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Taxation -- Reciprocal Trusts

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NOTES

Taxation

RECIPROCAL TRUSTS

Introduction

The doctrine of reciprocal trusts has been bandied about by the courts, both tax and appellate. At its inception this doctrine appeared to be both an efficient tax saving device and a convenient way to provide for the future of one's spouse all in one package. This illusion was short-lived, for, at the very outset, in the case of *Lehman v. Commissioner*,[1] some of the beneficial features were taken out of this tax saving trust device. No distinction was made between the tax-avoidance and beneficial features of these trusts. The courts have continued through recent years to deplete these trusts incorporating the doctrine of the *Lehman* case.

It is our purpose to examine the *Lehman* doctrine and its ramifications from its inception to the present, dwelling chiefly on the recent developments in the field of reciprocal trusts,[2] and referring to the application of the Internal Revenue Code of 1954. It will be seen that while the tax courts were the primary area for decision in reciprocal trust cases, recent developments show an expansion into other fields.[3]

Simply stated, a typical reciprocal trust arises in the following manner: A husband creates a trust, giving his wife a life estate with power to alter, amend, or terminate, with the remainder to his children, and with the wife and a bank as trustees. On the same day the wife creates a similar trust giving a life estate to her husband with the same powers as given her, with remainder to the children, and with the husband and same bank as trustees. If all the instruments considered in this field were as simple as this, there would be little trouble in taxing them,

[1] 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940).

[2] For a detailed explanation of the historical development of the law of reciprocal trusts, see Colgan and Molloy, *Converse Trusts — The Rise and Fall of a Tax Avoidance Device*, 3 TAX L. REV. 271 (1948); Lyman, *Reciprocal Trusts in Estate and Gift Taxation*, 42 CALIF. L. REV. 151 (1954).

[3] Security Trust Co. v. Sharp, 77 A.2d 543 (Del. Ch. 1950), see discussion *infra*.

but numerous variations[4] present a like amount of problems.[5] A large factor contributing to this variation is that the motives and desires of the deceased must be gleaned from the instruments themselves and the circumstances surrounding their creation.

Reciprocal Trusts and Taxation

EARLY DEVELOPMENTS IN THE TAX FIELD

The *Lehman* case[6] is the keystone in the early history of this doctrine. Every small segment of tax law seems to have its model which sets up the particular field and lends its color to all similar transactions. This situation has been present in reference to indirect benefits under a trust,[7] amounts realized in sale of property,[8] and assigned renewal commissions of insurance agents.[9] In the field of reciprocal trusts it is the *Lehman* case that prevails. Affecting only the field of estate tax at first, the *Lehman* doctrine was extended to apply to both income and gift tax cases. An examination of this case serves two purposes; it gives an excellent example of these trusts apart from the all too prevalent hypothetical situation; and it lays the foundation for this discussion.

In 1930 the two Lehman brothers decided to create trusts between themselves. They employed the same attorneys, used the same form, invested the same amount of money and reserved the same powers for each other, thereby creating in all respects, identical trusts. Each brother created a trust for the other with the net result that no one lost a thing. Each had just what he started with, except that it was in a trust created by his brother.

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[4] This point is shown in the variety of names alone, which arise from courts terming the instruments cross-trusts, Estate of Lindsay, 2 T.C. 174 (1943); parallel trusts, Estate of Bell, 46 B.T.A. 484 (1942), *rev'd*, 137 F.2d 454 (8th Cir. 1943); converse trusts, *In re* Perry's Estate, 111 N.J. Eq. 176, 162 Atl. 146 (1932); Siamese twins trusts, McArthur v. Faw, 183 Tenn. 504, 193 S.W.2d 763, *cert. denied*, 329 U.S. 780 (1946); or reciprocal trusts, Hanauer's Estate v. Commissioner, 149 F.2d 857 (2d Cir. 1945), *cert. denied*, 326 U.S. 770 (1945).

[5] "The issue is of the type, not unfamiliar in the law, where the distinctions are not black and white, but of varying shades of gray and where the shade chosen by a court will seem 'realistic' to him whose side wins and artificial or fanciful to the other." Commissioner v. Dravo, 119 F.2d 97, 99 (3d Cir. 1941).

[6] Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940).

[7] Helvering v. Clifford, 309 U.S. 331 (1940).

[8] Crane v. Commissioner, 331 U.S. 1 (1947).

[9] Helvering v. Eubank, 311 U.S. 122 (1940).

The court examined this system of cross-trust agreements and held that since each was created upon the inducement of a like trust being created in return, in effect, each was furnishing the consideration for settling a trust for his own benefit. As stated in Scott, *Law of Trusts*, "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 person."[10] Since each brother was the settlor he was not entitled to the rights and privileges of an ordinary beneficiary. Looking through the form to the substance the court invalidated this arrangement as a tax avoidance scheme. In reaching this decision the court solved one case but unfortunately opened the gates to many more questionable decisions. Its greatest significance was that it laid down the basic and still unchanged law of reciprocal trusts.

The *Lehman* doctrine's application in the field of estate tax is its main area of development. Here the courts expanded the scope of the doctrine by inferring the prerequisites for its application. In the *Estate of Fish*,[11] trusts between a husband and wife, revocable only on agreement between the parties, were held to be reciprocal as the grantor was actually reserving to himself the resulting income. In *Hanauer's Estate v. Commissioner*[12] simultaneous identical trusts were held to be under the *Lehman* doctrine on the basis of the wife's propensity to follow her husband's footsteps in business matters. The doctrine was stretched still further to apply in the *Estate of Eckhardt*.[13] Though the trusts were separately created, the court inferred from the evidence that there must have been at least a tacit agreement between the settlors because of their unusually intimate financial and business relationship. These cases placed the burden upon the administrators of the estates to rebut the inference that reciprocity was present. A partial application of the *Lehman* doctrine was present in *Cole's Estate v. Commissioner*,[14] wherein similar irrevocable trusts were created, the only difference being the size of the corpus of each. The husband placed 700 shares of stock in trust while the wife only settled 300 shares. The court held that to the extent of 300 shares the trusts were reciprocal and taxable as such. These decisions, none of which show bad intentions on the facts, as was the case with the Lehman brothers, appear to be a far cry from the original intention of the framers of the *Lehman* doctrine.

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10 1 SCOTT, TRUSTS § 156.3 (1939).

11 45 B.T.A. 120 (1941).

12 149 F.2d 857 (2d Cir. 1945), *cert. denied*, 326 U.S. 770 (1945).

13 5 T.C. 673 (1945).

14 140 F.2d 636 (8th Cir. 1944).

In three cases, the *Lehman* doctrine was held not to apply to the facts as presented. The distinguishing factor in *Commissioner v. Dravo*[15] was that control of the trusts executed by husband and wife was turned over to the trustees who had the power to pay the income to the parties at their discretion, and the motivating purpose of the settlors was the desire to reallocate the stock of a corporation in which they were principal stockholders. In *Estate of Lindsay*[16] the court, acting under a set of facts similar to those in the *Eckhardt* case,[17] held that the trusts were independent, and though created on the same day, were motivated by separate causes. In the *Eckhardt* case the court distinguished this case on the basis of the wife's dependence upon her husband's business judgement. It would seem that this would hardly qualify as a distinction anticipated to control the application of the *Lehman* doctrine. Finally, in the case of In re *Lueders' Estate*,[18] the fact that the trusts were created fifteen months apart prevented the appellate court from affirming the tax court's finding of consideration from one to the other.

Though its origin was in the field of estate tax, the *Lehman* doctrine soon appeared in the field of income tax also. In *Purdon Smith Whiteley*,[19] identical trusts between brother and sister were taxed under trust sections 166 and 167 of the Revenue Act of 1932.[20] The court held that the doctrine applied because what one lost in one trust he gained by the other. In two later cases,[21] §§ 22 (a) and 22 (b) (2),[22] regarding gross income and annuity rights were held to apply because, like the *Lehman* case, each settlor was beneficiary for the trust he settled. In *Hash v. Commissioner*,[23] the *Lehman* doctrine was extended to apply to trusts created by parents, owners of stock in a family corporation, where each spouse acted as co-trustee with the attorney, and under the *Clifford* doctrine they retained the "bundle of rights."[24]

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[15] 119 F.2d 97 (3d Cir. 1941).

[16] 2 T.C. 174 (1943).

[17] Estate of Eckhardt, 5 T.C. 673 (1945).

[18] 164 F.2d 128 (3d Cir. 1947).

[19] 42 B.T.A. 316 (1940).

[20] Internal Revenue Code of 1939, §§ 166, 167.

[21] Werner A. Wieboldt, 5 T.C. 946 (1945); Moses L. Parshelsky, 46 B.T.A. 456 (1942), *remanded*, 135 F.2d 596 (2d Cir. 1943).

[22] Revenue Act of 1938, §§ 22 (a), 22 (b) (2), 52 STAT. 457-58 (1938), see discussion in Moses L. Parshelsky, 46 B.T.A. 456, 461 (1942).

[23] 152 F.2d 722 (4th Cir. 1945).

[24] The "bundle of rights" doctrine, that is, the settlor's witholding of rights in the trust though professing to relinquish them, and its relation to the present case is fully discussed by the court in 152 F.2d at 724.

In *Welch v. Commissioner*,[25] the trusts were not taxable, as there was no evidence in the record that the shares transferred to the wife were transferred in consideration of her making the trust. The court did not apply the *Lehman* doctrine, refusing to assume that such transfer was made in consideration of the creation of the trust.

The *Lehman* doctrine drifted into the field of gift tax as it had in the income tax field. Here two main decisions prevail. In *Commissioner v. Warner*[26] each of three brothers created a trust for another with the third as co-trustee with a common attorney. The court held that each trust was created in consideration of the other, thereby making a gift from the real grantor not a complete gift of the corpus. An attempt to evade the gift tax by applying the *Lehman* doctrine was unsuccessful in *Commissioner v. McLean*.[27] The court held in reverse of its normal position that the evidence did not show cross consideration sufficient to rid the parties of their gift tax obligation.

It can be seen that the development of the *Lehman* doctrine in these three tax fields has led to a widening of its scope to an unforeseen extent. In attempting to apply this doctrine to new fields the courts seem to get more interested in applying the doctrine than finding the true intent of the parties, good or bad as it may be.

Recent Developments in the Tax Field

The most recent case supporting the commissioner's charge of reciprocity is *Orvis v. Higgins*.[28] The appellate court held that there was a "virtually irresistible inference"[29] of reciprocity though the trial court had found the trusts to be independent. An examination of the facts reveals a situation in which the intent to create independent trusts is hard to deny, yet the court of appeals did find that "reciprocity was intended."[30] In this case the Court of Appeals for the Second Circuit that originated the *Lehman* doctrine went to great lengths to make it applicable. It is significant that the only justice on the bench when the *Lehman* case was decided dissented in this case. If the facts were significantly similar, the application of the *Lehman* doctrine would be sound, but here it seems that the court has chosen to ignore the lack of bad intention so basic to the doctrine's

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[25] 8 T.C. 1139 (1947).

[26] 127 F.2d 913 (9th Cir. 1942).

[27] 127 F.2d 942 (5th Cir. 1942).

[28] 180 F.2d 537 (2d Cir. 1950).

[29] *Id.* at 540.

[30] *Id.* at 541.

application, and find reciprocity when any possibility of such a situation arises.

Two other recent cases have arrived at the opposite result, finding that the trusts were created independently. In *Newberry's Estate*[31] the Court of Appeals for the Third Circuit reversed the tax court's finding of reciprocity, holding that the only consideration in this case was the "historic 'consideration of love and affection' for the dependent members of one's family."[32] Refusing to apply the *Lehman* doctrine the court stated:[33]

> The essential picture which the crossed trusts must reveal to justify the result reached by the Tax Court in the present case is a declared grantor induced to establish a trust giving the party now to be treated for tax purposes as the grantor, a power which the latter has wanted and has paid for by setting up another trust to accomplish something desired by the declared grantor. Such in our view are the rather strict confines of the Lehman doctrine.

This view seems to embody the true meaning of the *Lehman* doctrine though it is accepted only by a minority of the courts. It is this view in opposition to earlier concepts that accounts for the split between the Second and Third Circuit Courts on this problem.

A more recent case of independent trusts was *Estate of Ruxton*[34] in which the husband, after long contemplation, created a trust for his wife on the same day she created a like trust for him. Holding the *Lehman* doctrine to be a concept of the court and not a statutory provision made operative by the terms of the instrument, the court stated,[35] "That concept is based on reason and analysis where the facts and circumstances of a particular case warrant going outside the formal terms of a trust instrument and looking to the reality of the situation . . . ." The court seemed to be desirous of finding the true intention evident in the situation rather than attempting to apply a doctrine.

These last cases present what we believe to be the most acceptable application of the well established *Lehman* doctrine. It is the interpretation of the intention of the parties that is important[36] and not the mere fact of actually furnishing the

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31 Newberry's Estate v. Commissioner, 201 F.2d 874, (3d Cir. 1953).

32 *Id.* at 877.

33 *Ibid.*

34 P.H. TAX COURT SERV. ¶20.66 (1953).

35 See below, note 36.

36 "It cannot too strongly be emphasized that intention of the parties is the touchstone of taxability. The full facts surrounding the creation of the trusts may be brought forward to rebut any implication of mutual consideration raised by coincidence of temporal identity of creation." Colgan and Molloy, *Converse Trusts — The Rise and Fall of a Tax Avoidance Device*, 3 TAX L. REV. 271, 281 (1948).

consideration. The *Lehman* doctrine was created to stop a present wrong arising from the intentional design of two brothers to evade taxes. Its application in many cases has gone far afield from this purpose. If this doctrine is to be clear and effective it must be limited to its purposes, and not indiscriminately applied.[37] The court in the *Ruxton* case put it this way:[38]

> In our opinion, that doctrine should be applied only when clearly warranted by the particular facts of a case considered in the light of the decided cases.

The main reason for which the *Lehman* doctrine exists is to prevent the intentional creation of reciprocal trusts for wrongful purposes. The court in examining these family trusts should diligently attempt to achieve this end by looking beyond the trust to ferret out intentional wrongdoers, but at the same time should refrain from invalidating trusts created in good faith. In applying this judicial doctrine, attempts to protect the family security should not prima facie be held to be schemes to defraud creditors and avoid taxes because on their face they appear to have been created in consideration of each other. The purposes of the *Lehman* doctrine would be fulfilled if the trend evident in the decisions of the Third Circuit would gain acceptance as the general rule in cases of reciprocal trusts. By such an acceptance a more just and equitable application of a well founded and established doctrine could be brought about in the tax field.

The body of this note was researched and written previous to the enactment of the Internal Revenue Code of 1954. A thorough study of the pertinent sections of the new code reveal that no direct cognizance was taken of this problem. While no specific reference was made to reciprocal trusts therein it is of course a possibility that the courts will continue to imply coverage from one or another sections of the code. It is therefore felt that the survey here presented is the law on the subject up to and including the 1954 code. What the future may hold lies in the realm of speculation.

Reciprocal Trusts and Involuntary Alienation

Following much the same lines evident in the early tax decisions, one court has recently applied the *Lehman* doctrine to involuntary and voluntary alienation. The rights of creditors

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[37] "I submit, however, that any blind or uncritical application of the *Lehman* doctrine — or any doctrine that ignores proper legal form for the purpose of limiting or obliterating economic facts — is likely to result in unfairness and injustice." Callman, *The Lehman Doctrine, Its Significance and Application,* 26 TAXES 233 (1948).

[38] P.H. TAX COURT SERV., ¶ 20.66 (1953).

under reciprocal trust agreements are intended to be contingent upon clauses denying involuntary alienation of the funds incorporated in these trusts. In *Security Trust Co. v. Sharp,*[39] the Delaware court considered a reciprocal trust and declared that the fund was accessible to creditors and, though expressly prohibited, assignable by the beneficiary. In this case, the husband created a trust for his wife and she in turn created an identical trust for him. Each trust contained clauses limiting involuntary and voluntary alienation, which were invalidated by the court. Regardless of what was professed, the true effect of the trust was "considered" and the court held that such provisions were not binding. The court stated that it did not matter how the tax courts had treated this doctrine,[40] but fitted the reciprocal trusts into the same line of reasoning used therein.[41] The court also placed this doctrine in the category of spendthrift trusts indirectly created by the settlor for his own benefit, by implying that each party was the settlor of the trust for his own benefit.

Because of well established precedent,[42] the invalidating of attempts to directly create spendthrift trusts presents no problem to the courts. The difficult problem arises when it must be decided who is the actual settlor or beneficiary. For the settlor-beneficiary relationship to exist, ". . . it is not necessary that the beneficiary shall have himself conveyed the property held in trust . . . . of which he is the beneficiary or one of the beneficiaries."[43]

The rule adopted by the courts in this situation is clearly seen in *McArthur v. Faw.*[44] Two people placed corporate stock in trust for each other to protect the fund from their creditors. The court invalidated it on the basis of its being a spendthrift trust created by each party for his own benefit and a protection against his creditors. The rule was easily applied after establishing the reciprocal relationship between the parties.

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[39] 77 A.2d 543 (Del. Ch. 1950).

[40] *Id.* at 547.

[41] Helvering v. Clifford, 309 U.S. 331 (1940); Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940), *cert. denied,* 310 U.S. 637 (1940).

[42] Bixby v. California Trust Co., 33 Cal.2d 495, 202 P.2d 1018 (1949); Wenzel v. Powder, 100 Md. 36, 59 Atl. 194 (1904); Jamison v. Mississippi Valley Trust Co., 207 S. W. 788 (Mo. 1918); Schenck v. Barnes, 156 N.Y. 316, 50 N.E. 967 (1898); McArthur v. Faw, 183 Tenn. 504, 193 S.W.2d 763, *cert. denied,* 329 U.S. 780 (1946); GRISWOLD, SPENDTHRIFT TRUSTS 474 (2d ed. 1947); 1 RESTATEMENT, TRUSTS § 156 (1935).

[43] 1 RESTATEMENT, TRUSTS § 156, comment *d* (1935). "It is sufficient that he paid the purchase price for a conveyance upon a trust. . . . "

[44] 183 Tenn. 504, 193 S.W.2d 763, *cert. denied,* 329 U.S. 780 (1946).

The intent of the parties is all too often neglected in these cases. In some cases, where intent to defraud the creditors is obvious from the facts,[45] the courts' decisions seem justifiable. In other cases, the rule seems rather harsh and arbitrary.[46] An excellent article by Costigan,[47] supported by Griswold,[48] suggests that there are situations in which bona fide trusts should be allowed if justice is to be achieved though this view is not adopted by the courts. One example of such a trust is where a person is plainly solvent at the time of making the trust and only wishes to prevent his own extravagance or the shrewd ways of others from depriving him of an easier life in old age. Here the "arbitrary" invalidation of such trusts seems unjust.

A similar situation would be presented where a husband and wife create reciprocal trusts under similar circumstances. Their only wish would be to take some excess funds in the prime of life to secure an easier future for each other. It is unfair to tell this man and his wife that they are defrauding people that extend credit to them after they have created such trusts. To grant the creditors the funds they are seeking, merely because this relationship is found to exist, is too shortsighted. Since the courts are ready to look at all the facts and circumstances to find the real settlor they should also be ready to consider the actual intention. This intention should govern the final validity of the alienability clauses of the reciprocal trusts.

Following quite naturally from the conclusion that the creditors could get at the trust fund, the case of *Security Trust Co. v. Sharp,* decided that the restraint on voluntary alienation or assignment of such funds should likewise be invalid.[49] Since it is concluded that the beneficiary created the trust, it necessarily follows that he also must have created the restraints. After being deprived of the beneficial elements of the trust the continuance of the burdensome features would not be just. As the court so aptly stated, "I think it would be highly unequitable to insist that he be bound by what are in reality self-imposed restraints . . . ."[50] It becomes clear that reciprocal trusts fit easily under the rules in the settlor-beneficiary trust cases, in a majority of which voluntary alienation has been allowed.[51] The close parallel between the two brings about the conclusion that the creator of a reciprocal trust, like the settlor of a settlor-beneficiary spend-

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[45] State v. Nashville Trust Co., 28 Tenn. App. 388, 190 S.W.2d 785 (1944).

[46] McColgan v. Walter Magee, Inc., 172 Cal. 182, 155 Pac. 995 (1916).

[47] Costigan, *Those Protective Trusts Which are Miscalled "Spendthrift Trusts"* Reëxamined, 22 CALIF. L. REV. 471, 492 (1934).

[48] GRISWOLD, SPENDTHRIFT TRUSTS 557 (2d ed. 1947).

[49] 77 A.2d 543, 545 (Del. Ch. 1950).

[50] *Id.* at 547.

thrift trust, " . . . may voluntarily transfer his interest although the terms of the trust contain an express restraint against his voluntary alienation."[52]

Generally, any clause prohibiting voluntary alienation will be linked with, and upheld or invalidated with, provisions prohibiting involuntary alienation. Therefore they occupy only a position of secondary importance in this consideration.

Conclusion

From the above consideration it is obvious that the courts have not been able to apply the *Lehman* doctrine consistently in reciprocal trust cases. On the one hand, the broad application of a formula, irrespective of the factual circumstances surrounding the creation of the trusts, has been invoked; while on the other hand, by taking into consideration the intent and good faith of the creators the courts have applied what we consider the more just view. If a consistently just rule is to be derived from the various decisions, the courts *must* consider the intent of the parties, the circumstances of their creation, and the real effect of the trusts on all parties concerned. While it is true that there may be intent to defraud the creditors or tax authorities that is not generally the case. The courts in considering this should refrain from assuming fraud merely because of the reciprocal relationship. They should look to all the circumstances and consequences as well as the good faith and good intent of the creators. It is believed if this view is generally accepted the resulting decisions in both the tax and alienation fields will better reflect reality and bring about more consistently just and equitable conclusions.

As previously mentioned the Internal Revenue Code of 1954 has not specifically dealt with reciprocal trusts. The judicial interpretations of this code will decide in which cases its sections will apply. We hope that this article will play a part in the acceptance of what we have presented as the more equitable application of the code.

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[51] Byrnes v. Commissioner, 110 F.2d 294 (3d Cir. 1940); McColgan v. Walter Magee, Inc., 172 Cal. 182, 155 Pac. 995 (1916); Schenck v. Barnes, 156 N.Y. 316, 50 N.E. 967 (1898); City Bank Farmers Trust Co. v. Kennard, 1 N.Y.S. 2d 369 (Sup. Ct. 1937); *In re* Blake's Will, 266 App. Div. 580, 235 N.Y. Supp. 324 (1st Dep't 1929). *Contra:* Hackley v. Littell, 150 Mich. 106, 113 N.W. 787 (1907).

[52] 1 RESTATEMENT, TRUSTS § 156, comment *e* (1935).