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ESTATE TAXATION OF RECIPROCAL TRUSTS

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I. INTRODUCTION

Since the basic purpose of the Federal estate tax legislation is the imposition of a tax upon the transfer of property interests taking effect at the time of a decedent's death, it is only natural that various Code sections are directed toward accomplishing this goal notwithstanding a purported lifetime disposition.[1] Hence, any inter vivos transfer that is not unequivocal and absolute may fail to remove the property from the decedent's gross estate for Federal estate tax purposes.

It is not essential, to inclusion in the decedent's gross estate, that the donor or transferor have a right to return the property to himself or that he have the ability to receive any financial benefit from the property. It is sufficient if he can designate the persons who can enjoy the property or the income therefrom as a result of a retained power to this effect.[2] Likewise, if the decedent, at the time of his death, has the right to change the enjoyment of such property because of the possession of a power to alter, amend, revoke, or terminate the property interest transferred, the value of such interest would be included in the decedent's gross estate.[3] It is immaterial whether these rights are ever exercised by the decedent. Their retention[4] or possession[5] is the crucial factor.

The rationale of such inclusion is obvious. As long as the transferor retains these powers over the property, he has not divested himself of all the incidents of ownership nor has he transferred all economic benefits to one other than himself. The final and complete transfer occurs only at the time when he can no longer exercise any control over the property through the utilization of the retained or possessed powers, *i.e.*, the date of death. The transfer, having taken place at the time of death, the decedent's gross estate will include the value of such property to the extent of his interest therein for it is in essence a testamentary disposition.

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1. In particular see INT. REV. CODE of 1954, § 2035 relating to transfers in contemplation of death; INT. REV. CODE of 1954, § 2036 regarding transfers with retained life estate; INT. REV. CODE of 1954, § 2037 involving transfers taking effect on death, and; INT. REV. CODE of 1954, § 2038 dealing with revocable transfers. Unless otherwise designated, all sections are from the *Internal Revenue Code of 1954*, as amended.
2. INT. REV. CODE of 1954, § 2036.
3. INT. REV. CODE of 1954, § 2037.
4. A § 2036 power must have been retained by the transferor at the time of the transfer in order for the section to apply.
5. A § 2038 power need not be originally retained by the transferor. It need only be possessed at the time of the decedent's death.

As is to be expected, many individuals desire to avoid the inclusion of all their property in their gross estates for Federal estate tax purposes. Counterbalancing this desire is the wish to continue to enjoy all or some of the benefits therefrom during their lifetimes. This has often led to a transfer in trust with the grantor retaining some rights in the property but divesting himself of enough interest so as to create a reasonable expectation of having the value of the property excluded from his gross estate. These often elaborate schemes have proved both successful and unsuccessful depending upon the particular factual situations involved. The purpose of this article is to explore one such type of transfer in view of the Supreme Court's recent decision in *United States v. Grace.*[6] In order to do so, some preliminary consideration should be given to sections 2036 and 2038 of the Internal Revenue Code in conjunction with previous decisions.

II. Sections 2036 and 2038

Section 2036 is designed to include in the decedent's gross estate the value of all property which he has transferred for less than an adequate and full consideration, and property in which he has retained possession, enjoyment or the right to receive income. It also includes those transfers where the decedent retains "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[7] It is not necessary to the application of section 2036 that the decedent reserve all of these powers in the transferred property. It is sufficient that he retain any of the enumerated interests or powers "for his life, for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death. . . ."[8]

Whereas section 2036 requires that these powers be retained by the transferor, section 2038 has reference to certain rights that are possessed by the decedent at the time of his death irrespective of when he acquired them. Accordingly, the decedent's gross estate would include the value of all property, to the extent of any interest therein, of which he has made a transfer for less than an adequate and full consideration

> where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate . . . .[9]

Again, the decedent need not have the power to return the property to himself by a revocation or termination of the transfer. The mere power

6. 395 U.S. 316 (1969).
7. Int. Rev. Code of 1954, § 2036 (a) (2).
8. Int. Rev. Code of 1954, § 2036 (a).
9. Int. Rev. Code of 1954, § 2038 (a) (1).

to alter or amend raises the possibility of a section 2038 inclusion. In this respect it is analogous to section 2036 where the power to control the economic benefits of the transferred property is the important factor and not the ability to return the property or income to the decedent.

These two sections must be hurdled by the individual desiring to avoid the inclusion of some of his property in his gross estate while retaining the use thereof during his lifetime. In many factual settings, both sections will apply to the same transfer although there are instances where only one will be applicable.[10]

III. The Problem of the Transferor

For section 2036 to be applicable to a retained interest, and for section 2038 to include a possessed power, the powers or interests must relate to a transfer of property made by the decedent. Hence, if the decedent was not the transferor, neither section would apply. This should not be interpreted to mean that the decedent's gross estate would not include the value of any part of the property to which the power relates,[11] but only that it would not be included under either of these two sections.

Lest it be assumed that the decedent can easily avoid being deemed the transferor by giving the property to a third person who in turn would make the transfer thereby giving the decedent some interest therein free of estate tax liability, it should be pointed out that the courts have consistently looked to the substance and not to the form of the transaction. The use of a strawman would not interfere with the courts' determination of the true transferor. For example, if the owner of the property transfers it to a donee with the specific instruction to create a trust or conditions the transfer on the creation of a trust, the donor will be treated as the settlor for purposes of sections 2036 and 2038.[12] If the rights or interests of the donor are covered by either section, the value of the property transferred, to the extent of any interest therein, would be included in the donor's gross estate although he was not the person who formally created the trust nor transferred legal title to the trustee. The same rule would apply if the donor gave property to the donee upon the understanding that a trust would be created by the donee.[13] The donor would again be considered as the transferor for estate tax purposes.

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10. For some of the comparisons and distinctions between §§ 2036 and 2038, see Industrial Trust Co. v. Comm'r, 165 F.2d 142 (1st Cir. 1947) and Treas. Reg. §§ 20.2036-1 (b) (2) (iii), 20.2038-1 (b). *See also* C. Lowndes & R. Kramer, Federal Estate and Gift Taxes § 9.14 (2d ed. 1962).

11. For example, the rights granted in the property might be deemed a general power of appointment and included under § 2041. Other pertinent sections would have to be considered in each case in order to be assured of non-inclusion.

12. State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959).

13. Estate of Grace D. Sinclair, 13 T.C. 742 (1949); Estate of George W. Hall, 6 T.C. 933 (1946).

On the other hand, if there has been a complete and irrevocable gift without any agreement or understanding between the parties as to what the donee can do with the property after the gift, the donor would not be considered as the transferor or settlor if the donee should subsequently create a trust and give the donor some interest therein.[14]

Whether the donor or donee is the actual transferor is a question of fact to be determined on a case by case basis. In determining this issue, the courts will go beyond the trust instrument in order to ascertain "whether the significant shifting of economic interests and the change of dominion and control over property has been different from what the trust instrument indicates."[15] Where "such analysis shows that another than the formal settlor is in reality the transferor, his estate may be taxed accordingly."[16]

IV. Reciprocal Trusts

The question of the settlor of a trust is not only important where there has been a gift preceding the creation of the trust, but also arises where there are dual or reciprocal trusts. One of the leading cases involving this problem was *Lehman v. Commissioner*,[17] where the decedent and his brother each created a trust. The decedent agreed to create a trust for his brother and his issue in consideration of his brother creating a trust for the decedent and his issue. The two brothers executed trust agreements simultaneously wherein the trustee was to pay the income to the other brother for life, remainder to his issue. The life tenant was given the right to withdraw $150,000 from the principal.

Upon the decedent's death, the court held that $150,000 was properly includible in his gross estate since, at the date of his death, he possessed the ability to change the enjoyment of the transferred property by exercising his power to receive the $150,000.[18] There was no dispute that this amount would have been included in the decedent's gross estate if this right had been reserved by him in the property which he transferred. However, the power was given to the decedent by his brother and related to the property placed in trust by the brother. The real issue, therefore, centered around the determination of the actual transferor. The court concluded that there was absolutely no reason why the decedent should not be considered as the settlor of this trust. The decisive point was that the decedent, by transferring his property for his brother's use, caused the brother to create

14. Plimpton v. Comm'r, 135 F.2d 482 (1st Cir. 1943).
15. Newberry's Estate v. Comm'r, 201 F.2d 874, 876 (3d Cir. 1953).
16. *Id.*
17. 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940).
18. This was included under § 302(d) of the Internal Revenue Code of 1926 and is very similar to the language now employed in Int. Rev. Code of 1954, § 2038. The entire value of the transferred property would now be included under § 2036 as a result of the retained life interest but such was not the case at the time of the decedent's death in *Lehman*.

the trust in favor of the decedent. In so holding, the court stated that while the Internal Revenue Code

> speaks of a decedent having made a transfer of property with enjoyment subject to change by exercise of power to alter, amend or revoke in the decedent, it clearly covers a case where the decedent, by paying a *quid pro quo,* has caused another to make a transfer of property with enjoyment subject to change by exercise of such power by the decedent. [Hence,] the transfer by the decedent's brother having been paid for and brought about by the decedent, was in substance a 'transfer' by the decedent, and the property so transferred formed part of his taxable estate . . . to the extent that the decedent had power 'to alter, amend or revoke' the enjoyment of it, that is to say, to the extent of $150,000.[19]

The court ignored the formalities involved in the creation of the two trusts and looked to the substance thereof. In so doing, each brother was treated as the settlor of the trust created by the other. Reciprocal trusts involving consideration between the settlors were thereby denied effectiveness as a method of retaining some control over or interest in property while avoiding its inclusion in the decedent's gross estate.

A. *The Issue of Consideration*

Since the *Lehman* decision was premised upon the presence of consideration, the courts were immediately presented with the necessity of determining whether, under the factual situation of each case, there was consideration. (As expected, the parties after *Lehman* were not always as patent in setting forth their subjective intentions nor in detailing the nature of the consideration for the reciprocal trusts if it in fact existed.)

The proximity in time of the creation of each trust is naturally important to this determination. Consideration has been found to exist where a husband and wife simultaneously created trusts and granted identical benefits therein to each other[20] although the amounts contained in each trust were not necessarily the same.[21] To the extent that the amounts were identical, there would be little difficulty in finding consideration.[22] Such a decision was reached by the Tax Court where the spouses created reciprocal trusts within six days of each other and there was evidence that the spouses habitually consulted each other in connection with their business and personal matters and were unusually intimate in their financial and business affairs.[23] These factors led the court to hold that the trusts

19. Lehman v. Comm'r, 109 F.2d 99, 100 (2d Cir. 1940), *cert. denied,* 310 U.S. 637 (1940).
20. Hanauer's Estate v. Comm'r, 149 F.2d 857 (2d Cir. 1945), *cert. denied,* 326 U.S. 770 (1945).
21. Cole's Estate v. Comm'r, 140 F.2d 636 (8th Cir. 1944).
22. *Id.*
23. Estate of John H. Eckhardt, 5 T.C. 673 (1945).

were made in consideration of each other, thus establishing tnat simultaneous transfers are not imperative to a finding of consideration.[24] However, if the trusts are created some months apart, the fact that they contain similar or identical provisions for the other settlor may not be enough to establish that they were created in consideration for each other.[25]

Other factors to be considered in determining whether there is consideration are: whether the rights granted to the other are the same or similar; whether the amounts involved in each trust are identical; and whether the instruments were prepared by the same person.[26] However, notwithstanding the presence of all these factors, in the absence of concerted action, consideration need not be presumed from the creation of two trusts. The mere

> fact that the trusts were created at the same time and contained reciprocal provisions does not prove that one was created in consideration of the other, and the fact that the transfers were in equal amounts and made at the same time does not show that one was made in consideration of the other.[27]

In short, the question of consideration, therefore, is one of fact often turning on a determination as to the parties' intent in such particular situation.

This determination is well illustrated in *Newberry's Estate v. Commissioner*.[28] In that case the husband created two irrevocable trusts wherein he named himself and his wife as trustees. He gave his wife broad powers to alter, amend, or terminate the trusts, but under no circumstances could any part of the income or principal be revested in him. At the time each trust was created, the wife executed a similar trust giving the husband the same powers of alteration that she was given in the instruments executed by him. On each occasion when the husband amended the trusts by limiting the wife's power, the wife made identical or equivalent changes in the trusts which she had created.

At the wife's death, the Commissioner sought to include in her gross estate the value of the property interest transferred in trust by the husband since the enjoyment of that interest was subject to change through the exercise by her of a power to alter or revoke.[29] It was admitted that the decedent had the requisite power of alteration, but it was argued that she had this power as a result of the husband's transfer and not as a result of

24. *Id. See* Estate of Laura Carter, 31 T.C. 1148 (1959); Werner v. Weiboldt, 5 T.C. 946 (1945); and Purdon Smith Whiteley, 42 B.T.A. 316 (1940). The last two cases involve income tax, but the principles involved with regard to reciprocal trusts are the same as those relating to estate tax.

25. *In re* Lueders' Estate, 164 F.2d 128 (3d Cir. 1947).

26. Moreno v. Comm'r, 260 F.2d 389 (8th Cir. 1958).

27. Marrs McClean, 41 B.T.A. 1266, 1267 (1940). Although this case involved the application of the gift tax, the principles espoused would apply to the estate tax.

28. 201 F.2d 874 (3d Cir. 1953).

29. This power would presently be covered by § 2038.

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consideration she gave by transferring property to him. Again the issue was whether she should be considered as the real transferor of this property placed in trust by her husband since she had created identical trusts at the time her husband gave her this power.

It was established that the spouses usually talked over important financial matters. Furthermore, the wife had taken part in the discussions leading to the creation of the trusts and became interested in the plan as soon as the husband suggested the trust idea to her. She never gave any indication that she would not create her trusts if the husband did so. On the contrary, the facts led to the impression that she thought the husband's plan was a good one and that she wanted to create the same type of trusts. However, the husband gave uncontroverted testimony to the effect that he would have executed these trusts irrespective of whether his wife had decided upon a similar course of action.

Recognizing that one other than the formal transferor could be treated as the transferor for tax purposes, the court held that in order to do so, it must be shown that the declared grantor must have been "induced to establish a trust giving the party now to be treated for tax purposes as the grantor, a power which the latter wanted and has paid for by setting up another trust to accomplish something desired by the declared grantor."[30] In other words, there must be consideration for the reciprocal trusts. The court felt that this was the requirement of the *Lehman* decision and concluded that *facts* did not warrant such an interpretation here. Since spouses often work together in planning for the disposition of their estates in such a manner as to adequately provide for their children, in the usual case "it is a distortion of meaning to say that the action of one spouse is a *quid pro quo* inducing the action of the other."[31] The only "consideration" present would be that of love and affection which was insufficient to invoke the sanction of *Lehman.*

The court conceded that it was possible that a true bargain and exchange might be unprovable although actually existing since "domestic privacy and informality may effectively conceal understandings made and honored between husband and wife at variance with the formal and apparent aspects of family financial transactions."[32] Nevertheless,

> when on the facts the conclusion is inescapable that each spouse by a distinct and bona fide transaction has dispensed of his own separate estate in accordance with his own personal desires and without receiving a *quid pro quo* from the other, we think a court cannot justifiably refuse to recognize each spouse as the real transferor of the trust he has formally created.[33]

30. Newberry's Estate v. Comm'r, 201 F.2d 874, 877 (3d Cir. 1952).
31. *Id.*
32. *Id.* at 878.
33. *Id.*

This is true even though the parties may have chosen the route which entails the least amount of taxation. "[T]ax saving motivation does not justify the taxing authorities or the courts in nullifying, or disregarding, the taxpayer's otherwise proper and bona fide choice among courses of action."[34]

It is clear that the court in *Lehman* was in a much better position to find consideration since there each party had agreed to create a trust in return for a like promise by the other party. However, in *Newberry* it was not shown that the creation of either set of trusts was actually dependent on the other set. Even so, it is not at all unlikely that other courts would have been willing to infer such consideration from the reciprocal provisions themselves coupled with the simultaneous creation of the trusts by marital partners.[35] In any event, *Newberry* caused additional confusion in the already troublesome area of consideration.

This problem of consideration was made more manifest in *McLain v. Jarecki*[36] where a husband and wife each executed a trust containing similar provisions beneficial to the other on the same day. The court was unable to find any specific facts establishing consideration and was unwilling to infer any. To do so "would mean compounding probabilities on the subjective impression we have of the objective stipulated facts."[37]

Conversely, the dissenters felt that the majority had overlooked the significance of the fact that a beneficial interest was contemporaneously bestowed upon the maker of each trust by the settlor of the other and felt that it would be unreasonable to assume that the transaction lacked consideration. Again, it was obvious that each case turned upon its own peculiar facts.

B. *Estate of Grace*

The troublesome problem of consideration continued until the Supreme Court's recent decision in *United States v. Estate of Grace.*[38] In what is now a familiar pattern, the husband and wife simultaneously created similar trusts granting certain powers and interests to the other marital partner. The nature of these interests were such that the beneficiary (the spouse of the settlor) would receive the income for life and had the power to designate, either by an inter vivos or testamentary instrument, the manner in which the corpus would be distributed among the settlor and their children. If each settlor had retained these powers in the property which he placed in trust, it would have been included in his gross estate for Federal

34. *Id.*
35. See for example Orvis v. Higgins, 180 F.2d 537 (2d Cir. 1950); and Cole's Estate v. Comm'r, 140 F.2d 636 (8th Cir. 1944).
36. 232 F.2d 211 (7th Cir. 1956).
37. *Id.* at 213.
38. 395 U.S. 316 (1969).

estate tax purposes.[39] Upon the husband's death, the Commissioner claimed that the trusts were "reciprocal" and asserted that the husband's gross estate should include the value of the property placed in trust by the wife. The Court of Claims disagreed on the basis that there was no consideration passing between the spouses and that neither trust was established as a *quid pro quo* for the other.[40]

The Supreme Court granted certiorari[41] and reversed.[42] In so doing the Court made several important observations with regard to the reciprocal trust situation. First, any attempt to ascertain the subjective intent of anyone, particularly spouses, is a very difficult chore. This is particularly true in a case such as *Grace* where both parties are deceased and some thirty years has passed since the creation of the trusts. If too great an emphasis is placed on attempting to ascertain subjective intent, substantial obstacles to the proper application of the estate tax laws could easily be created.

Second, even where there is no real evidence of the settlor's subjective intent it is highly probable that any such reciprocal trust arrangement was created with the predominant thought of saving or avoiding taxes. If this were not true, why go through the elaborate procedure of having each spouse give the powers and interests to the marital partner. Why not simply retain them in the property being placed in trust?

Third, even if there was no actual tax-avoidance incentive, the settlor did in fact retain a real economic interest while purporting to give away his entire interest in the property which he placed in trust. He retained this economic interest by knowing in advance that he could safely give away all the incidents of ownership in his own property while being assured that the interests which he would like to retain would be given him in the property which his spouse was to place in trust. If this is true, he has not really made a complete and final gift of all his rights in the property which he placed in trust.

Last, the court felt that it was unrealistic to assume that the settlors would have created the trusts without consideration had there not existed a familiar relationship between them. Consideration, in the traditional sense, would not normally enter into interfamily transactions and therefore, the Court held that the application of the reciprocal trust doctrine was not dependent upon any finding of consideration nor was it necessary to establish that the parties had a tax-avoidance motive. The Court concluded, "application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic positions as they would have been in had they created trusts naming themselves as life

39. This would be included under what is now section 2036.
40. Estate of Grace v. United States, 393 F.2d 939 (Ct. Cl. 1968), *rev'd*, 395 U.S. 316 (1969).
41. 393 U.S. 975 (1968).
42. 395 U.S. 316 (1969).

beneficiaries."[43] Applying this test to the facts in *Grace,* the Court concluded that the value of the property placed in trust by the wife should be included in the husband's gross estate since the effective position of each party *vis-a-vis* the property did not change at all. The parties were in the same objective economic position after the transfers as they were preceding them.

This test of reciprocity should be more easily administered than an inquiry into the presence of consideration. The courts may now make an objective determination as to what the economic positions of the respective parties are after the creation of the trusts. This is not to suggest that subjective factors will not play a role in future reciprocal trust decisions but only that the courts will not be totally dependent upon them. Not only is the *Grace* test more easily applied, but it would appear to require a result more closely approximating that intended by the Code. If a party possesses an economic interest in property transferred by another comparable to that which he would have retained in property he transferred in trust, the net economic effect is the same, any difference in subjective intent notwithstanding. In either event, property interests have been "retained" and the value of the property should be included in the decedent's gross estate.

V. Conclusion

Estate of Grace[44] represents a significant clarification of the prior confused situation in the area of reciprocal trusts by laying the consideration issue to rest. However, while *Grace* rejected the doctrine of consideration as a true test of reciprocity in the trust area, it did not completely nullify its possible relevance in all factual situations. Consideration may still be important in establishing the link between the two trusts even though it is no longer essential to prove reciprocity. If there is in fact bargained-for consideration, the result would be the same as in *Estate of Grace* but it should be remembered property may be included in the deceased's gross estate without actually finding consideration.

43. *Id.* at 324.

44. Of significance is the fact the Court, in granting certiorari, stated that it did so "because of an alleged conflict between the decisions below and certain decisions in the courts of appeals and because of the importance of the issue presented to the administration of the federal estate tax laws." *Id.* at 318. Grace may represent a new Supreme Court policy of granting certiorari in tax cases with a greater degree of frequency in an attempt to resolve conflicts among the circuits. The result would be a more uniform administration of the Federal tax laws. This is certainly a desirable trend.