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THE TAX IMPLICATIONS OF RECIPROCAL TRUSTS

J. HENRY LANDMAN

CROSSED trusts, proven reciprocal in substance, are because of this fact uncrossed for federal tax purposes into independent trusts with their own respective estate, gift and income tax consequences. Estate tax planners will find the device of reciprocal trusts for tax minimization fraught with almost insuperable obstacles in judicial, statutory and Treasury administrative law.[1]

I. ESTATE TAXES

A LEADING decision on this subject is the *Lehman* case. It germinated the doctrine which bears its name. In 1930, Allan S. Lehman and his brother simultaneously created trusts for one another's benefit. They contained the same terms and were organized in consideration for one another. They each had the right to draw down equal amounts of money. The Second Circuit Court held that the withdrawal from the brother's trust estate was includible in the gross estate of the decedent-brother as a transfer subject to a power to alter, amend or revoke a trust.[2]

In the *Lueders' Estate (City Farmers Bank Farmers Trust Co.)* case the trust for the decedent's benefit was not includible in the latter's estate because of the absence of the proximity of time in the drafting of the two trusts and of the nonexistence of mutual consideration.[3] The need for concurrency in the drafting of converse trusts as an indispensable factor in the proof by the Treasury for reciprocity is further borne out in the cases of the *Estate of Freder-*

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[1] A few law review articles on this subject are: Hepler and Bebenek, *Reciprocal Trusts*, 30 NOTRE DAME LAW. 149 (1954); Walker, *Reciprocal Trusts and the Federal Estate Tax: Economic Realty Disregarded*, 5 DUKE B. J. 33 (1955); Lyman, *Reciprocal Trusts in Estate and Gift Taxation*, 42 CALIF. L. REV. 151 (1954); Colgan and Molloy, *Converse Trusts—The Rise and Fall of a Tax Avoidance Device*, 3 TAX L. REV. 271 (1948); Callman, *The Lehman Doctrine, Its Significance and Application*, 26 TAXES 233 (1948); *Marx, The Switching of Settlors in Inter-Vivos Trusts*, 26 TAXES 622 (1948).

[2] The Tax Act of 1926, § 302(d) is involved. Allan S. Lehman et al., 39 B. T. A. 17, *aff'd* 109 F. 2d 99 (2d Cir. 1940), 24 Am. Fed. Tax R. 198 (1940), *cert. den.*, 310 U. S. 637, 60 S. Ct. 1080, 84 L. Ed. 1406 (1940).

[3] Lueders' Est. (City Bank Farmers Trust Co.) v. Commissioner, 164 F. 2d 128 (3d Cir. 1947), 36 Am. Fed. Tax R, 233, *rev'g* 6 T. C. 587.

ick S. Fish[4] and of *Fred C. Scholler.*[5]

In the *Cole* case in 1931, two spouses created simultaneous and irrevocable living trusts the income of each of which was to be paid to the other spouse, their children and grandchildren for life, terminating upon the death of the last survivor named. The Eighth Circuit agreed with the Tax Court that while the transfers of the property to the opposing trust were not made in contemplation of death, each spouse was the real owner of such corpus and therefore includible in his or her own gross estate.[6]

The *Lehman Doctrine* invalidated reciprocal trusts as estate and income tax minimization devices. In numerous cases[7] adjudicated on this principle, the courts have placed the burden of rebutting the Treasury's inference of reciprocity on the estate's representative. The Second Circuit has been the leading proponent of the view that the exchange of similar powers over trusts of almost concurrent creation by settlors of close kinship gives rise to a conclusive inference of reciprocity, rebuttable by the taxpayer by a preponderance of evidence to show that the simultaneity of several events of the various parties was without concerted action.

To undo this practically worthless tax saving plan, taxpayers become once again subject to the gift tax law in order to retransfer the property and income of the respective trusts. Therefore a statute was enacted in the year 1949 to enable creators of reciprocal trusts established prior to January 1, 1940 to annul their vain and futile tax machinations by relinquishing their powers over the trust principal and income without gift tax imputations, provided the relinquishment took place before 1951 and a gift tax was paid in the first transfer to the trust. In addition thereto, this relinquishment will not be treated as having been done in contemplation of death and therefore not

[4] Estate of Frederick S. Fish, 45 B. T. A. 120 (1941), dismissed by the Second Circuit Court on January 20, 1942, following Lehman v. Commissioner, 109 F. 2d 99 (2d Cir. 1940) and the Estate of Mary H. Hughes, 44 B. T. A. 1196 (1941).

[5] Fred C. Scholler, Ex'r, 44 B. T. A. 235, *dismissed* Aug. 1, 1942.

[6] Estate of H. S. Cole, ¶ 43,014 P-H Memo T. C., *aff'd without discussion* (8th Cir. 1944). See also, Estate of Thomas Neal, ¶ 43,518 P-H Memo T. C.

[7] Other decisions following the Lehman Doctrine are: Orvis, Ex'r v. Higgins, 180 F. 2d 537 (2d Cir. 1950), *rev'g* 80 F. Supp. 64 (D. C. N. Y. 1949), 37 Am. Fed. Tax R. 402 (2d Cir. 1950), *cert. denied,* 340 U. S. 810, 71 S. Ct. 37, 95 L. Ed. 595 (1950); Hanauer's Estate (Strauss) v. Commissioner, 149 F. 2d 857 (2d Cir. 1945), 33 Am. Fed. Tax R. 1474, *aff'g* ¶ 43,502 P-H Memo T. C., *cert. denied,* 326 U. S. 770, 66 S. Ct. 175, 90 L. Ed. 465 (1945); Estate of Oliver v. Commissioner, 148 F. 2d 210 (3d Cir. 1945), 33 Am. Fed. Tax R. 912, *aff'g* ¶ 44,138 P-H Memo T. C.; Estate of Elizabeth D. Hill (2d Cir. Jan. 1956).

subject to estate tax as well, in the instance of decedents who died after February 10, 1939.[8]

The broad application of the *Lehman Doctrine* was restricted in the year 1953 by the opinion in the *Estate of M. H. Newberry*.[9] The facts therein were that the decedent and her husband had at the same time created trusts for the ultimate benefit of their children. The amounts involved were equal, and the trust instruments were also in all other respects alike. Although the transferred properties were nearly indistinguishable, the court decided that the testimony had conclusively shown absence of such unity and interdependence of action in a quid pro quo sense. This decision reversed the Tax Court[10] where reciprocity had been found on the basis of similar terms of the trust instruments, the relationship of the settlors, the simultaneity of creation, and the equal number of shares of stock in each trust.

The effect of this Third Circuit reversal of the Tax Court is that the Treasury is denied a favorable inference of reciprocity out of identical cross trusts. The burden of persuasion is thus placed on the Treasury as the proponent of reciprocity in any given situation. Proof must be adduced by it to establish a mutual intent to avoid tax by the use of the cross trust device.

The recent *McLain*[11] decision followed the *Newberry Doctrine* and specifically repudiated the Second Circuit's version of the *Lehman Doctrine*. It holds that consideration inferred from the creation of identical trusts will not stand. Evidence must be supplied which will establish intent to avoid taxes, and the bargain and exchange between the grantors.[12]

The creation of reciprocal trusts might conceivably be effected in contemplation of death and therefore the transferred corpus would be includible in the decedent's estate. Living transfers made in contemplation of death without adequate consideration are includible in decedent's estate for estate tax purposes. More specifically those made within three years prior to decedent's death are subject to the rebuttable presumption that the transfers were made in contemplation

[8] Technical Changes Act of 1949, 63 STAT. 891 (1949), added §§ 1000(g), 811(d) of the 1939 Code.

[9] Estate of M. H. Newberry, et al. v. Commissioner, 201 F. 2d 874 (3d Cir. 1953).

[10] 17 T. C. 597 (1951).

[11] H. C. McLain, Ex'r v. Jarecki, 126 F. Supp. 621 (N. D. Ill. 1955).

[12] The terms "settlors," "grantors" and "creators" are used as interchangeable words in this article to aid in clarifying its fundamental ideas.

of death if they constitute a material part of the estate and were in the nature of a final distribution. Transfers prior to the three-year period are not considered at all as in contemplation of death.[13]

In the absence of a contemplation of death, transfers that take effect in possession or enjoyment at or after death as in the case of a life estate or power of revocation in the donor, are taxable in the decedent's estate. In reverter cases, only the value of the property subject to the reverter and not of the reverter is subject to estate tax.[14]

Finally, all transfers, in trust or otherwise, where the decedent reserved the right, either alone or with any other person or persons, to designate the persons who shall enjoy the property, or where the decedent reserved the power to change the beneficiaries, are includible in the decedent's estate.[15]

II. INCOME TAXES

RECIPROCAL trusts also have federal income tax implications. As a tax avoidance plan, reciprocal trusts are expected by the transfers of property to escape estate taxes and also the income taxes on the earnings and profits from these properties. Just as reciprocal trusts are relative failures, they have also proven to be unsuccessful as federal income tax minimizers. As in the field of estate and gift taxes, the income tax consequences depend upon the provisions of the trust instruments. Once trusts are found to be reciprocal, their estate, gift and income tax consequences become interdependent. Crossed trusts proven reciprocal are treated as uncrossed for federal income as well as for estate and gift taxes.

For income tax purposes, a grantor is taxable on that part of the trust income which may be presently or in the future distributed to

[13] Int. Rev. Code of 1939 § 811 (*l*), 44 STAT. 70 (1926) (now INT. REV. CODE OF 1954, § 2038, Reg. 105, § 81.20). Prior to Sept. 24, 1950, transfers more than two years prior to death could not be taxed or challenged as taxable.

[14] Int. Rev. Code of 1939 § 811(c)(h)(i); INT. REV. CODE OF 1954, §§ 2035-2037, 2043(a), 2044; Helvering v. Hallock, 309 U. S. 106, 60 S. Ct. 444, 84 L. Ed. 604 (1940); Technical Changes Act of 1949; Klein v. United States, 283 U. S. 231, 51 S. Ct. 398, 75 L. Ed. 996 (1931); United States v. Artemus C. Wells, et al. Ex'r, 283 U. S. 102, 51 S. Ct. 446, 75 L. Ed. 867 (1931), 9 Am. Fed. Tax R. 1440, *aff'g* 39 F. 2d 998 (Ct. Cl. 1930), 8 Am. Fed. Tax R. 1064.

[15] Int. Rev. Code of 1939, § 811(d), 44 STAT. 70 (1926) (now INT. REV. CODE OF 1954, § 2038, Reg. 105, § 81.20; Giannini v. Commissioner, 148 F. 2d 285 (9th Cir. 1945), 33 Am. Fed. Tax R. 927, *aff'g* 2 T. C. 1160, *cert. denied,* 326 U. S. 730, 66 S. Ct. 38, 90 L. Ed. 1091 (1945); Mollenberg's Estate v. Commissioner, 173 F. 2d 698 (2d Cir. 1949), 37 Am. Fed. Tax R. 1196, *aff'g* ¶ 47,332 P-H Memo T. C.; May, Ex'r v. McGowan, 97 F. Supp. 326 (D. C. N. Y. 1950), ¶ 72,417 P-H Fed. (1951); Estate of Ambrose Fry (Mitchell), 9 T. C. 503 (1947); Central Trust Co., Admin. v. United States, 167 F. 2d 133 (6th Cir. 1948).

him in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income.[16] In the *Tobin* case[17] the Fifth Circuit held that the trusts in question were not reciprocal because the terms were not identical and an advisory committee, made up mostly of persons other than the grantor or beneficiary, controlled the income and principal available for distribution.

The United States Supreme Court in the famous *Clifford* case held that the income of a trust is taxable to the grantor under Section 22 (a) of the 1939 Code although it is not payable to the grantor himself and is not to be applied in satisfaction of his legal obligation, if he has retained so complete a control of the trust that he is still in practical effect the owner of its income.[18] In the *Stuart* case the Supreme Court held that where the *Clifford Doctrine* applies not only Section 22(a) but also Sections 167(a)(1) and (2) of the 1939 Code, *supra,* also apply.[19]

The *Clifford Doctrine* caused so much litigation that the Treasury promulgated regulations applicable to taxable years beginning after December 31, 1945. They define and specify the factors that demonstrate grantor's retention of trust control sufficient to constitute constructive receipt of the income therefrom. Generally the grantor is taxable on trust income if he has a reversionary interest after a relatively short term, a power to determine or control beneficial enjoyment of income or corpus, or administrative control of the trust.[20]

These Clifford Treasury regulations under the 1939 Code remain as yet unchanged. They explain more specifically as to short term trusts that trust income is taxable to a grantor who has a reversionary interest in corpus or income to take effect within 10 years and 15 years in certain specified cases. In the *Clark* case,[21] the Tax Court

16 Int. Rev. Code of 1939, § 167(a)(1)(2), 52 STAT. 519 (now INT. REV. CODE OF 1954, § 677).

17 Tobin v. Commissioner, 183 F. 2d 919 (5th Cir. 1950), 39 Am. Fed. Tax R. 822, *rev'g* 11 T. C. 928 (1949). See, also, D. G. McDonald, et al., 19 T. C. 672 (1952); Oleta A. Ewald, 2 T. C. 384 (1944), *aff'd* 141 F. 2d 750 (6th Cir. 1944), 32 Am. Fed. Tax R. 482; Irish v. Commissioner, 129 F. 2d 468 (3d Cir. 1942), 29 Am. Fed. Tax R. 932, *aff'g* 43 B. T. A. 864.

18 Helvering v. Clifford, 309 U. S. 331, 60 S. Ct. 554, 84 L. Ed. 788, 23 Am. Fed. Tax R. 1077 (1940).

19 Helvering v. Stuart, 317 U. S. 154, 63 S. Ct. 140, 87 L. Ed. 154, 29 Am. Fed. Tax R. 1209 (1942).

20 INT. REV. CODE OF 1954, § 61, Reg. 118, ¶ 39.22(a)-21.

21 Commissioner v. Clark et al., 202 F. 2d 94 (7th Cir. 1953), *aff'g* 17 T. C. 1357 (1951). See, also, Central Nat. Bank of Cleveland, 141 F. 2d 352 (6th Cir. 1944).

refused to apply this strict ten-year rule and held that the grantor was not taxable on the income from a charitable trust solely on the ground that he had a reversionary interest in corpus that was to take effect in 9 instead of 10 years. On appeal, the Tax Court's decision was affirmed by the Seventh Circuit but this Court decided that the trust term was actually 10 and not 9 years. It also held that the 10 year provision of the regulation was unreasonable, arbitrary and unconstitutional and could not be applied retroactively to the trust in question. Deductions, like income, are to be computed as if they were those of the taxpayer individually.[22]

To prevent the use of transfers in trust as a means of avoiding taxes by the grantor, Sections 166 and 167 of the 1939 Code, known as Sections 676 and 677 of the 1954 Code, had been enacted. This is accomplished by creating exceptions to the general rule that trust income is either taxable to the trustee or the beneficiary. One exception under Sections 166 and 167 provides that the grantor remains subject to income taxes on trust income where the trust principal is regarded as being owned by the grantor as in the case of a revocable trust. He is not so taxable if the power of revocation is held by, or shared with a person who has a substantial adverse interest. A mere possibility of a reversion does not make the grantor taxable.[23] Income of trusts are taxable to the grantor where the latter retains an interest in the trust. This would be so if the income is accumulated for the grantor, or the trust income is distributable to the grantor, or the trust income may be applied to pay premiums on the insurance policies on the life of the grantor. Beginning in 1943 discretionary trusts for maintenance or support of wife or minor child whom the grantor is legally obligated to support, render the grantor subject to income

[22] Silverthau v. United States, 26 F. Supp. 242 (D. Conn. 1938), 22 Am. Fed. Tax R. 558; Mary E. Wenger, 42 B. T. A. 225 (N. A. C. B. 1940-2, p. 14), *aff'd* 127 F. 2d 523 (6th Cir. 1942), 29 Am. Fed. Tax R. 329, *cert. denied,* 317 U. S. 646, 63 S. Ct. 40, 87 L. Ed. 527 (1942); Balch, 44 B. T. A. 269, *aff'd,* 129 F. 2d 472 (6th Cir. 1942), 29 Am. Fed. Tax R. 936; Cochran v. United States, 105 Ct. Cl. 628 (1945).

[23] Reg. 118, ¶ 39.166-1 for years beginning 1946. Fulham v. Commissioner, 110 F. 2d 916 (1st Cir. 1940), 24 Am. Fed. Tax R. 812, *aff'g,* 40 B. T. A. 48; Reinecke v. Smith, 289 U. S. 172, 53 S. Ct. 570, 77 L. Ed. 1109, 12 Am. Fed. Tax R. 47 (1933), *rev'g,* 61 F. 2d 324 (7th Cir. 1932); Helvering v. Wood, 309 U. S. 344, 60 S. Ct. 551, 84 L. Ed. 796 (1940), *aff'g,* 104 F. 2d 1013 (2d Cir. 1939) which *aff'd* 37 B. T. A. 1065; Carkhuff v. Commissioner, 83 F. 2d 626 (2d Cir. 1936), *cert. denied,* Oct. 12, 1936; Sterling Morton, 38 B. T. A. 1283, *aff'd,* 109 F. 2d 47 (7th Cir. 1940), 24 Am. Fed. Tax R. 188; Harry J. Miller, ¶ 53,160 P-H Memo T. C.; Welch v. Bradley, 130 F. 2d 109 (1st Cir. 1942), 29 Am. Fed. Tax R. 1062, *rev'g,* 37 F. Supp. 788 (D. Mass. 1941), 26 Am. Fed. Tax. R. 941. Reg. 118, ¶ 39.22(a)-21.

taxes therefor if he, acting as trustee, or another person, so does but only to the extent that the expenditures are made.[24] Income of trusts used to satisfy grantor's other legal obligations are also taxable to the grantor.[25] The income of trusts in which grantor retains substantial dominion or control over the trust corpus is also taxable to the grantor.[26]

The Clifford regulations,[27] promulgated in the year 1947, proved so salutory despite much grumbling and the charge of unconstitutionality[28] that they were incorporated in large measure as Sections 671 through 678 of Subpart E of the 1954 Internal Revenue Code.

The 1954 Code thus provides that the income of a trust may be taxable to the grantor rather than to the trustee or beneficiary. The grantor is taxable if he retains a reversionary interest in the trust corpus or income which may take effect within 10 years from the creation of the trust. However, if the trust income is payable to an income beneficiary for life with a reversion in the grantor, the latter is not taxable on the income even though the life expectancy of the income beneficiary is less than 10 years. On the other hand, if the trust income is payable only to a designated school, hospital or a church, the grantor will not be taxable because of the grantor's reversionary interest unless the reversion will take place within two years.[29]

The grantor is taxable on the trust income if he or an adverse party or both have the power to dispose of the corpus or income

[24] Reg. 118, ¶ 39.167-1, 2. Everett D. Graff, 40 B. T. A. 920, *aff'd,* 117 F. 2d 247 (7th Cir. 1941), 26 Am. Fed. Tax R. 395; Kent v. Rothensies, 120 F. 2d 476 (3d Cir. 1941), 27 Am. Fed. Tax R. 465, *cert. denied,* 314 U. S. 659, 62 S. Ct. 113, 86 L. Ed. 528 (1941); Kent v. United States, 103 Ct. Cl. 714, 60 F. Supp. 203 (1945), 33 Am. Fed. Tax R. 1308; McDonald, et al., 19 T. C. 672 (1953), Oleta A. Ewald, 2 T. C. 384 (1943), *aff'd,* 141 F. 2d 750 (6th Cir. 1944); Burnet v. Wells, 289 U. S. 670, 53 S. Ct. 761, 77 L. Ed. 1439 (1933), 12 Am. Fed. Tax R. 65, *rev'g,* 63 F. 2d 425 (8th Cir. 1932); Du Pont v. Commissioner, 289 U. S. 685, 53 S. Ct. 766, 77 L. Ed. 1447 (1933), *aff'g,* 63 F. 2d 44 (3d Cir. 1933); Henry G. Miller, et al., ¶ 52,208 P-H Memo T. C.; Edgar E. Peieris, 12 T. C. 741 (1949); Estate of Emanuel Sturman, 11 T. C. 890 (1948).

[25] Douglas v. Willcuts, 296 U. S. 1, 56 S. Ct. 59, 80 L. Ed. 3 (1935); Reg. 118, ¶ 39.167-1; Sokol, 7 T. C. 567 (1946); Hamilton et al., ¶ 45,299 P-H Memo T. C.; Krause, ¶ 45,299 P-H Memo T. C.

[26] Reg. 118, ¶ 39-22(a)-21; Helvering v. Clifford, 309 U. S. 331, 62 S. Ct. 333, 84 L. Ed. 788 (1940); Helvering v. Stuart, 317 U. S. 154, 63 S. Ct. 140, 87 L. Ed. 154 (1942).

[27] Reg. 118. § 39.22(a).

[28] Commissioner v. Clark, et al., 202 F. 2d 94 (7th Cir. 1953), *aff'g,* 17 T. C. 1357 (1951).

[29] INT. REV. CODE OF 1954, § 170(b)(1)(a).

without the consent of any adverse party. However, the power in anyone will *not* cause the income to be taxed to the grantor (a) to apply trust income to support grantor's dependents except to the extent so applied, (b) to change the distribution of income only after 10 years of the existence of a trust, (c) to affect by will the distribution of the current incôme except the accumulated income of a trust, (d) to shift corpus or income from one charity to another, (e) to invade corpus for the benefit of any designated beneficiary, (f) to postpone payment of income to a beneficiary for a reasonable time, (g) to postpone payment of income to a beneficiary during his minority or disability, and (h) to apportion receipts and disbursements between corpus and income according to sound trust accounting principles.[30]

The grantor is not taxed on trust income if the power to distribute corpus or income within a class of beneficiaries is held by a person other than the grantor or one related and subservient to him. Nor is he taxed on the trust income if the power to apportion income among a class of beneficiaries according to a reasonably definite external standard recited in the trust agreement, such as illness or education, is held by a trustee other than the grantor or his wife. However, if any person has a power to add to the designated beneficiaries except after-born or after-adopted children, the income is taxable to the grantor.

The grantor is taxable on trust income where the administration of the trust is exercisable chiefly for the benefit of the grantor rather than the beneficiaries. This would be true if, for example, the power vested in the grantor or in a nonadverse party, or both, without approval of an adverse party, to deal with the trust property or income for inadequate consideration, or if the power similarly vested enabled the grantor to borrow trust corpus or income without adequate interest or security. The grantor would also be taxable on the trust income where the grantor had directly or indirectly borrowed trust corpus or income and had not repaid same by the end of the taxable year, or if the general powers of administration exercisable by anyone redounded to the grantor's advantage.

The trust income is taxable to the grantor if he or anyone without adverse interest has the power to revoke the trust. But if this power is not exercisable for 10 years or two years in the case of

[30] *Id.* § 674.

charitable trusts after its creation, the grantor is not taxed on the income during that period. He will be taxable thereon after this period unless he renounces the power to revoke.[31]

Income for the benefit of the grantor is taxable to him if it is or may be in the discretion of the grantor or a nonadverse party, distributed to the grantor, accumulated for future distribution to him, or used to pay premiums on his life insurance policies except policies irrevocably payable to charity. But trust income is taxable to the grantor, only to the extent that the income is applied for, to support or maintain beneficiaries whom he is obligated to so treat.[32]

A power to acquire or release trust corpus or income may render a person other than the grantor subject to income taxes thereon. However this general rule is excepted if the grantor is already taxable on its income, or if the other person actually applies the trust income to support a legal dependent, or if such other person disclaims this power soon after he discovers it.[33]

III. CONCLUSION

THE use of reciprocal trusts as a means of minimizing estate and income taxes has proven to be a vain and futile device. Even though the *Newberry Doctrine* of 1953 restricts the broad application of the *Lehman Doctrine* by requiring the Treasury to adduce evidence to establish tax avoidance by more than a coincidence of a number of simultaneous factors, taxpayers should not expect much tax saving appeal from the new doctrine.

In conclusion it must be acknowledged that the federal estate and income tax savings of cross trusts can be salvaged by taking adequate precautions to insulate the trusts against the imputation of reciprocity. This can be achieved by avoiding the use of substantially identical provisions and the same draftsmen, and the execution of the trusts at about the same time in consideration for one another.

31 *Id.* § 676.
32 *Id.* § 677.
33 *Id.* § 678.