Denver Law Review

Volume 35 | Issue 2 Article 9

May 2021

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Recommended Citation
Bruce T. Buell, Reciprocal Trusts and the Mask of Consideration, 35 Dicta 124 (1958).

NOTES

RECIPROCAL TRUSTS AND THE MASK OF CONSIDERATION

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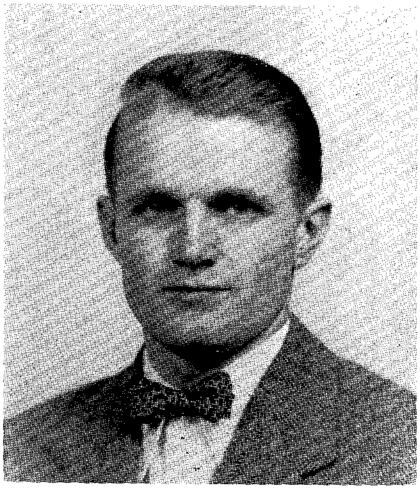

Fred and Fran Fortune, a prudent, elderly couple, each of whom has substantial wealth, wish to devise an estate plan. Will intervivos trusts fit into this plan? If their objectives will be served, intervivos trusts, properly conceived, will certainly save estate taxes and administration expenses. One device, however, the reciprocal trust arrangement, should be treated with great caution.

Assume, for example, that Fred wishes to distribute his wealth, or part of it, to their children and grandchildren and at the same time provide a life income for Fran. Fran also desires that her property should go to the offspring. However, she feels that Fred's guidance may be necessary sometime in the future, and she would like to have this property subject to his control, at least indirectly. Both are concerned about anticipated estate taxes.

Their attorney might conclude that irrevocable intervivos reciprocal trusts would provide the perfect solution to accomplish all of these objectives. Under such an arrangement, Fred would execute a trust naming Fran as life income beneficiary and the children as remaindermen. Fran would create a trust naming the children as sole beneficiaries, but giving Fred a power to alter or terminate the trust in favor of the beneficiaries should he see fit.

On its face, this scheme appears desirable as favoring the expressed objects of Fred and Fran's bounty. It also seemingly accomplishes the end that the property Fred and Fran transfer in trust will not be taxed in their respective estates. Neither grantor retains a power over the trust property transferred which would subject it to estate tax under sections 2036-38 of the Internal Revenue Code.[1]

Their attorney, however, would be ill-advised in his conclusions. This reciprocal trust arrangement would bear no beneficial estate tax consequences. Fred's estate would be taxed for the value of property which Fran transferred and over which Fred had the power to alter or terminate. Fran's estate would be subjected to tax on the value of Fred's transfer in which she was the life income beneficiary. Similar results would occur wherever Fred and Fran Fortune, or any two parties, execute intervivos trusts that vest in each other any power which, if reserved in the grantor, would subject his estate to a tax under sections 2036-38.[2]

Why should the estate tax law be interpreted in such a manner as to levy a tax on the estate of Fred Fortune because he holds a power to alter or terminate a trust when the code provides only that Fran's estate will be subject to tax if she retains this power?[3] Likewise, Fran, not Fred, is the life income beneficiary of Fred's trust. The code states only that Fred's estate will be taxed if he reserves a life estate.[4] Nowhere is it provided that an income beneficiary's estate is taxed on the value of the trust corpus of which he is the beneficiary.

The answer, in brief, is that Fred is in the same position as a result of the two trusts as he would have been had he, in his own transfer, reserved the power to alter or terminate. On the other hand, Fran's future would be just as secure as if she had reserved a life estate in the trust which she created. In view of these results, why should sections 2036-38[5] of the estate tax law not apply?

STATUTORY BACKGROUND

From the inception of the federal estate tax, it was apparent that Congress intended to tax in a decedent's estate not only property transferred on the death of the decedent, but also those intervivos transfers over which the deceased transferor has retained certain powers still in effect at his death. In the early acts, Congress levied only on the value of the *powers* retained over transferred property by the deceased transferor.[6] In later laws, however, the retention of taxable powers, under most circumstances, has subjected the entire value of the *property* transferred to taxation in the deceased transferor's estate.[7]

These provisions have required imposing an estate tax on property which the deceased did not own at death, but from which, due to the existence of certain powers, substantial economic benefits could or did accrue to him during his lifetime. These powers are enumerated in sec-

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[1] Int. Rev. Code of 1954. In substance, the transferor's estate is taxed on the value of all property transferred by trust or otherwise where: (a) The transferor retains a life estate, income for life, or right to designate beneficiaries. Id. § 2036. (b) Possession or enjoyment of the property can, through ownership, be obtained only by surviving the decedent and the decedent has retained a reversionary interest of 5% of the value of such property. Id. § 2037. (c) Enjoyment of the property was subject at decedent's death to a power in himself alone or in conjunction with any other person to alter, amend, revoke or terminate such transfer. Id. § 2038.

[2] Id. §§ 2036-38.

[3] Id. § 2038.

[4] Id. § 2036.

[5] Id. §§ 2036-38.

[6] Rev. Act. of 1926, § 302(d), 44 Stat. 71 (now Int. Rev. Code of 1954, § 2038). This subsection required inclusion in the gross estate of property to the extent of any interest therein, which the decedent transferred during his life, by trust or otherwise, where the enjoyment thereof was subject at his date of death to any change through the exercise of a power, either by decedent alone or in conjunction with any person, to alter, amend or revoke . . . except in case of a bona fide sale for an adequate and full consideration in money or money's worth.

[7] These changes in the law were first made in 1932. 47 Stat. 279.

tions 2036-38 and 2041 of the present code.[8] Congress has never taxed the value of property over which such powers have been retained to the extent that the transfer was a "bona fide sale for an adequate and full consideration in money or money's worth."[9] The theory is that the transferor's estate can in such cases be taxed on the consideration received.[10]

THE LEHMAN CASE

Taxpayers and their attorneys early moved to take advantage of broad statutory language concerning powers which would subject transferred property to an estate tax in the estate of the transferor. The countermove by the Commissioner of Internal Revenue resulted in the case of *Lehman v. Commissioner*,[11] still the leading authority in the field. The Lehman brothers owned equal shares in stocks and bonds. In 1930 each brother agreed to transfer his share of the securities in trust for the other and the latter's issue, in consideration of a similar transfer by the other. They simultaneously executed trust instruments with reciprocal provisions. Under each, the benefited brother was to receive the income for life, remainder to his issue, and the life income beneficiary had the power to withdraw $150,000 from trust corpus. The decedent had never exercised this power to withdraw.

The executor of the decedent brother's estate did not include any of the property involved in either trust in the gross estate. The Commissioner determined that $150,000 should have been included in the gross estate as the amount over which the decedent held the power to withdraw.[12]

That this particular case presented a tax avoidance scheme was self-evident and the facility with which it could be employed no doubt alarmed the Commissioner. It cannot be assumed that trusts with reciprocal provisions executed by relatives were invented to avoid taxes. Certainly they existed before the estate tax was conceived. Nevertheless, the Commissioner was charged with the integrity of tax administration, and with the tailor-made situation in the *Lehman* trusts at hand, the controversy was litigated.

In this case of *Lehman v. Commissioner*, the Court of Appeals for the Second Circuit affirmed the decision of the Board of Tax Appeals[13] and held that the Commissioner's determination had been correct. The court grounded its finding on a "well established principle" found in Professor Scott's treatise on trusts, to the effect that, "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."[14]

As a result of this principle, the court said, the fact that the trusts were reciprocated or crossed was a mere trifle. If *X* furnishes consideration in return for the creation of a trust by *Y*, with *X* being named a beneficiary, this results in *X*'s becoming the real settlor. Here each trust

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8 Int. Rev. Code of 1954, §§ 2036-38 and 2041.

9 Id. §§ 2036-38.

10 Colgan and Malloy, Converse Trusts—The Rise and Fall of a Tax Avoidance Device, 3 Tax L. Rev. 271 (1948).

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

12 Rev. Act. of 1926, § 302(d), 44 Stat. 71, which governed this trust, did not require the entire property transferred to be taxed where a power to alter or amend was reserved, but only the portion of the property subject to the power. The Revenue Act contained no provision for retained life income.

13 Estate of Harold M. Lehman, 39 B.T.A. 17 (1939).

14 1 Scott, Trusts § 156.3 (1st ed. 1939).

was created in consideration of the other trust so that the life beneficiary of each was actually the settlor. The court declared that there was a transfer involved and that when the settlors were properly uncrossed they had reserved the power which Congress had declared taxable. The court therefore concluded that the decedent Lehman brother had derived from the reciprocal trusts exactly the economic relationship to specified property that he would have retained had he transferred the same property in trust. Since this power would have been taxable had he been the settlor, and because Professor Scott's principle classifies him as the settlor, the decedent brother was taxed as the settlor of the trust created by his brother. Consequently, because the decedent brother had a power to alter, his estate was taxed on $150,000, the amount subject to this power.

ANALYSIS OF ALTERNATIVES AVAILABLE TO THE LEHMAN COURT

It is submitted that there were at least four methods by which the court could have decided the *Lehman* case. First, it could have reversed the Commissioner's determination on the ground that the language of the statute did not cover the type of situation presented by trusts in consideration of one another. However, the court felt that the intent of Congress to tax reserved powers had been violated. It could not permit such an arrangement to go untaxed in view of the resulting economic positions of the parties involved.

That taxation of an economic condition resulting from a transfer in trust can be adequately covered by Congress is illustrated by sections 671-78 of the Internal Revenue Code of 1954 which collectively are entitled, "Grantors and Others Treated as Substantial Owners." These code provisions are indeed an outgrowth of the doctrine pronounced in the *Clifford* case[15] which was decided just one month after the *Lehman* case.

A second possible method of disposing of the issue raised by the *Lehman* situation would have been to employ the language in each of the "reserved power" code provisions that reservation of the power would not subject the property transferred to an estate tax where the transfer was a bona fide sale for an adequate and full consideration in money

[15] Helvering v. Clifford, 309 U.S. 331 (1940). It is interesting to note that the reciprocal trust situation has never been treated by statute nor even illustrated in the estate tax regulations.

or money's worth.[16] This would have absolved the decedent Lehman brother of any tax liability arising out of the trust arrangement because the fact that the transfers were for full consideraton had been stipulated. The equities demanded rejection of this course of action.

The third, and, the author submits the best, possible countermove which the Government might have made to the *Lehman* type arrangement, would have involved casting aside all incidents of the form of transfer. The court could then have characterized the matter strictly from substantive results as was done in the *Clifford* case. The *Lehman* court appeared willing to interpret broadly congressional intent as desiring to tax an economic condition resulting from transfers with certain designated powers reserved, or the economic equivalents of such transfers. It should therefore have been willing to say that the equivalent transactions would be taxed regardless of the legal device employed. In the long run this would have eliminated much confusion. The taxpayers and their counselors then would have had only to concern themselves with the substantive results of their transfers in trust, rather than, in addition, the contracts doctrine of consideration.

The fourth approach to the reciprocal trust arrangement, the one chosen by the *Lehman* and all succeeding courts, utilizes the concept of consideration and is based on Professor Scott's principle discussed above.[17] Prior to the *Lehman* case the reciprocal trust doctrine had twice been urged and rejected in the courts.[18] In view of this the Lehman estate undoubtedly felt that its safest defense was to plead adequate and full consideration, thereby at least prevailing under the code language that a bona fide sale for adequate and full consideration would relieve the property transferred from estate taxation.[19]

DEVELOPMENT OF THE CONSIDERATION DOCTRINE

The Lehman estate stipulated that the transfers in trust between the brothers were in consideration of one another. This aided the *Lehman* court in avoiding a pitfall that a New Jersey court had encountered previously when it held that transfers similar to those of the Lehman brothers had actually been illusory.[20] The New Jersey court found there had been no transfer in a tax sense, and the property involved escaped taxation under statutory language which taxed "property transferred" in the transferor's estate.

In *Lehman,* the transfer and consideration both having been stipulated, the court merely cited the doctrine that 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. Once the court had indicated its acceptance of this theory it had no trouble showing the validity of the result in light of the facts in the case. Both brothers had retained the same attorneys, employed exactly the same language and substantive provisions in their respective trust instruments and had transferred property of equivalent value. Each brother, as trust beneficiary, had held the same powers over the property transferred. In short, the facts showed

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[16] Int. Rev. Code of 1954, §§ 2036-38.
[17] 1 Scott, Trusts 785 (1st ed. 1939).
[18] Phillips v. Gnichtel, 27 F.2d 662 (3d Cir.), cert. denied, 278 U.S. 636 (1928); Estate of Margaret A. Holmes, 27 B.T.A. 660 (1933).
[19] Rev. Act of 1926, § 302(d), 44 Stat. 71.
[20] In re Perry, 111 N.J. Eq. 176, 162 Atl. 146 (1932).

complete interdependence of action and precluded any other than a tax scheme as the apparent motivation.

A brief word might here be mentioned concerning the "well established principle" of trusts on which the *Lehman* court based its adoption of the reciprocal trust theory in the field of estate taxation. This principle is stated in Professor Scott's treatise under the section relating to spendthrift trusts. It establishes that *X* cannot isolate himself from claims of creditors by giving consideration to *Y* in return for *Y*'s creating a spendthrift trust with *X* as beneficiary.[21] In support of this "well established principle," Professor Scott cited only one decision, a California case.[22] As will be demonstrated, the concept is undoubtedly of more utility in the field of spendthrift trusts than in estate taxation.

The key word in the reciprocal trust theory as employed by the courts in estate tax cases is *consideration*. This is what made the *Lehman* facts the landmark case for the application of the doctrine, *viz.* it was both stipulated and apparent from the facts that the brothers had bargained for and received a quid pro quo in return for their respective transfers in trust.

In every case since *Lehman* where the doctrine has been applied, this fact of consideration has been illusive and disputed. Since the taxability of trust property in the reciprocal trust situation depends on a finding of consideration, this issue has been the turning point of each controversy. Consequently, whether a legal device has prevailed over what is essentially a taxable economic condition has been made to depend upon the interpretation and application of the legal term consideration.

An example of the problems the courts encounter in basing their decisions on consideration may be found in the fact of bargaining which, in some form, is an essential element of the contracts doctrine of consideration.[23] Imagine the difficulty, at least where one party to the transfers is dead and there is no recitation of consideration in the instruments, of showing by objective evidence that bargaining preceded the creation of two trusts with reciprocal provisions. Obviously, the courts have had to devise many presumptions to accommodate this situation.

No matter how tenuous the fact of consideration in any given case, every court since the *Lehman* decision has felt compelled to base application of the reciprocal trusts theory on a finding of consideraion. This finding, in turn, has become essential to the Commissioner's determination that the reciprocal trusts situation exists and that the estate of a party holding one of the taxable powers should be taxed on the value of the property in trust.

In view of the presumption accorded the Commissioner in most courts, few arrangements objectionable from a tax view point have been passed over for want of a finding of consideration. On the other hand, the conclusiveness of the finding on consideration as employed under the benefit of the Commissioner's presumption has been said to work

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21 1 Scott, Trusts, 785-86 (1st ed. 1939).

22 McColgan v. Walter Magee, Inc., 172 Cal. 182, 155 Pac. 995 (1916). Scott cites the Lehman and succeeding estate tax cases in support of the principle that, "Where one person creates a trust for another in consideration of the other's creating a similar trust for him, each is in substance creating a trust for himself." 2 Scott, Trusts 1103 (2d ed. 1956).

23 Restatement, Contracts § 75 (1932): Consideration for a promise is an act . . . or a return promise bargained for and given in exchange for the promise.

an inequity on many arrangements in which tax avoidance or objectionable economic positions play little if any part.[24]

CASE LAW SINCE LEHMAN

The issue never having been specifically decided by the United States Supreme Court, one must look to the various circuits and to the Tax Court for the authoritative case law on reciprocal trusts. It is somewhat incongruous that the doctrine has been applied almost solely to close relatives, *e.g.*, husband and wife, parent and child or brother and sister. This kinship ordinarily connotes the natural object of one's bounty. It would seem that these are the very persons who would make transfers in trust providing for each other's welfare without requesting anything in return, and that more often than not the reciprocating is out of love, affection or other familial concern.[25] However, the Commissioner and most of the courts have seen fit to impute to the family relationship an element of conduct giving rise to the inference of commercially interdependent action and reciprocity. Thus the prevailing view has developed that unless there is strong evidence to the contrary, the fact that trusts are reciprocal between members of the family in itself shows the necessary concert of action and tacit agreement on a quid pro quo to support a finding of consideration.[26]

If the presumption is this favorable towards the Commissioner, obviously the element of bargain plays a minor role in the determination of consideration. The courts appear actually to have reached their decisions on the basis of retention of effective economic control.

There are many shades of opinion in the courts relative to the presumption of consideration and the need for objective facts to support or rebut its existence. The Court of Appeals for the Third Circuit is at the extreme of the legalistic approach to consideration. It will not infer consideration if there is any evidence to the contrary. Proof of actual consideration bargained for must be shown.[27]

The Third Circuit has recognized that its test is substantially different from those of the other circuits, but has suggested that it is for Congress to declare another basis of taxability if it does not feel the court's concept of consideration is correct.[28] In *In re Lueder's Estate*,[29] the court in effect shifted the presumption in favor of the taxpayer by saying that the stipulation of facts concerning the decedent's trust created a prima facie case of gift and that it was up to the Commissioner to rebut.

The view at the other extreme is held by the Second Circuit which will, in accordance with the general view of the Tax Court, infer consideration from the terms of the trusts and circumstances surrounding their creation unless evidence to the contrary is convincing.[30] This court finds it highly improbable that spouse *H* could create a trust for the other's benefit unless induced to do so by a quid pro quo provided by spouse *W*'s reciprocal transfer. The case of *Orvis v. Higgins*[31] found

24 Orvis v. Higgins, 180 F.2d 537 (2d Cir.), cert. denied, 340 U.S. 810 (1950).
25 Note, 30 Notre Dame Law. 149 (1954).
26 Johnson, Reciprocal Trusts—A Tax Avoidance Device With Recuperative Powers, 36 Neb. L. Rev. 564 (1957).
27 Newberry's Estate v. Commissioner, 201 F.2d 874 (3d Cir. 1953); In re Lueder's Estate, 164 F.2d 128 (3d Cir. 1947).
28 Note, 34 N.C. L. Rev. 560 (1956).
29 In re Lueder's Estate, 164 F.2d 128 (3d Cir. 1947).
30 Orvis v. Higgins, 180 F.2d 537 (2d Cir.), cert. denied, 340 U.S. 810 (1950).
31 Orvis v. Higgins, supra note 30.

the Second Circuit reversing the Tax Court's determination of an absence of reciprocity based upon negative evidence that the grantors, husband and wife, did not know of one another's intention. The Court of Appeals said this did not rebut the clear inference that there must have been concert of action.

Between these two extremes are a variety of discernible views regarding consideration. The Eighth Circuit will infer consideration from the objective facts in the absence of evidence to the contrary.[32] The Fifth and Seventh Circuits refuse to infer the existence of consideration unless supported by some evidence.[33]

What type of evidence or objective fact is persuasive in finding consideration? Of course, recital of its existence in the instruments would probably be conclusive. Direct testimony that such was intended would be given equal weight. Unfortunately, only the *Lehman* case was that simple and in no litigation since that time has the evidence been so clearcut. The objective facts surrounding the creation of the trusts, as well as reciprocal provisions in the instruments themselves, will generally support the finding that each settlor has given the other something of value.[34]

Some courts require proof of actual bargaining.[35] Others, depending on the inference they attach to the familial relationship and the presence of reciprocal provisions, require only that the facts show the parties, or one of them, were motivated to act by the knowledge of each other's transfer. Still other courts hold that a showing of awareness by the parties of each other's intentions will suffice to support consideration. The most liberal courts will find the necessary bargaining solely from the facts of close relationship, reciprocal provisions and any semblance of simultaneous creation of instruments. Lack of evidence pertaining to knowledge and motivation of the parties is no deterrent to these courts unless positive evidence to the contrary appears.[36] When the presumption of consideration becomes this strong, any similarity to the legal concept of consideration is strictly coincidental.

Factual events supporting the Commissioner's inference of reciprocity include prior agreement between the grantor,[37] mutual planning,[38] use of the same attorneys, advisers and trustees,[39] simultaneous creation of trusts, and a relationship of mutual trust and confidence between grantors.[40] The exchange of similar powers, *e.g.*, *X* gives *Y* a life estate and *Y* gives *X* power to invade corpus, strongly supports reciprocity.

Where there have been reciprocal provisions in the instruments, the decedent's estate has overcome the Commissioner's inference only when the facts have indicated independent action by the settlors. For example, evidence of failure of one spouse ever to mention to the other her intention to create a trust was held to sustain the burden of proof in establishing that the transfers were separate, independent and uncon-

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32 Cole's Estate v. Commissioner, 140 F.2d 636 (8th Cir. 1944).
33 Tobin v. Commissioner, 183 F.2d 919 (5th Cir. 1950); McLain v. Jarecki, 232 F.2d 211 (7th Cir. 1956).
34 Comment, 42 Calif. L. Rev. 151 (1954).
35 See note 27 supra.
36 Orvis v. Higgins, 180 F.2d 537 (2d Cir.), cert. denied, 340 U.S. 810 (1950).
37 Blackman v. U.S., 48 F. Supp. 362 (Ct. Cl. 1943).
38 Estate of John H. Eckhardt, 5 T.C. 673 (1945).
39 Estate of Florence Moreno, 28 T.C. No. 98 (July 26, 1957); Estate of Grace D. Sinclaire, 13 T.C. 742 (1949). But cf. In re Lueder's Estate, 164 F.2d 128 (3d Cir. 1947).
40 Estate of Carrie S. Newberry, 6 T.C.M. 455 (1947), aff'd per curiam, 172 F.2d 220 (3d Cir. 1948).

nected transfers. The court here did not find reciprocal trusts, even though they were executed almost simultaneously and were similar in provisions and amount of corpus.[41] Where the trusts were created fifteen months apart, the Third Circuit held that there was no evidence to indicate bargaining or that one trust was created in return for the promise to establish the later one. The court pointed out that under the circumstances, the wife may have felt a moral obligation to return the husband's transfer, but that a moral obligation was insufficient to constitute consideration.[42] Lack of participation in each other's plans and lack of prior agreement as to the creation or the provisions of the trusts were held to be indicative of independent action and an absence of the necessary exchange in another case.[43] Here it was positively shown that the motives of the grantors in creating the trusts were dissimilar.

The typical trust arrangement in which the Commissioner has attempted to employ the reciprocal trusts theory has concerned equivalent principal amounts. However, the existence of unequal trust corpora has presented no obstacle. The decedent's estate sustains a tax on the proportionate value of property transferred to the deceased as beneficiary.[44]

RECENT CASES

A peculiar situation arose in *Estate of Carl J. Guenzel,*[45] decided in the Tax Court in April 1957. There, a husband and wife created trusts simultaneously in 1936. Each transfer in trust provided for life income to the spouse, remainder to issue unless the grantor survived the benefited spouse. In this event the grantor would receive the income for life, the remainder to issue.

The wife died first, in 1947, and the Commissioner claimed that she was the actual grantor of the trust set up by her husband under the reciprocal trusts doctrine. Her estate conceded the point and was taxed on the entire value of the property. The husband was then left with income benefits both from the trust created by his wife and the one he himself had set up. The husband in 1949 renounced all rights in the trust created by his wife.

When the husband died in 1951, the Commissioner sought to include in his estate not the trust created by the wife, over which the husband would have been deemed grantor under the reciprocal trust theory, but the trust he himself had created and which had been taxed in his wife's estate. It is evident that the property in the trust created by the wife could not have been reached in the husband's estate because of the husband's renunciation of rights. It is also true, however, that the nature of economic benefits which the husband held warranted taxation of one trust or the other in his estate.

The Tax Court sustained the Commissioner's determination that

41 Estate of Samuel Lindsay, 2 T.C. 174 (1943).

42 In re Lueder's Estate, 164 F.2d 128 (3d Cir. 1947).

43 Estate of Louise D. Ruxton, 20 T.C. 487 (1953); Estate of Arnold Resch, 20 T.C. 171 (1953).

44 Estate of Carolyn P. Boardman, 20 T.C. 871 (1953). The estate of the decedent beneficiary of the larger trust (the decedent being deemed the settlor of that trust under the reciprocal trusts doctrine) is taxed on that proportion of the date of death value of the trust as the value of the smaller trust bears to the value of the larger trust when originally created. The estate of the grantor of the smaller trust will, of course, be taxed on the date of death value of that property. See Cole's Estate v. Commissioner, 140 F.2d 636 (8th Cir. 1944) wherein the husband's trust consisted of 700 shares and the wife's trust of 300 shares of the same kind of stock.

45 Estate of Carl J. Guenzel, 28 T.C. No. 10 (April 17, 1957), appeal docketed, 8th Cir.

the trust created by the husband, and previously taxed in the wife's estate, should now be taxed in the husband's estate. In so doing, the court reasoned that where a grantor creates a trust and retains a secondary life estate or life income, the transfer is taxable in the grantor's estate. The court then met the indignant objection of the estate that the trust had already been taxed as if the wife had been settlor. The court said that it would not go into the applicability of the *Lehman* doctrine when the transfer in trust was plainly includible in the nominal grantor's estate under the statute, as the husband's trust admittedly was here. It further stated that the petitioner could not base an argument of estoppel against the Commissioner upon a showing of inconsistency with the assertion of tax liability against another taxpayer.

In what must have been a common reaction to the decision, the *Lawyer's Weekly Report* observed,

> We think the case is wrong. Although this point is not referred to in the decision, the Code exempts transfers for a full and adequate consideration. Since the trust the husband had created had been sold to the wife for full value (the wife's trust), it should be excluded from his gross estate. Indeed, *Lehman's* logic rests on reciprocal consideration.[46]

Had the logic of the Commissioner in assessing the wife's estate rested on a realistic appraisal of substance over form, instead of on consideration, this righteous complaint could not have been made.

The *Weekly* raised a further issue:

> What about the wife's trust—was it includible in the husband's estate? This question did not come up, because the husband had surrendered all his rights in that trust. But this should not matter: If he had not surrendered, then, under *Lehman,* the wife's trust should certainly be in his estate. And if both trusts wind up in the husband's estate, that is obviously the wrong result.[47]

This author cannot agree that inclusion of the property of both trusts in the husband's estate would necessarily be a wrong result, especially had he not renounced his rights to the trust created by his wife. This conclusion is based upon the assumption that under section 2013 of the present statute,[48] the husband's estate could receive a credit for part of the taxes paid by the wife's estate on trust property subsequently in-

[46] 12 Lawyer's Weekly Report No. 40 (July 1, 1957).
[47] Ibid.
[48] Int. Rev. Code of 1954, § 2013.

cluded in the husband's gross estate. A similar argument was advanced in the principal case. However, the applicable provision of the 1939 Code, which governed this situation, allowed a deduction only for previously taxed property "received by . . . inheritance . . . ."[49] The court rejected the estate's contention saying that the deceased husband had not received by inheritance the secondary life estate provided for in his own trust.

Estate of Florence Moreno[50] should be mentioned as the latest decided case concerning reciprocal trusts. The Tax Court there had little trouble finding reciprocity and consideration. The case did involve, however, a more remote power over the property in trust than in most previous cases. Here, each respective beneficiary had a life estate in the other's trust contingent on the nominal settlor's death. The court simply applied the reciprocal trust doctrine and found that each settlor had retained a right to income from transferred property for a period not ascertainable without reference to his death. The property therefore was rendered taxable under section 2036.[51]

PROBLEMS IN RELATION TO THE GIFT TAX

The manner in which consideration enters into the Commissioner's determination of a taxable transfer in the reciprocal trust situation has been demonstrated. The synthetic nature of the concept of consideration so used becomes apparent when contrasted with the view of the Commissioner in cases where he attempts to disprove consideration and thereby subject a transfer to the gift tax. Where the Commissioner has sought to tax a transfer as a gift, evidence that the trusts were created simultaneously, in equal principal amounts and contained reciprocal powers has not been deemed sufficient to overcome the presumption of absence of consideration.[52] Yet, as has been shown, these same facts constitute the primary support for determining the presence of consideration in establishing reciprocal trusts.

In a related area, the taxation of reciprocal trusts has created a definite complication where gift taxes have been paid by the settlors at the time the trusts were executed. The problem arises under section 2012 which allows a credit for gift taxes paid by a decedent on property included in his gross estate.[53] In the typical reciprocal trust arrangement, each grantor has paid gift taxes on his transfer. Thus the property in both trusts has been fully taxed, but not to the grantors as they appear after the parties have been crossed in applying the reciprocal trusts doctrine for estate tax purposes.

It seems entirely unfair that the estate of each grantor in this situation should not receive some credit for gift taxes paid when the trusts were executed. The cases have not decided the issue, but strictly speaking, under the code, the Commissioner cannot allow any such credit to a decedent's estate. To subject property to the estate tax the Commissioner must determine that the transfer was for consideration. This determinaton eliminates the possibility that a gift was made and ordinarily would render the estate eligible for a refund of gift taxes unnecessarily paid. However, when estate taxes are assessed, the party who

49 Int. Rev. Code of 1939, § 812 (c), 53 Stat. 124 (now Int. Rev. Code of 1954, § 2013).

50 Estate of Florence Moreno, 28 T.C. No. 98 (July 26, 1957), appeal docketed, 8th Cir.

51 Int. Rev. Code of 1954 § 2036.

52 Commissioner v. McLean, 127 F.2d 942 (5th Cir. 1942).

53 Int. Rev. Code of 1954 § 2012.

paid the gift tax ends up as the grantor of the trust created by the other party. The deceased has therefore not paid a gift tax on the same property for which his estate will pay estate tax. The credit granted by section 2012[54] is thus lost and a double taxation on each reciprocal transferor and his estate results.

CONCLUSION

The reciprocal trust arrangement is dead as a tax avoidance device. Indeed, it has been shunned by the tax lawyer since the *Lehman* case. Occasionally, especially after a Third Circuit opinion, some see a faint glimmer of hope for its revival.[55] This is a false hope, however, resulting solely from difficulties experienced in the various courts with the doctrine of consideration. Unfortunately, this doctrine has too often been allowed to cloud the real issues.

There has been no basic change in the prevailing legislative, executive and judicial attitude that where a taxable power exists in substance the tax will not be defeated by the use of the trust device. Nor is the policy to be limited to those with a tax avoidance motive. Proof of intent to do no more than protect the family security will not stay the hand of the Commissioner where by reciprocal trusts one or more powers made taxable by sections 2036-38[56] are vested in each transferee.

Perhaps in the future the situation will be treated by statute. Certainly Congress sanctioned the effect of the reciprocal trusts doctrine when it passed the Technical Changes Act of 1949.[57] This act mitigated the effect of retroactive application of the *Lehman* doctrine under certain circumstances where the trusts had been created prior to 1940. The act in no way disapproved the doctrine. In fact, Congress appears to be ahead of many courts in its recent thinking on this matter, as demonstrated by its illustration in committee reports of taxable reciprocal trusts.[58] The illustration was based not upon the presence of legal consideration, but upon the retention of effective economic control which resulted from the reciprocal arrangement.

This should not frighten the attorney away from the legitimate family trust. It can serve many valuable ends, including tax economy, and should be employed with this in mind.[59] However, let the attorney beware of reciprocal trusts, no matter what the intention or motive, where any type of reversion, life estate or taxable power is vested in the beneficiaries. The rules set out in sections 2036-38[60] are certain to be invoked to render the reciprocal trusts taxable under the estate tax whenever the presence of these interests is manifested in any form.

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54 Ibid.

55 Johnson, Reciprocal Trusts—A Tax Avoidance Device With Recuperative Powers, 36 Neb. L. Rev. 564 (1957).

56 Int. Rev. Code of 1954, §§ 2036-38.

57 63 Stat. 893 (1949).

58 H.R. Rep. No. 920, 81st Cong., 1st Sess. 6 (1949); Sen. Rep. No. 831, 81st Cong., 1st Sess. 5 (1949).

59 Gray, How to Save Taxes Through Family Trusts, P-H Tax Ideas ¶6008 (1955). It is apparent, however, that even though the courts have thus far applied Professor Scott's principle only to reciprocal trusts in the estate tax field, no reason exists why the doctrine should not be extended. Consideration, on which the courts base a taxable situation, may be given to the promisor or to some other person. If X creates a trust for Y as consideration for Z's creating a trust for X, Scott's principle applies to make X the settlor of the trust created by Z. Should Z's trust contain taxable powers, the property ought to be taxed in X's estate and probably would be, at least if consideration were evident.

60 Int. Rev. Code of 1954, §§ 2036-38.