the making of gifts. The Tax Court in *Sather v Commissioner*[4] held that gifts made between the families of three brothers were reciprocal. In each case, the brothers and their wives made gifts to their own children that exceeded the amount of their available annual exclusions. In an attempt to shelter further gifts, all three couples made additional gifts, in approximately the same amount, for the benefit of their nieces and nephews.

The Court applied the reciprocal trust doctrine of *Grace* in holding that the couples were in the same economic position before and after the gifts were made. The gifts were held to be reciprocal and the annual exclusions for the gifts to the nieces and nephews were disallowed. The court deemed the gifts to the nieces and nephews as having been made by the parents to their own children and, therefore, they exceeded the available annual exclusions.

In Summary

It’s not uncommon for married couples to establish two trusts for owning life insurance. To avoid application of the reciprocal trust doctrine, the provisions of the trust should be fundamentally different. Other factors such as different trustees and separate assets contributed to the trust also help to avoid application of the reciprocal trust doctrine. Because of the way in which the doctrine of reciprocal trusts has developed over the years, the question of whether or not a trust or gift is reciprocal is not always easy to answer. Whenever licensed financial representatives find themselves in situations that call for establishing two life insurance trusts, it is important that clients retain legal counsel knowledgeable of the reciprocal trust doctrine.

---

[1] 109 F.2d 99 (2nd Cir. 1940).
[2] 395 U.S. 316 (1969).
[3] T.C. Memo 1983-453.
[4] Sather v Commissioner, TC Memo 1999-309.

For the Education of Financial Advisors & Financial Professionals. Not for use with the General Public.

This material has been prepared to assist our licensed financial professionals and clients’ advisors. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that we are not rendering legal, accounting or tax advice. Such services must be provided by the client’s own advisors. Accordingly, any information in this document cannot be used by any taxpayer for purposes of avoiding penalties under the Internal Revenue Code.

5501 Excelsior Boulevard | Minneapolis, MN 55416