NOTES

RECIPROCAL TRUSTS AND THE FEDERAL ESTATE TAX: ECONOMIC REALITY DISREGARDED

A SIGNIFICANT PORTION of the Federal Estate Tax is designed to prevent its avoidance.[1] The necessity for these detailed precautionary measures becomes apparent from an inspection of some of the ingenious devices which have been employed to escape its incidence.[2] At least one such device, the reciprocal trust transfer,[3] seems to have survived the stop-gap efforts of Congress and the courts.

The technical basis of the reciprocal trust doctrine was recently considered in *Newberry's Estate v. Commissioner*.[4] There, John J. Newberry and his wife, Myrtle, had each created four trusts principally for the benefit of their two children. Each grantor had conveyed the same amount of property to the trusts, and had vested in his or her spouse the same limited power to alter them, although neither grantor had *reserved* any powers over the trust which he or she had created. Upon the death of Myrtle Newberry, the commissioner included in her gross estate the value of the trusts which had been created by her husband. The Tax Court affirmed, agreeing that, in practical effect, her powers over the trusts which her husband had created were equivalent to powers over her own trusts, and hence were taxable under section 811(d)(2) of the 1939 Code.[5] The Court of Appeals, however, re-

[1] The controlling theory of the Estate Tax is that it is a levy upon the privilege of transferring property at death. However, many of the substantive provisions comprising the Tax are concerned with inter vivos transfers. INT. REV. CODE OF 1954, § 2035 (transfers in contemplation of death), § 2036 (transfers with a retained life estate), § 2037 (transfers taking effect at death), § 2038 (revocable transfers). See generally HUGHES, FEDERAL DEATH TAX 114 (1938).

[2] See generally Leapheart, *The Use of the Trust to Escape the Imposition of the Federal Income and Estate Taxes*, 15 CORNELL L.Q. 587 (1930); Lowndes, *Tax Avoidance and the Federal Estate Tax*, 7 LAW & CONTEMP. PROB. 309 (1940); PAUL, STUDIES IN FEDERAL TAXATION: TAXATION WITHOUT MISREPRESENTATION 27 *et. seq.* (1937).

[3] This has also been characterized as the "cross," "converse," and "parallel" trust transfer. See generally Colgan and Molloy, *Converse Trusts, the Rise and Fall of a Tax Avoidance Device*, 3 Tax L. Rev. 271 (1948).

[4] 201 F.2d 874 (3d Cir. 1953).

[5] 17 T.C. 597, 606 (1951). The court said, "The essential consideration here is that, if the power to chauge the beneficiaries had been reserved in decedent's own trust, there would be no doubt that it would fall under section 811(d)(2) and, therefore, the trust corpus fall within the gross estate; and the result is the same if there are no

versed, reasoning that since the trusts had not been created in consideration for each other, the wife's powers over the husband's trusts did not render them taxable to her.[6]

Had the powers of alteration not been crossed—*i.e.*, had each reserved to himself the powers over the trust which he or she created—without doubt the corpus would have been taxable to the grantor's estate.[7] Accordingly, the instant decision is difficult to justify rationally. It is supported, however, by a long line of decisions, beginning with *Lehman v. Commissioner*[8] in 1940. In that case, both Allan and Harold Lehman simultaneously created substantially identical trusts giving the other a life estate and a limited power to invade the corpus. When Harold died, the commissioner included in his gross estate the sum which he had been empowered to withdraw from the corpus of the trusts created by Allan.[9] The Board of Tax Appeals affirmed[10] on the ground that the decedent's power to invade the corpus of Allan's trusts was *equivalent* to a power to invade his own, and that it was thus an interest in property of which the decedent had "made a transfer . . . where the enjoyment thereof was subject at the date of his death to a change through the exercise of a power . . . to alter, amend, or revoke

cross trusts, exchanging the same power so that there is in substance a transfer by the decedent."

[6] 201 F.2d 874, 878 (3d Cir. 1953).

[7] INT. REV. CODE OF 1954, § 2038(a)(2) taxes property of a decedent:

> "To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power either by the decedent alone or in conjunction with any other person, to alter, amend, revoke, or where the decedent relinquished any such power in contemplation of his death. . . ."

[8] 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940). This was not the first tax case involving crossed trusts. It was, however, the first case in which a tax rationale for reciprocal trusts was articulated, and it has since been followed in the majority of cases involving crossed trusts. See, *e.g.*, Hanauer's Estate v. Comm'r, 149 F.2d 857 (2d Cir. 1945), *cert. denied*, 326 U.S. 770 (1945); Cole's Estate v. Comm'r, 140 F.2d 638 (8th Cir. 1944); Orvis v. Higgins, 180 F.2d 537 (2d Cir. 1950), *cert. denied*, 340 U.S. 810 (1950); *In re* Leuder's Estate, 6 T.C. 587 (1946), *rev'd on other grounds*, 164 F.2d 128 (3d Cir. 1947); Estate of Frederick H. Fish, 45 B.T.A. 120 (1941); *cf.* Parshelsky v. Comm'r, 46 B.T.A. 456 (1942). *But cf.* Comm'r v. Dravo, 119 F.2d 97 (3d Cir. 1941).

[9] The Commissioner did not include the entire amount of the property in the decedent's gross estate, as would be the case today where there is a reservation of a life estate in the grantor [see INT. REV. CODE OF 1954, § 2036], as the trusts involved in this case were created prior to 1931 and hence fall under the rule of May v. Heiner, 281 U.S. 238 (1930). See note 32 *infra*.

[10] Allan S. Lehman *et al.*, Ex'rs, 39 B.T.A. 17 (1939).

. . . ,"[11] taxable under section 302(d) of the 1926 Act.[12] The Court of Appeals affirmed,[13] but for substantially different reasons. Relying on the settled rule of trust law that "the person who furnishes the consideration for a trust is the settlor even though in form the trust was created by another person,"[14] the court held that Harold was the "true settlor" of the trusts of which Allan was the named settlor, and to the extent that Harold could invade the corpus of the trusts of which he was the "true settlor," they were includable in his gross estate.[15]

It is not apparent why the court substituted its *quid pro quo* rationale for the approach of economic equivalence followed by the Board of Tax Appeals. Nevertheless, that substitution has had profound effect upon subsequent reciprocal trust cases, for it has made the earmark of taxability one of subjective intent rather than of economic consequences[16]—and this area of subjective intent, nebulous in any context, is especially fraught with difficulties in applying the Estate Tax.[17] Usually, the transfer has occurred years before the matter reaches litigation, the party whose intent is in issue is dead, and surviving parties who would be best qualified to testify concerning the intent of the decedent are frequently either scattered or dead, or their testimony is of little probative value because of obvious self-interest. The problem is further aggravated by the fact that in the peculiar circumstances surrounding the creation of typical reciprocal trusts, it is quite probable that no clearly defined intent may be discernible. Therefore, courts have been forced to infer this intent largely from objective

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[11] *Id.* at 27.

[12] This section, as amended, now appears as INT. REV. CODE OF 1954, § 2038(a).

[13] 109 F.2d 99 (1940), *cert. denied,* 310 U.S. 637 (1940).

[14] 1 SCOTT, TRUSTS § 156.3 (1939).

[15] Perhaps one reason why the court was prone to adopt this particular rationale is that it was made easy by a stipulation of counsel before the Board of Tax Appeals that the trusts were created in consideration for one another. 39 B.T.A. 17, 20 (1939). This may be cited as an *easy* case that made bad law, because very few cases have arisen since the *Lehman* decision in which this unfortunate stipulation has been made. *But cf.* Estate of Thomas Neal, P-H 1943 TC MEM. DEC. ¶ 43,518 (1943); Estate of Olive H. Oliver, P-H 1944 TC MEM. DEC. ¶ 44,138 (1944).

[16] The vast majority of cases which have arisen subsequent to the *Lehman* case have either followed or have been forced to distinguish the subjective approach of mutual consideration for which that case stands. See, *e.g.*, Orvis v. Higgins, 180 F.2d 537 (2d Cir. 1950), *cert. denied,* 340 U.S. 810 (1950); Hanauer's Estate v. Comm'r, 149 F.2d 857 (2d Cir. 1945), *cert. denied,* 326 U.S. 770 (1945); Estate of John H. Eckhardt, 5 T.C. 673 (1945); *cf.* Parshelsky v. Comm'r, 46 B.T.A. 456 (1942), *rev'd on other grounds,* 135 F.2d 596 (2d Cir. 1943) (involves the Federal Income Tax, but the analysis as to reciprocal trusts is applicable in Estate Tax cases). *But cf.* Estate of Samuel S. Lindsay, 2 T.C. 174 (1945).

[17] See Colgan and Molloy, *op. cit. supra* note 3, at 276 *et. seq.*

data and circumstances surrounding the transfer,[18] the most significant of which would seem to be the fact that the trusts arose out of a close family relationship.[19] Other facts which have supported inferences of reciprocity have been the proximity of times of creation,[20] the identity of trustees and legal advisors to the respective grantors,[21] the similarity of trust instruments[22] and of subsequent amendatory action,[23] and the correspondence in amounts of the respective trusts;[24] and although no one of these factors is generally held to control the question, their cumulative effect has been considerable.[25] But in spite of the aid of such objective indicia, this subjective test remains a tenuous one, conducive of numerous difficulties.[26]

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[18] *Compare* Estate of John H. Eckhardt, 5 T.C. 673 (1945) *with In re* Leuder's Estate, 6 T.C. 587 (1946), *rev'd*, 164 F.2d 128 (3d Cir. 1941).

[19] No cases have been found involving reciprocal transfers which have not been carried out between close family relations. Arrangements between husband and wife predominate. *E.g.*, Hanauer's Estate v. Comm'r, 149 F.2d 857 (2d Cir. 1945), *cert. denied*, 326 U.S. 770 (1945); Cole's Estate v. Comm'r, 140 F.2d 636 (8th Cir. 1944); Estate of John H. Eckhardt, 5 T.C. 673 (1945); Estate of Frederick H. Fish, 45 B.T.A. 120 (1941). Father and daughter: *e.g.*, Estate of George W. Sweeney, 4 T.C. 265 (1944), *aff'd sub nom.* Merganthaler v. Comm'r, 152 F.2d 102 (2d Cir. 1945). Mother and son: *e.g.*, Claire G. Hoffman, 2 T.C. 1160 (1943), *aff'd*, 148 F.2d 285 (9th Cir. 1945). Brothers: *e.g.*, Estate of H. H. Scholler, 44 B.T.A. 235 (1941); Comm'r v. Warner, 127 F.2d 913 (9th Cir. 1942); Lehman v. Comm'r, 109 F.2d 99 (1939), *cert. denied*, 310 U.S. 637 (1940); Parshelsky v. Comm'r, 46 B.T.A. 456 (1942), *rev'd on other grounds*, 135 F.2d 596 (2d Cir. 1943).

[20] See, *e.g.*, Hanauer's Estate v. Comm'r, 149 F.2d 857 (2d Cir. 1945), *cert. denied*, 326 U.S. 770 (1945); *In re* Leuder's Estate, 6 T.C. 587 (1946), *rev'd*, 164 F.2d 128 (3d Cir. 1947).

[21] See, *e.g.*, Hanauer's Estate v. Comm'r, *supra* note 20; Estate of John H. Eckhardt, 5 T.C. 673 (1945); Comm'r v. Warner, 127 F.2d 913 (9th Cir. 1942).

[22] See, *e.g.*, Allan S. Lehman *et al.*, Ex'rs, 39 B.T.A. 17 (1939), *aff'd*, 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940).

[23] Estate of Myrtle H. Newberry, 5 T.C. 597, 600 (1951). Although the Tax Court considered the amendments significant, the Court of Appeals apparently felt that they did not bear upon the essential issue of consideration. *See* 201 F.2d 874, 876 (3d Cir. 1953).

[24] See, *e.g.*, Estate of John H. Eckhardt, 5 T.C. 673 (1945); Werner A. Weiboldt, 5 T.C. 946 (1945); Estate of Henry S. Downe, 2 T.C. 967 (1943); Bishop v. Comm'r, 4 T.C. 862 (1945).

[25] See, *e.g.*, Estate of John H. Eckhardt, 5 T.C. 673 (1945). *But cf.* Estate of Samuel S. Lindsay, 2 T.C. 174, 178-79 (1943), where the court said:

> "But the facts that the trusts were executed at the same time, were in substantially equal amounts, and had similar provisions are not conclusive that the trusts were interdependent and were executed in consideration for each other."

[26] This has long been the experience of the courts which have dealt with transfers in contemplation of death under what is now § 2035 of the 1954 Internal Revenue Code, the wording of which makes a subjective inquiry practically unavoidable.

In view of the demonstrated inadequacy of the *quid pro quo* rationale as an impediment to tax avoidance, the question arises whether such a treatment is necessary to preserve the integrity of the Estate Tax. The general climate set by the more recent cases seems to indicate that it is not.[27] *Helvering v. Clifford*[28] is illustrative here. The crux of the decision to tax the grantor of the trust in that case was the fact that he had not changed his *economic position* by reason of the transfer.[29] There is no apparent reason why such an enlightened view should not be adopted in cases involving reciprocal trusts. The fact that the transferor's economic position has not been changed by the creation of the trusts would seem sufficient to justify subjecting him to the provisions of the Estate Tax governing inter vivos transfers.[30] Such an approach has gained the approval of the courts in numerous cases involving the constitutionality of federal tax measures,[31] and surely it could appropriately be applied in this instance.[32]

In at least four cases involving reciprocal trusts, the courts have found the consideration rationale either inadequate or illusory and have deviated from the supposed technical confines of the *Lehman* doctrine. In *Werner A. Weiboldt*,[33] an income tax case,[34] there was

For a discussion of the difficulties involved in such a subjective inquiry see the dissenting opinion of Mr. Justice Stone in Heiner v. Donnan, 285 U.S. 312, 332 (1931); 1 PAUL, FEDERAL ESTATE AND GIFT TAXATION 279 *et seq.* (1942); Lowndes and Rutledge, *An Objective Test of Transfers in Contemplation of Death*, 24 TEXAS L. REV. 134 (1946).

[27] For an excellent summary of the treatment of cases since Helvering v. Clifford, 309 U.S. 331 (1940), with emphasis upon the "new" concept of economic reality in federal taxation, see Goldring, *The Taxation of Economic Control*, 24 TAXES 751 (1946).

[28] 309 U.S. 331 (1940). For a compendium of the articles which have commented upon the *Clifford* doctrine, see 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 37.17(b) n. 55 (revised ed. 1949).

[29] Helvering v. Clifford, 309 U.S. 331, 336 (1940).

[30] See note 1 *supra*.

[31] This so-called "penumbra" doctrine, stated simply, is that if the federal government has the undisputed power to tax trausfers of property at death, then, a fortiori, it may tax inter vivos transfers which, unless so taxed, would escape taxation. See Helvering v. City Farmers Trust Co., 296 U.S. 85 (1935); Lowndes, *Current Constitutional Problems in Federal Taxation*, 4 VAND. L. REV. 469, 486 *et. seq.* (1951).

[32] Unfortunate situations have resulted in the past when courts have refused to give the Estate Tax the liberal construction which the purpose of the tax would seem to dictate. The prime example is May v. Heiner, 281 U.S. 238 (1930), where it was held that the reservation of a life estate was *not* taxable as a transfer "taking effect at death," because, under property concepts, the remainder vested at the time of the transfer.

[33] 5 T.C. 946 (1945).

[34] There is no significant difference between the considerations involved in the reciprocal trust situation under the estate and income taxes. See Colgan and Molloy, *op. cit. supra* note 3, at 287.

a finding that the petitioners, in establishing the trusts, did not consider that they were being created in consideration for one another,[35] but the court nevertheless held that they were taxable to the respective grantors, noting that "we are constrained to concern ourselves with the realities of the situation and not with mere form."[36] A similar emphasis was placed upon the practical results of the transfer in *Bishop v. Commissioner*,[37] also an income tax case, where the court held that transfers were not "gifts" as defined by the statute when each grantor reserved a life estate to the other, because "in the establishment of these trusts petitioners have received from each other all the incidents of ownership that were of importance to them."[38] Likewise, in *Estate of Frederick H. Fish*,[39] arising under the Estate Tax, the court paid lip service to the *Lehman* decision, but the truly pertinent language of the opinion evinced a more realistic approach: ". . . The rights each received under the trust created by the other were of the unrestricted character not essentially to be distinguished from complete ownership."[40] And perhaps the most candid departure from the *Lehman* rationale which has arisen under the Estate Tax is *Cole's Estate v. Commissioner*,[41] where the court found consideration, but stated unequivocally that the tax results would have been the same without such a finding, because the law attaches consequences to what the parties do, regardless of their private intentions.[42]

Although these cases may, to some extent, have impaired its vitality, the *quid pro quo* rationale persists as a constant threat to the administration of the Estate Tax. This is dramatically illustrated by the *New-*

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[35] Werner A. Weiboldt, 5 T.C. 946, 950, 951 (1945).

[36] *Id.* at 953. In support of this proposition, the court also cited *Helvering v. Clifford*, and clarified its view of the case by saying:

> "If either grantor had retained such power [as was exchanged here], he would have been subject to tax on the income under Stockstrom v. Commissioner, 148 F.2d 491 [1945]. Certainly the effect of that case may not be circumvented by a simple expedient on the part of a husband and wife of exchanging the rights with each other."

[37] 4 T.C. 862 (1945).

[38] *Id.* at 869, 870. In so holding, the court found it unnecessary to consider the doctrine of reciprocal trusts.

[39] 45 B.T.A. 120 (1941).

[40] *Id.* at 125.

[41] 140 F.2d 636 (8th Cir. 1944).

[42] *Id.* at 638. The exact wording of the opinion is perhaps more revealing here:

> "Assuming, arguendo, that no specific finding of consideration was made, the court's decision may be sustained on another basis. . . . [A]s a result of the identical and simultaneous trusts, and of the 'family relationships,' each decedent 'retained the substance of full enjoyment of all the rights [for life] which previously he had in the property.' . . . Helvering v. Clifford, 309 U.S. 331, 336 [1940]. . . . To the extent of the income from the 300 shares of the stock there was no change in the economic position of either grantor."

berry case. There every evidentiary fact, save one, pointed unequivocally to a carefully worked out scheme to avoid taxation.[43] The only evidence which tended to contradict interdependency was the testimony of the husband that Myrtle Newberry had indicated to him that she would have created her trusts even if he had not created his, because she was impressed by the soundness of the disposition.[44] Nevertheless, the court held that the trusts were not created in exchange for one another. Had the court been unfettered by the impressive authority supporting the *Lehman* rationale,[45] it might have decided the case differently, and Judge Hastie would not have felt constrained to admit:

> Undoubtedly, in this connection as in others, domestic privacy and informality may effectively conceal understandings made and honored between husband and wife at variance with formal and apparent aspects of family financial transactions. A bargain and exchange, within the meaning of the Lehman doctrine, may exist, yet be unprovable.[46]

In the present state of the law, it is difficult to determine which approach a given court is likely to follow, but it is clear that the proper one is a repudiation of the *Lehman* doctrine of subjective intent in favor of a more objective test. Such a course is constitutionally sound;[47] it is accurate as an interpretation of the estate tax;[48] and it provides a definite standard by which tax results may be determined and predicted.[49]

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[43] What is probably most significant is that the timing conclusively suggests that the trusts were amended for the sole purpose of keeping abreast of changes in the Internal Revenue Code and thus maintaining the tax-free character of the transfers. In reviewing the evidence on appeal, Judge Hastie, speaking for the court, concluded that "we have no doubt that the parties, advised by counsel, deliberately chose the alternative which appeared to entail the less burdensome tax consequences." 201 F.2d 874, 878 (3d Cir. 1953).

[44] Newberry's Estate v. Comm'r, 201 F.2d 874, 875 (3d Cir. 1953).

[45] Perhaps it should be pointed out that what Judge Hastie and many others have conceived to be the strict limitations of the *Lehman* case are actually nonexistent. Absent the stipulated case of mutual consideration, it is arguable that the court would not have adopted the ground of decision followed by the Tax Court. See note 15 *supra*.

[46] 201 F.2d 874, 878 (3d Cir. 1953).

[47] *Cf.* Helvering v. City Farmers Trust Co., 296 U.S. 85 (1935); Cole's Estate v. Comm'r, 140 F.2d 636 (8th Cir. 1944).

[48] See, *e.g.*, Cole's Estate v. Comm'r, *supra* note 47.

[49] It should be noted that, since the *Newberry* case, at least one court has rejected the suggested approach. In McLain v. Comm'r, 126 F. Supp. 621, 625 (N.D. Ill. 1955), the court, specifically adopting the *Newberry* rationale, concluded that "since the stipulated facts are barren of any reference to any consideration . . . the two trusts created simultaneously by the decedent and his wife are not reciprocal within the doctrine first announced in Lehman v. Commissioner."