Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1271

Date: 03-Apr-08

From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: Can Husband Create Irrevocable Trust For Benefit of His Wife and Visa Versa?

Can Husband Create Irrevocable Trust For Benefit of His Wife and Visa Versa?

The Doctrine of Reciprocal Trusts – Part I

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm** which is a boutique firm emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection – first edition, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, the Asset Protection Journal.

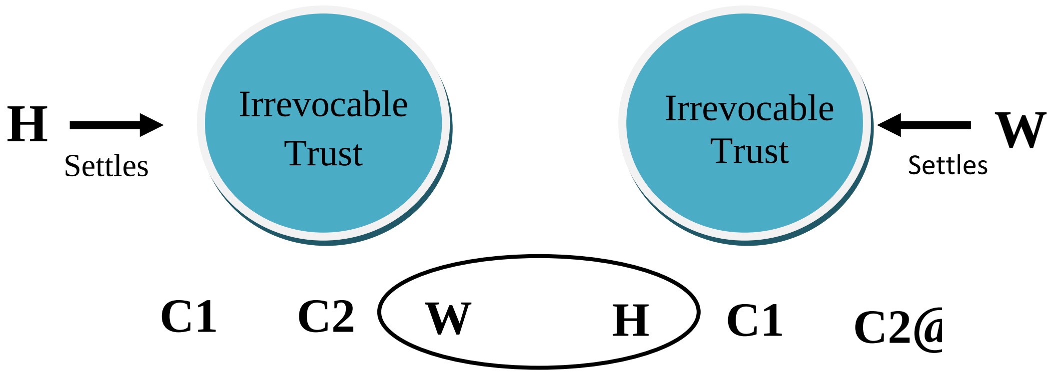
Mark speaks nationally on estate planning and asset protection and will be given an upcoming five day estate planning seminar sponsored by the University of Denver Graduate Tax Program. (http://www.internationalcounselor.com/HotofthePress.htm).

This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.™ [1]

EXECUTIVE SUMMARY:

Suppose a husband creates an irrevocable trust and names the couple's children and the grantor's wife as beneficiaries. Assume at some later date, the wife creates an irrevocable trust and names their children and her husband as the beneficiaries. Suppose that, should either husband or wife need the property gifted to the trusts, depending on the distribution terms, all or part of the trust property may be distributed back to them or, if the property is not needed by husband or wife, it then would pass pursuant to the terms of the trust, free from estate tax. Is this type of estate planning too good to be true?

Many estate planners take the position that this result *is* too good to be true and claim such planning violates the doctrine of reciprocal trusts. Conversely, other estate planners claim that one may draft *out* of the pitfalls of the doctrine of reciprocal trusts. This series of **LISI** commentaries analyzes almost all of the cases and private letter rulings on reciprocal trusts since *Estate of Grace*, discusses some methods that planners have articulated that might possibly avoid reciprocal trust problems, and furthermore comments on how grey this planning area may well be.



Reciprocal Beneficiaries

FACTS:

I. HISTORY OF RECIPROCAL BENEFICIARIES

The idea of using reciprocal beneficiaries to avoid estate tax and still have access to the gifted property is not new. In fact, it was utilized shortly after the estate tax was passed in the twentieth century. The concept is relatively straight forward: if each spouse creates a trust where the *other* spouse retains a beneficial interest before a large estate develops, for many clients, the estate tax could be completely avoided. All couples or even brothers and sisters would merely create reciprocal trusts for the benefit of each other and their descendants. Naturally, the Internal Revenue Service did not allow such tactics to go unchecked and began to assert the case law doctrine of "reciprocal trusts."

The First Case

The first reported case regarding reciprocal trusts reached the Second Circuit Court in 1940. In *Lehman v. Commr.*,[2] there were two brothers, and each brother settled a trust for the other brother and his descendants. The court listed the following three stipulations when determining that the trusts *were* reciprocal and therefore would result in estate tax inclusion:

1. the parties were left in the same economic position they were before the trusts were established because each brother created a trust for the other brother and his descendants;

2. there was a similarity of trust provisions (i.e. the trusts were interrelated); and

3. there was a quid pro quo (i.e consideration) for each brother to create a trust for the other brother.

The last stipulation required by the Second Circuit made it particularly troublesome for the Service to win in reciprocal trust cases. The Service would have to prove *intent* of the parties to prove that there was an agreement in which one party created a trust as consideration for the other party creating a trust, in other words a "quid pro quo."

SPLIT BETWEEN CIRCUITS:

The Court of Claims followed the Second Circuit in requiring a "quid pro quo" for the doctrine of reciprocal trusts to apply. However, the Seventh Circuit and the Third Circuit had only *two* requirements: (1) the parties were left in the same economic position; and (2) the trusts were interrelated. [3]

While these cases did not provide a precise definition for the term "interrelated," in general terms, it meant some combination of the following factors were present:

1. The trusts were created at approximately the same period of time (i.e. part of the same plan);
2. The trusts had substantially identical terms;
3. The trusts had the same trustee; and
4. The trusts were funded with the same assets.[4]

SPLIT RESOLVED – *U.S. V. GRACE*

To resolve the conflict between circuits, the Supreme Court held in *U.S. v. Grace* [5] that the trusts only need to be (1) interrelated and (2) creation of the trusts put them in the same economic position (reciprocal beneficiaries).

The Supreme Court held the Service did <u>*not*</u> have to prove that there was a quid pro quo when the trusts were created. In *Grace*, the following factors were specifically mentioned indicating that the trusts were interrelated:

1. Created at the same time (i.e. pursuant to a plan); and
2. Substantially identical terms.

Many estate planners misconstrue the notion of "trust creation at the same time". These planners will have husband settle an irrevocable trust in the current year, and in the next year the wife will settle an irrevocable trust. As explained in the case law, the *real* factor is whether the trusts were created pursuant to the same *plan*.

A distance in time such as a couple of years provides some evidence that the trusts were not part of the same plan.

However, if prior to the husband settling the first trust, the estate planner created one of those beautiful Viso diagrams showing that both trusts would be formed as part of the same estate plan, then the fact that the trusts were created one to two years apart would probably have little bearing. The factor of creating the trusts as part of the same plan would be met.

After *Grace*, many planners began to speculate: were there now only *two* factors to show that the trusts were interrelated? The third factor from prior case law regarding the same trustee was not discussed in the Supreme Court's opinion. However, identical trustees were present in *Grace*.

On the other hand, the fourth factor from prior case law was missing - the husband and wife did not fund the trusts with the same assets as in *Grace.* While *Grace* holds that only *two* factors are needed to prove the trusts are interrelated, subsequent case law appears to allow *other* factors to also conclude that trusts are interrelated.

II. RECIPROCAL TRUST (BENEFICIARY) CASES AFTER *GRACE*

It should be noted, that there have not been many reciprocal *beneficiary* cases since *Grace*. Most of the cases that have followed *Grace* appear to be the Service seeking an expansion of the reciprocal trust doctrine into the area of reciprocal trustees and reciprocal gifts. However, there are two to three cases that have exemplified reciprocal beneficiary cases since *Grace.*

In *Krause*,[6] the Seventh Circuit followed *Grace* and held that trusts with reciprocal beneficiaries were interrelated because

(1) the trusts were created on the same day (i.e. part of the same plan);

(2) the trusts contained substantially identical provisions; and

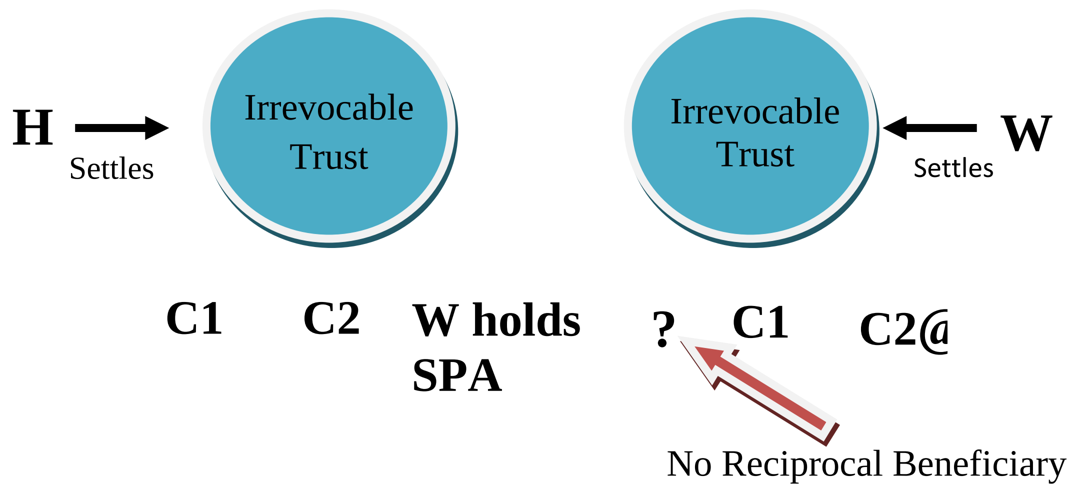
(3) the trusts named the same trustee.

The first two determinative factors from *Grace* are met in *Krause.* However, *Krause* listed the third factor from prior case law of identical trustees, as a *further* reason to hold that the trusts were reciprocal.

The second case since *Grace* was *Exchange Bank & Trust.*[7] When listing the factors to meet "interrelated" prong, the Court of Appeals *expanded* the literal language of *Grace*, stating that the reciprocal trust doctrine was in essence a "substance over form" argument. This would imply that the doctrine of reciprocal trusts could well be applied *outside* of the two *Grace* requirements needed to prove that the trusts were interrelated.

Furthermore, the *Exchange Bank & Trust Court* [8] referred to the fourth factor under prior case law, to determine whether the trusts were interrelated: where the same asset was contributed to both trusts.

The third case, *Estate of Levy* [9], is frequently cited as authority that one might easily break the interrelated factors by merely including a special power of appointment in *one* trust, but not in the *other* trust. By doing so, some estate planners claim that the trusts are not substantially identical.



I disagree with the statement that a special power of appointment - by itself - would sufficiently distinguish the trusts so that the trusts were not substantially identical.

However, there is a much greater error that many planners make when relying on *Levy*. As will be discussed in detail in the third **LISI** installment, *Levy* was not a reciprocal beneficiary case. Only the *wife* could bring assets back into the family unit through a special power of appointment. There was no reciprocal provision for the *husband* to do the same. In this respect, the first prong of *Grace* was broken, the husband and wife were *not* in the same economic position.

III. SYNTHESIS OF THE ABOVE CASES

Grace provides the following two prong test where both of the following tests must be met for the doctrine of reciprocal trusts to apply:

(1) The settlers must be left in the same economic position (e.g., reciprocal beneficiaries); and

(2) The trusts must be interrelated.

When determining whether the trusts are interrelated, cases subsequent to *Grace* still appear to use the following same four factors as articulated by the cases prior to *Grace*:

(1) created under the same estate plan;

(2) substantially identical terms;

(3) the same trustee is appointed on both trusts; or

(4) the trusts are funded with the same assets.

Before *Grace,* it was uncertain if one factor might carry more weight than another, however, under *Grace* the first two factors when combined proved to be fatal.

COMMENT:

Planners may prevent the doctrine of reciprocal trusts from applying by breaking *either* one of the two prongs articulated in *Grace:* (1) the settlers are left in the same economic position and (2) the trusts are interrelated.

However, if planners want clients to have the ability to have all of the assets distributed back to the family unit, breaking the first prong reciprocal beneficiaries would only accomplish half of the planner's goal. The assets from one trust would be available to be distributed back to the family unit, but the same would not be true for the assets of the second trust. Therefore, the more aggressive estate planners seek to find ways to break the *second* prong - interrelated trusts.

In our next installment of this series, I'll discuss how the doctrine of reciprocal trusts has possibly been expanded to include reciprocal trustees and moreover to include reciprocal gifts.

I'll then discuss the four factors of interrelated trusts. When this **LISI** series is concluded, we will have discussed almost all the reciprocal trust cases since *Grace* as well as the PLRs, and then you, as an estate planner, can decide how "grey is grey" when you attempt – if you dare - to draft around the doctrine of reciprocal trusts.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Mark Merric

CITE AS:

CITES:

[1] The Modular Approach to Estate Planning is trademarked by Mark Merric.

[2] 109 F.2d 99 (2nd Cir. 1940).

[3] *McLain v. Jarecki*, 232 F.2d 211 (7th Cir. 1956); *Newberry's Estate v. Commr.*, 201 F. 2d 874 (3rd Cir. 1953); *In re Lueder's Estate*, 164 F. 2d 128 (3rd Cir. 1947); *Moreno's Estate*, 260 F.2d 389 (8th Cir. 1958).

[4] *Id*.

[5] 395 U.S. 316 (1969).

[6] 497 F.2d 1109 (7th Cir. 1974); 57 TC 890 (1972).

[7] *Exchange Bank & Trust v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1982).

[8] Please note that some authors consider this solely a reciprocal trustee case, which will be defined and discussed on the next installment of the Doctrine of Reciprocal Trusts LISI. On the other hand, the Sixth Circuit classified it as a reciprocal beneficiary case, because the settlors could discharge a legal obligation with the crossed trusts. *Estate of Green*, 68 F.3d 151 (6th Cir. 1995).

[9] T.C. Memo 1983-453.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1275

Date: 15-Apr-08

From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: Expansion of the Reciprocal Trust Doctrine

Expansion of the Reciprocal Trust Doctrine to Reciprocal Trustees and Reciprocal Gifts

The Doctrine of Reciprocal Trusts – Part II

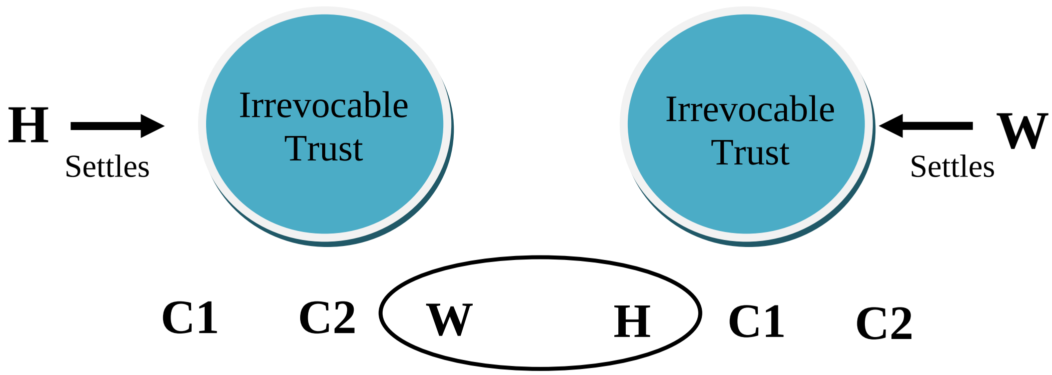
LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm,** emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection – first edition, The Asset Protection Planning Guide (first edition), and the ABA's treatises on asset protection: *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, and the Asset Protection Journal. Mark speaks nationally on estate planning and asset protection and is giving an upcoming five day estate planning seminar sponsored by the University of Denver Graduate Tax Program (http://www.internationalcounselor.com/HotofthePress.htm).

EXECUTIVE SUMMARY:

My last **LISI** (Estate Planning Newsletter # 1271) delineated the two prong test under the U.S. Supreme Court decision in *Grace*[2] that must be met to invoke the doctrine of reciprocal trusts: (1) the trusts leave the settlers in the same economic position; and (2) the trusts are interrelated. Some planners would instantly look at the factors in determining whether the trusts are interrelated and focus primarily on drafting around the "substantially identical terms" factor. However, before addressing the drafting issues and whether a planner may break the second prong of the *Grace* test, an estate planner should review how the doctrine of reciprocal trusts has expanded into the areas of reciprocal trustees and reciprocal gifts, which affects the first prong of *Grace*. An estate planner must know what being "left in the same economic position" means.

The holding from *Grace* states,

> "*Rather, we hold that the 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 the same economic position as they would have been if they had created trusts naming themselves as life beneficiaries*."



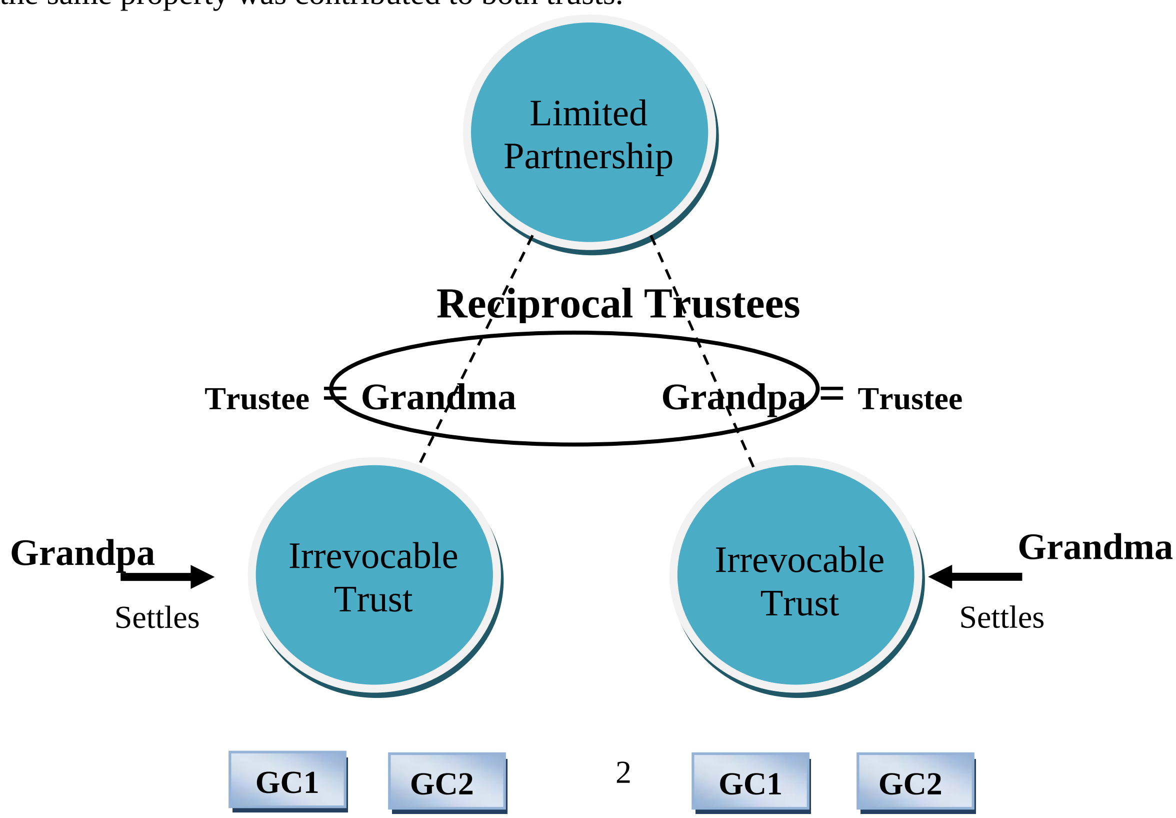
Reciprocal Beneficiaries

The above diagram shows the retained life interests of husband and wife. Unfortunately, under the doctrine of reciprocal trustees as well as reciprocal gifts, the retained life interest requirement of *Grace* has been dropped, resulting in an *expansion* of the doctrine of reciprocal trusts.

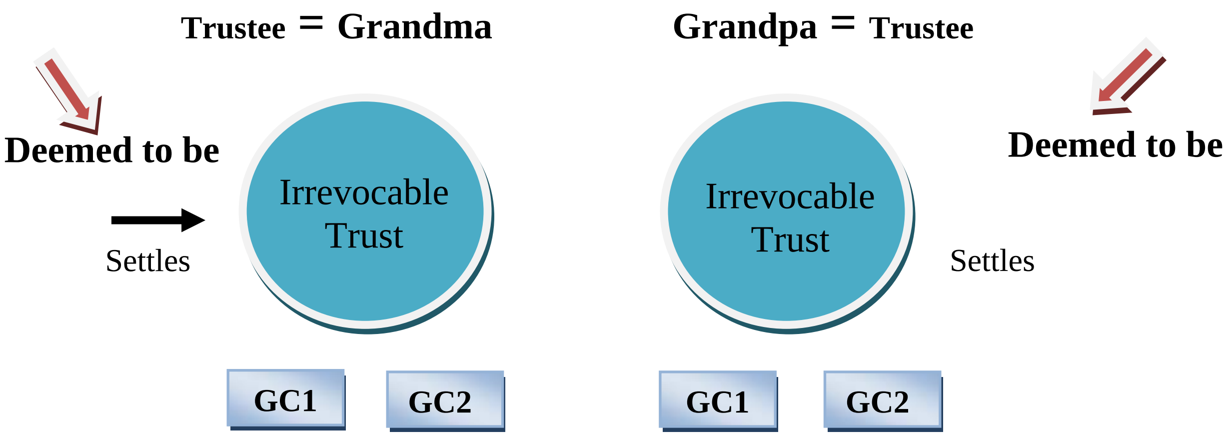
FACTS:

I. RECIPROCAL TRUSTEES

The reciprocal trustee doctrine is *not* the same thing as the "same trustee factor" when determining whether the trusts are interrelated. The reciprocal trustee doctrine is concerned with the crossing of trustees, where the settlor of one trust becomes the trustee of the other trust and the same property was contributed to both trusts.



Estate of Bischoff [3] Using the above diagram, in Bischoff, the Service was successful with the reciprocal trustee argument, resulting in grandpa being deemed as the settlor of the trust that grandma settled, and grandma being deemed as the settlor of the trust that grandpa settled (see diagram below). Bischoff also had the same partnership interests in a business transferred to the trusts.



As noted in the previous **LISI**, the holding that trusts are reciprocal, does not automatically result in the equivalent value of each trust being included in the deemed settlor's estate.

Rather, the second step in determining whether there is a basis for estate inclusion must be analyzed. *In Bischoff*, after application of the reciprocal trust doctrine, grandpa can now make discretionary distributions from a trust he was deemed to have settled, and the same is true for grandma. Under IRC § 2036(a)(2), if the settlor can make the decision of who receives a distribution and it is not limited by an external (e.g. ascertainable)[4] standard, the trust is included in the settlor's estate. Under IRC § 2038, if the settlor can alter the timing or manner or enjoyment of a beneficial interest[5],the trust is included in the settlor's estate.

This was the final holding in *Bischoff* – the trust settled by grandma was brought back into grandpa's estate and the trust settled by grandpa was brought back into grandma's estate, even though neither grandpa or grandma held a life interest in either trust.

***Exchange Bank & Trust v. U.S.*[6]**

In *Exchange Bank & Trust v. U.S.*, the Court of Appeals followed the *Bischoff* rationale in holding that

> *"Nowhere in Grace can we find the requirement that the transferors retain a substantial economic interest in order for the reciprocal trust doctrine to apply."*

In other words, the Circuit Court of Appeals endorsed the concept that reciprocal beneficiaries were *not* required for application of the reciprocal trust doctrine.

It should be noted that *Exchange Bank* dealt with transfers to Uniform Gift to Minor Accounts. However, such cases are properly analyzed as trust cases with the Custodian deemed the trustee. Also, the settlors transferred the same property into the UGMA accounts, and interest in Fishhawk Ranch, Inc. that was later exchanged for Continental Oil shares.

***Estate of Green*[7]**

In *Estate of Green*, grandma transferred property to trust for grandchild 1, and grandpa transferred property in trust to grandchild 2. Grandpa was the appointed trustee of the trust that grandma settled, and grandma was appointed trustee of the trust that grandpa settled. The Sixth Circuit court disagreed with the holding in *Estate of Bischoff* that *Grace* did not require that the settlors held an economic benefit. It held

> "*the settlor/trustee retained fiduciary powers to reinvest income and time distribution of trust income and corpus until the beneficiaries reach 21 years of age <u>do not</u> constitute a retained economic benefit that satisfies the core mandate of Grace 'that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been had they created trusts naming themselves as life beneficiaries*." Citing *Grace.*

The case does not mention whether the settlors in Green contributed the same assets.

The Service Has Not Conceded the Reciprocal Trustee Issue

Since Green, it is uncertain how diligent the Service will pursue a reciprocal trustee issue. Reciprocal trustees were present in Estate of Levy, PLR 9643013, and PLR 200426008. However, the Service did not discuss the issue. In Levy, the facts and whether the trusts were reciprocal were stipulated by the parties. Under the stipulation, the outcome of the case depended on whether an SPA was valid under New Jersey law. Therefore, the Tax Court did not address the reciprocal trustee issue. The Levy case will be discussed in detail in the next installment of this LISI series. Therefore, the Levy case as well the above two PLRs may be distinguished from a pure reciprocal trustee case.

In PLR 9643013, the Service may not have discussed the issue for two reasons. First, this PLR may be distinguished from a true reciprocal trustee case, because there were independent distribution trustees, and husband and wife were merely management trustees. Separate assets were contributed to the trusts. In order for a reciprocal trustee doctrine to apply, it appears that one would need to retain control as trustee over the same type of assets transferred. When separate assets are contributed, this would not be possible.

In PLR 200426008, husband and wife contributed separate assets. Therefore, it appears that the doctrine of reciprocal trustees did not apply. On the other hand, in PLRs 200748008, 200748011, 200748012, 200748013, and 200748016, the Service still considered the issue of reciprocal trustees. However, that time the Service noted it did not apply to the facts under these PLRs because the husband and wife were not trustees of trusts that each one settled. While these PLRs do not provide any discussion of the reciprocal trustee issue, because it did not remotely apply, they do confirm that the Service has not abandoned the reciprocal trustee theory.

What if the distribution standard was limited by an ascertainable standard? Bischoff dealt with a discretionary distribution standard not limited by an ascertainable standard. Therefore, once the doctrine of reciprocal trustees applied, the equivalent value of each trust was included in each settlor's estate. In Exchange Bank, the equivalent value of each UGMA account was included in the parent's estate. The Exchange Bank Court noted that a parent had an obligation of support for a minor child, and therefore, all courts had held when a parent creates an UGMA (or UTMA) account and appoints himself or herself as custodian such UGMA (or UTMA) is included in the parent's estate. Fortunately, should the beneficiary of the UGMA (or UTMA) live pass the age of majority, there is no inclusion issue in the parent's estate.[8]

Some planners have suggested a planning technique where the husband creates a trust for his wife and children and the wife does the same for the husband. The distribution standards in both trusts are limited to an ascertainable standard. As previously stated, when a parent creates a trust for the support of his child who is a minor and the parent passes away before the age of the child's majority, there the trust is included in the parent's estate. A similar estate inclusion issues arises when a husband or wife creates an inter vivos trust for the benefit of his or her spouse, because both a husband and his wife have a support obligation for their spouse[9] Therefore, extreme care in drafting the distribution standard needs to be observed to avoid this estate inclusion issue that is independent of the reciprocal trustee issue estate inclusion.

Synthesis

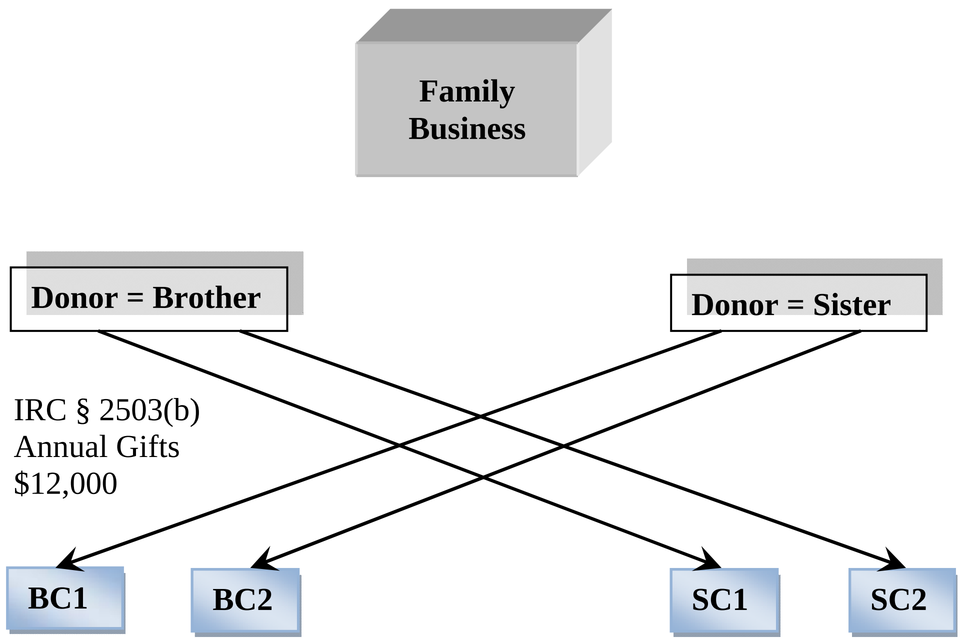
While the Sixth Circuit in the Estate of Green held that the reciprocal trust doctrine should only apply where the settlors retained some type of life or economic interest in the trust, the Tax Court, the Court of Appeals, and Eight Circuit (discussed in the following reciprocal gift cases) apparently have completely deleted the "life interest" or economic interest from the Supreme Court decision in Grace. Further, in the 2007 PLRs, the Service has continued to articulate the concept of reciprocal trustees.

II. Reciprocal Annual Gifts Under IRC §2503(b)

At first, one might wonder why a discussion of reciprocal gifts is included in a reciprocal trust article. The justifying reason is that it shows the trend of the courts to continue to expand the concept of reciprocal trusts by not requiring that the donor retain a life interest to meet the first prong of the *Grace* test.

In the reciprocal gift cases, brothers and sisters wished to transfer the family business to the next generation. Rather than using applicable exclusions and making gifts of business interests to irrevocable trusts, GRATs, or IDITs under a comprehensive estate plan, the brothers and/or sisters used the simplistic approach of making annual IRC § 2503(b) gifts to their children, and their sibling's children as diagrammed below.

Reciprocal Gifts



Sather v. Commr.[10]

In Sather, the Eighth Circuit (quoting language from Exchange Bank) held that the reciprocal trust doctrine was "a variation of the substance over form concept." Later in the opinion, the Sather Court stated,

> "We do not believe that the Supreme Court [referring to Grace] meant to limit the doctrine to cases involving life estate trusts, or even to cases where the donor retains an economic interest, but used the language in the specific facts of the case."

After Sather, the Eight Circuit, similar to the Tax Court in Bischoff and the Court of Appeals in Exchange Bank, completely deleted any notion that the donor retains a life interest. In essence, the Eighth Circuit held that it was wrong for four brothers as part of a planning process to make gifts to the sibling's children and avail themselves of the annual exclusions. This conclusion was justified under the "reciprocal trust doctrine."

It should be noted that one brother did not even have children hence there was no possibility of reciprocity, which the court found as immaterial.

Estate of Schuler[11]

In Estate of Schuler, a case involving two brothers who had made reciprocal gifts as part of a planning process, the Eighth Circuit again reached the same conclusion. The annual gifts were not permitted based on its on definition of expanding the reciprocal trust standard. The Schuler Court stated,

> "The application of the reciprocal trust doctrine is not limited only to identifying the true transferor or transferee, but also applies to determining the nature of the property transferred."

CONCLUSION:

Since Grace, the doctrine of reciprocal trusts has been expanded to include both reciprocal trustees and reciprocal gifts. Under the Service's position with both reciprocal trustees and reciprocal gifts, there is no requirement that the donor (e.g., settlor) retain a life interest under the first prong of Grace.

As applied to the reciprocal trustee doctrine, the Seventh Circuit has rejected the Tax Court position and the Court of Appeals position that a life or economic interest was not required.

Since the issue of reciprocal trustees is unsettled, I would suggest taking the conservative road, and simply not appointing reciprocal trustees, rather than trying to draft out of the issue with the distribution language.

TO BE CONTINUED…

The next installment of this series discusses how some estate planners have attempted to break the interrelated prong of the identical trust factor by including a special power of appointment in one trust, but not the other and citing to the case Estate of Levy[12]

As discussed in this upcoming installment Levy may be one of the most frequently miscited cases.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Mark Merric

CITE AS:

CITES:

[1] The modular approach to estate planning is trademarked by Mark Merric.

[2] *U.S. v. Grace,* 395 U.S. 316 (1969).

[3] 69 T.C. 32 (1977).

[4] Most practitioners use the term "ascertainable standard" from IRC § 2041 interchangeably with the term "external standard" created by case law under IRC § 2036 and § 2038 as well as the grantor trust term of "reasonably definite standard." The case cites for the external standard are *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Hurd v. Comm'r,* 160 F.2d 610 (1st Cir. 1947).

[5] Treas. Reg. 20.2038-1(a)

[6] 694 F.2d 1261 (Fed Cir. 1982).

[7] *Estate of Green,* 68 F.3d 151 (6th Cir. 1995).

[8] Rev. Rul. 79-154; *Townsend v. Thompson,* 50-2 USTC P 10,780 (W.D. Ark. 1950).

[9] *Commr. V. Dwight's Estate,* 205 F.2d 298 (2nd Cir. 1953); *First Ntl. Bank of Montgomery v. U.S.*, 211 F. Supp. 403 (D. Ala. 1962); and *Est. of Stephen L. Richards*, TC Memo 1965-263.

[10] 251 F.3d 1168 (8th Cir. 2001).

[11] 282 F.3d 575 (8th Cir. 2002).

[12] T.C. Memo 1983-453.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1282

Date: 25-Apr-08

From: Steve Leimberg's Estate Planning Newsletter

Subject: A Frequently Miscited Case?

Estate of Levy – A Frequently Miscited Case?
The Doctrine of Reciprocal Trusts – Part III

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm,** a boutique firm emphasizing activity in the areas of estate planning, international tax, and asset protection planning. Mark is co-author of CCH's treatise on asset protection – first edition, The Asset Protection Planning Guide (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, and the Asset Protection Journal. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal.

This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.[1]

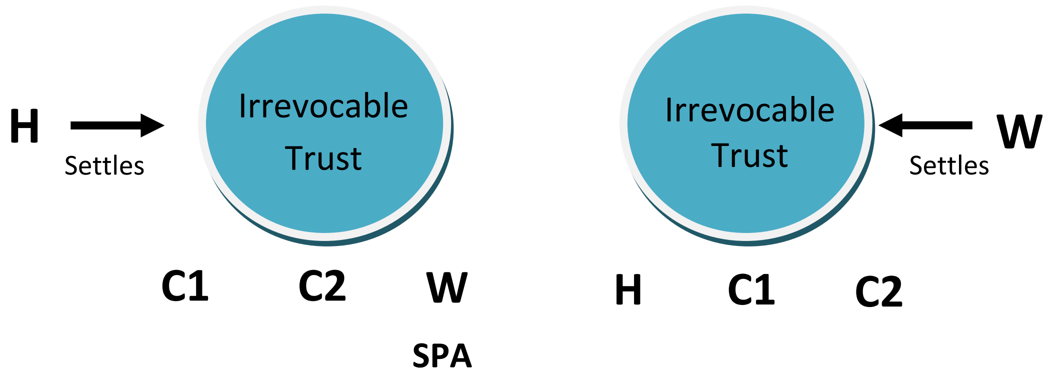
EXECUTIVE SUMMARY:

My first **LISI** on this topic, **Estate Planning Newsletter # 1271**, delineated the two prong test under the U.S. Supreme Court decision in *Grace*.[ii]

My second **LISI** on reciprocal trusts, **Estate Planning Newsletter # 1276**, discussed the first prong of *Grace* and how any life interest requirement may have well been eliminated under the doctrine of reciprocal trustees and reciprocal gifts and a life interest or economic interest may no longer be a requirement under the reciprocal trust doctrine. This third installment will discuss the *Estate of Levy*[iii], which may be one of the most miscited cases in estate planning literature.

FACTS:

Some planners have stated that the doctrine of reciprocal trusts could be broken merely by including a special power of appointment in one of the trusts, but not the other. In other words, husband would create a trust for the benefit of his wife and children, and wife would create a trust for the benefit of husband and her children. *One* of the trusts would contain a special power of appointment, but not the *other.*[iv] Please refer to the diagram below.



Planners that advocate that the above structure will break the reciprocal trust doctrine are focusing on the *second* prong of *Grace* – whether or not the trusts are interrelated. As discussed in the first LISI, *Grace* stipulated *two* requirements to determine whether the trusts were interrelated:

1. the trusts were created at the same time (i.e. pursuant to the same estate plan); and

2. the trusts had substantially identical terms.

COMMENT:

If a mere insertion of an SPA into one trust broke the interrelated connection, it would be no more than child's play to circumvent the doctrine of reciprocal trusts.

However, based on the following analysis, I would disagree that a mere special power of appointment in one trust would break the doctrine of reciprocal trusts.

Conversely, if the two trusts are drafted with fundamentally *different* provisions, the substantially identical factor of the interrelated test should be broken. Assuming other factors such as different trustees are appointed, not husband and wife, and separate assets are contributed to the trusts, I am hopeful that the interrelated prong should be broken.

I. *Estate of Levy* is <u>Not</u> a Reciprocal Beneficiary Case

Some of the facts of the case are as follows:

(1) Pursuant to the same plan, husband and wife each create a trust for the benefit of their son;

(2) The husband is appointed the trustee of the trust settled by the wife, and the wife is appointed as trustee of the trust settled by the husband (i.e., there is no question there are reciprocal trustees);

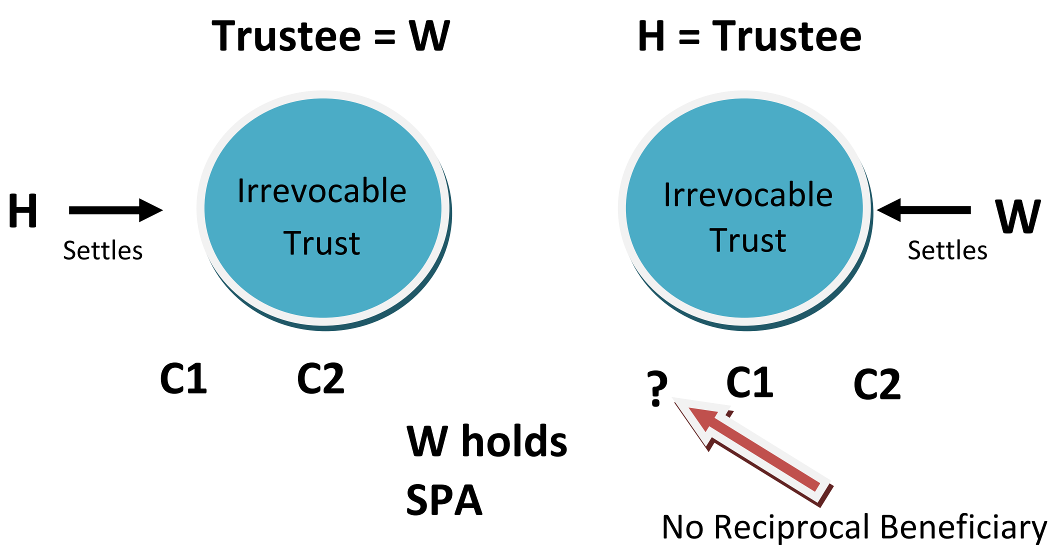
(3) The husband was <u>not</u> a beneficiary of the spouse settled by trust created by the wife, and the wife was <u>not</u> a beneficiary of the trust settled by the husband.

(4) The trust settled by the husband granted his wife an <u>inter vivos</u> SPA where she could appoint the trust property to anyone other than herself, her creditors or the creditors of her estate. In other words she could appoint the property to him.

(5) The trust settled by the wife did *not* grant the husband *any* power of appointment.

(6) Other than the SPA, the terms of the trusts were identical.

A diagram depicting the structure is below



When comparing the above diagram to the first diagram in this LISI, one should note that the two diagrams have fundamentally different assumptions:

The first diagram assumes that there are reciprocal beneficiaries and that an SPA held by *either* the husband or wife, but not both, hopefully breaks the interrelated prong of the *Grace* test.

With the second diagram, neither the husband nor the wife is a beneficiary of either trust. However, due to the SPA solely in the husband's trust for the benefit of the wife, she has ability to bring these assets back into the family unit. Therefore, the logical conclusion would be that the first prong of *Grace* had been broken, and husband and wife were *not* in the same economic position.

THE TAX COURT'S ANALYSIS

Reading all of the conclusions of the *Levy* case, it appears that the Tax Court came to the same result, but by a different logic process. Rather, than analyzing each prong of *Grace* separately, the Tax Court seemed to combine all the issues in both prongs to determine whether the trusts were interrelated. The Tax Court stated when determining whether the trusts were interrelated,

> "*we consider their terms, corpus, trustees, and beneficiaries, as well as their date of creation and their relation, if any, to a prearranged plan*."

Without reviewing each of these six factors, the Tax Court made the following conclusion;

> "During her life, and prior to the death of Herbert Levy, Isle Levy could appoint the income and the corpus of the Herbert Levy Trust when and as she please except to herself, her creditors or her estate. In contrast, Herbert Levy had no power of appointment over the income or corpus of the Isle Levy Trust. He was merely its trustee. As a result, decedent and his wife had markedly *different interests in, and control over*, the trusts created by each other. *The reciprocal trust doctrine does not purport to reach transfers in trust which create different interests and which change 'the effective position of each part vis a vis the* [transferred] property . . .' citing *U.S. v. Grace.*" [Italic emphasis added]

While the Tax Court began by discussing the interrelated prong, its conclusion seems to have addressed the same economic position prong. Unfortunately, the case analysis and holding is not a model of clarity.

WHEN A CASE SEEMS CONFUSING, WHY NOT CALL BOTH COUNSEL FOR CLARIFICATION?

When I reviewed *Levy*¸ there seemed several areas of confusion:

First, why didn't the Tax Court discuss all of the factors it listed as interrelated?

Second, why did the Tax Court combine both prongs of *Grace* into one test?

Third, how could a mere SPA possibly break the doctrine of reciprocal trusts?

Logically, I therefore located the counsel who represented the Service in the case, as well as the counsel that represented the taxpayer.

After speaking with both counsel, *neither* of them thought that a mere SPA in one trust would break the doctrine of reciprocal trusts. They both felt that the SPA was very specific to the business interest that had been contributed to both of the trusts. Further, they clarified and added to some of the following facts and opinions:

(1) The facts of the case as well as the outcome were stipulated.

(2) In the stipulated facts, the Service agreed the reciprocal trust doctrine would <u>not</u> apply if the special power of appointment were valid. This is why most of the discussion regarding the case was on whether the SPA was valid under New Jersey law, and the case did not discuss all of the other factors of interrelated trusts.

(3) Since the outcome of the case depended on whether the SPA was valid, the Service argued that the SPA (a) was not valid under New Jersey law; and (b) subjectively the power would not be exercised.

(4) Through the combined voting power of the SPA and her own shares, the wife could effectively block any major reorganizations of the family business under New Jersey law.

   (a) There were 100 shares of stock outstanding.

   (b) Husband and Wife each owned 35 shares individually.

   (c) Each trust owned 12.5 shares.

   (d) Wife could gift to a third person her 35 shares + 12.5 under her POA. The receiving person would have the power to block any corporate reorganizations by holding a greater than 1/3 vote, since New Jersey Law requires a 2/3 vote for a corporate reorganization.

After husband and wife each transferred 12.5 share to each trust, because of the SPA, wife had significantly greater control in her ability to block a corporate reorganization as noted above. In addition to more control, she had a significantly different economic interest in the trust. She had the ability to appoint the trust assets to her husband (i.e. back to the family unit) or any other person other than herself. Her husband did not have any similar reciprocal beneficiary equivalent power. In essence, while the Tax Court combined both prongs of *Grace* under the term "interrelated," it appears that it actually decided the case under the "same economic position" prong of *Grace.*

WHY DIDN'T THE SERVICE PURSUE THE RECIPROCAL TRUSTEE ISSUE?

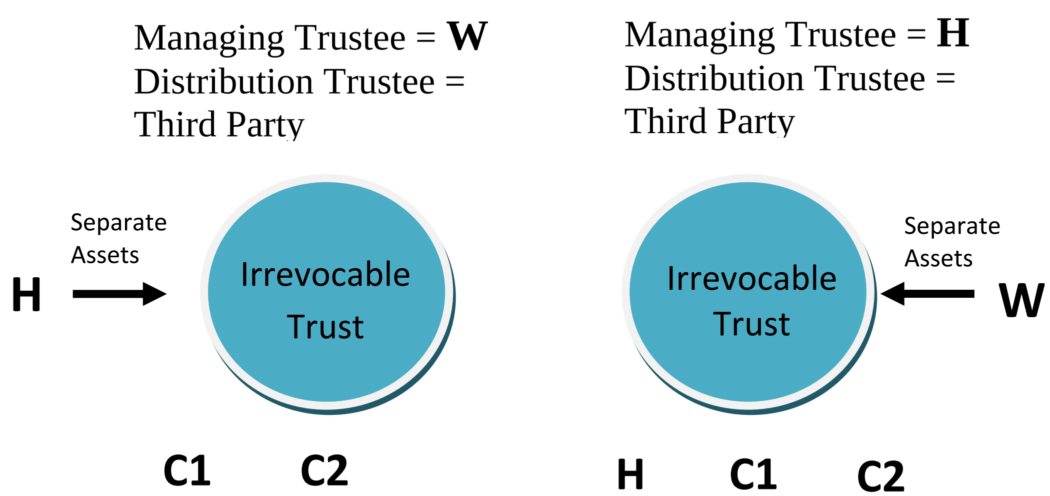
Both spouses contributed the same property and shares in the corporation. The trustees were crossed with husband serving as a trustee on the trust settled by the wife, and wife serving as trustee on the trust settled by the husband. Why didn't the Service pursue the reciprocal trustee doctrine discussed in our last **LISI** (**Estate Planning Newsletter # 1276**)? Counsel for the Service informed me that the reciprocal trustee issue under *Bischoff* was not presented to the Tax Court, because the facts and outcome were stipulated, something he noted that he would never do again. The only issue for the Tax Court to decide was whether the SPA was valid under New Jersey law. If it was, the parties had agreed that the doctrine of reciprocal trusts would not apply. Counsel for the Service also stated that the Service thought the case was an aberration.

WHAT POSSIBLE CONCLUSION DOES THE ESTATE OF LEVY SUPPORT?

Assuming that reciprocal trustees are not present, which they were in *Levy*, the *Estate of Levy* provides support that if a spousal access trust[v] is created only by one spouse, but not the other, the first prong of the *Grace* test has been broken, and the doctrine of reciprocal trusts does *not* apply.

II. PLR 9643013 ALSO NOT A RECIPROCAL BENEFICIARY FACT PATTERN

Levy was decided in 1983 and since then there have not been any other reciprocal trust cases. Rather, there have been only two PLRs directly on point. In PLR 9643013, husband settles a trust and names a third person as the distribution trustee and his wife as the managing trustee. Wife reciprocates and settles a trust naming the husband as a managing trustee and a third person as a distribution trustee. Husband does <u>not</u> name the wife as a beneficiary of the trust that he settles. However, wife names the husband as a beneficiary of the trust that she settled. Both trusts have SPAs, however neither SPA may be exercised in favor of the other spouse. Settlors also contributed separate assets. A diagram of the structure is detailed below



Unfortunately, the PLR substantially lacks any analysis of the reciprocal trustee issues. It also does not discuss the reciprocal beneficiary issue in detail. Rather, after citing verbatim IRC Sections 2036, 2037, and 2038, it concludes,

> *"In view of the differences between the trusts created by A and B, we conclude that the M and N trusts are not reciprocal within the meaning of U.S. v. Estate of Grace."*

Therefore, since no analysis was provided in PLR 9643013, I have provided the following discussion.

NO RECIPROCAL TRUSTEE ISSUE

Some planners may well conclude that the Service did not consider the reciprocal trustee issue, and only looked at the reciprocal beneficiary issue. On the other hand, other planners note that the reciprocal trustee doctrine probably does not apply, because the powers of the trustee were divided between the managing and distribution trustee, who was the clients' CPA. It is true that the managing trustees were both husband and wife and could make all of the investment decisions regarding the trust. However, all of the distribution powers of a trustee were vested in a third person. As to the distribution of assets, *neither* husband nor wife was left in the same economic position. Furthermore, there is a second reason why the doctrine of reciprocal trustees should not apply: both husband and wife each contributed their separate assets to the trust. Therefore, after the trusts, neither husband nor wife was left in the same economic position regarding the management of the same assets.

RECIPROCAL BENEFICIARY ANALYSIS

Since the SPAs did not allow either spouse to appoint the property to the other spouse, neither husband nor wife could force the distribution of assets on behalf of the other. Further, only the husband was a beneficiary of one of these trusts. In this respect, the trustee of the trust settled by the wife could distribute such assets for the benefit of the husband, but the reverse was not true. Therefore, the facts under PLR 9643013 support the conclusion that the first prong of the *Grace* test had been broken, the parties had *not* been left in the same economic position. Once either prong of the *Grace* test is broken, the reciprocal beneficiary doctrine does not apply.

THE INTERRELATED PRONG

Conversely, there were some issues with the interrelated prong. As discussed in my first LISI, **Estate Planning Newsletter # 1271,** courts have primarily used the following four factors to determine whether two trusts were interrelated, with the presence of the first two being deadly.

1. The trusts were formed as part of the same estate plan;
2. The trusts were substantially identical;
3. The trustees had the same trustee; and
4. The settlers contributed the same assets.

I will discuss the first, third, and fourth factors first.

There is no question that the trusts were part of the same estate plan as there is also no question that both trusts used the same trustee, the clients' CPA. However, husband and wife each contributed their own separate assets to the trust that he or she settled. Therefore, the fourth element in favor of finding the trusts were interrelated was missing.

As noted in *Grace*, when the first and second factor are combined, the interrelated prong is met. Therefore, whether the trusts are interrelated may depend solely on whether the second factor is met. [vi] If one was to take a broad reading of the PLR, he or she may note that the PLR listed quite extensively many of the provisions of the two trusts, and for the most part they were identical. The only significant differences were (1) the wife was not a beneficiary of the trust settled by the husband; (2) the wife held an SPA on the trust created by the husband, but an independent person held the SPA on the trust created by the wife.

As noted above, the SPA could be exercised in favor of the husband's and wife's descendents or their spouses, <u>but neither SPA could be exercised to appoint the property to either the husband or wife.</u> Those who take a broad reading of the PLR might point to the SPAs, refer to *Levy*, and conclude that a mere SPA breaks the interrelated prong of the *Grace* test, and consequently breaks the doctrine of reciprocal trusts. `

I disagree with this conclusion, and would take a narrower reading of the PLR as there were two drafting differences between the trusts: First, the wife was not a beneficiary of the trust settled by the husband. Therefore, even if one was to attempt to argue that a mere SPA could break the doctrine of reciprocal trusts, an SPA was not the only drafting difference. Second, as discussed above, husband and wife were not left in the same economic position. There were neither reciprocal trustees nor reciprocal beneficiaries in the PLR. Therefore, I would take the position that this PLR stands for the proposition that

"As long as there are not any reciprocal trustee or reciprocal beneficiary issues, a spousal access trust may be created only by one spouse, but not the other."

CONCLUSION:

Levy may well be one of the most frequently miscited cases. For the most part, the case discussed whether the settlers were left in the same *economic* position, *not* whether the trusts were interrelated. Further, there were no reciprocal beneficiaries in *Levy.* Rather, the SPA held by only the wife could only bring assets back to the family unit from one of the trusts. In this respect, *Levy* more likely stands for the proposition that:

"If only one spouse may benefit from one of the trusts settled by husband and wife, husband and wife are not left in the same economic position." [vii]

A similar conclusion may be reached under PLR 9643013, where the husband was the only person who benefited from a spousal access trust.

The estate planner must ask, "Is half a loaf better than no loaf at all." Husband and wife have access to only one trust in the above two fact patterns, but not both. In my next **LISI**, we will look at a golden PLR where we have a true reciprocal beneficiary case, the estate planning attorney drafted around the substantially identical trust terms, and the Service blessed it.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

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1 The modular approach to estate planning is trademarked by Mark Merric.

ii *U.S. v. Grace*, 395 U.S. 316 (1969).

iii T.C. Memo 1983-453.

iv Part of this confusion may be attributable to reading the West head note and not reading the case. The head note states: "Decedent and wife created trusts which had similar terms but under the decedent's trust, wife had a special power of appointment over the trust corpus. Held the trusts are not interrelated and therefore not reciprocal within the meaning of *United States v. Grace*." However, if one reads the case, one discovers not only was there an SPA in one trust, but there were no reciprocal beneficiaries.

v The insurance industry frequently uses the term "spousal access trust" to refer to an inter vivos trust that names the spouse of the settlor as a beneficiary.

vi As discussed in the first installment of this article, some courts have included having the same trustee and contributing the same assets as factors finding in favor of reciprocal trusts. However, due to the limited number of cases regarding these factors, the author is unable to distill what weight should be granted to these factors when finding in favor of reciprocal trusts.

vii This statement assumes that the doctrine of reciprocal trustees does not apply.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1332

Date: 13-Aug-08

From: Steve Leimberg's Estate Planning Newsletter

Subject: Attempting to Draft Out of the Doctrine of Reciprocal Trusts

Attempting to Draft Around the Substantially Identical Factor of Reciprocal Trusts

The Doctrine of Reciprocal Trusts – Part IV

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm** which is a boutique firm emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection – first edition, The Asset Protection Planning Guide (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, and the Asset Protection Journal. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal. Mark speaks nationally on estate planning and asset protection and is giving an upcoming five day estate planning seminar sponsored by the University of Denver Graduate Tax Program http://www.InternationalCounselor.com/HotoffthePress.htm

This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.™[1]

Executive Summary:

My first LISI delineated the two prong test under the U.S. Supreme Court decision in *Grace*.[2] The second installment focused on how the reciprocal trust doctrine had expanded to reciprocal trustees and reciprocal gifts, where a life interest or economic interest may no longer be a requirement under the reciprocal trust doctrine.

In the third installment of the reciprocal trust doctrine, I discussed the *Estate of Levy* as well as PLR 9643013. Our concern with both of these fact patterns was that neither one was a reciprocal beneficiary fact pattern. Both fact patterns allowed one spouse to bring back trust assets into the family unit from one trust, but not from both. They were half a loaf solutions. Since *Grace* and until 2004, we had little authority regarding how to possibly break the reciprocal trust doctrine when there were reciprocal beneficiaries. Then the golden PLR 200426008 arrived. The Service ruled positively on a true reciprocal beneficiary case where the estate planner had drafted around the substantially identical trust factor of the interrelated prong of *Grace*.

In this fourth installment of this LISI series, I will discuss whether PLR 200426008 is truly 24 carat gold or is it merely fool's gold. Unfortunately, many of the drafting differences in this PLR appear to be immaterial differences that the Service may have missed. Conversely, on the positive side, it may be possible to draft around the substantially identical factor of the interrelated prong by making several significant drafting differences between the trusts.

I. A True Reciprocal Beneficiary Fact Pattern - PLR 200426008

As previously mentioned, PLR 200426008 is a true full loaf planning structure where both husband and wife have access to trust assets that have been gifted away. At first glance, it also appears that there might be reciprocal trustee issues.

Structure

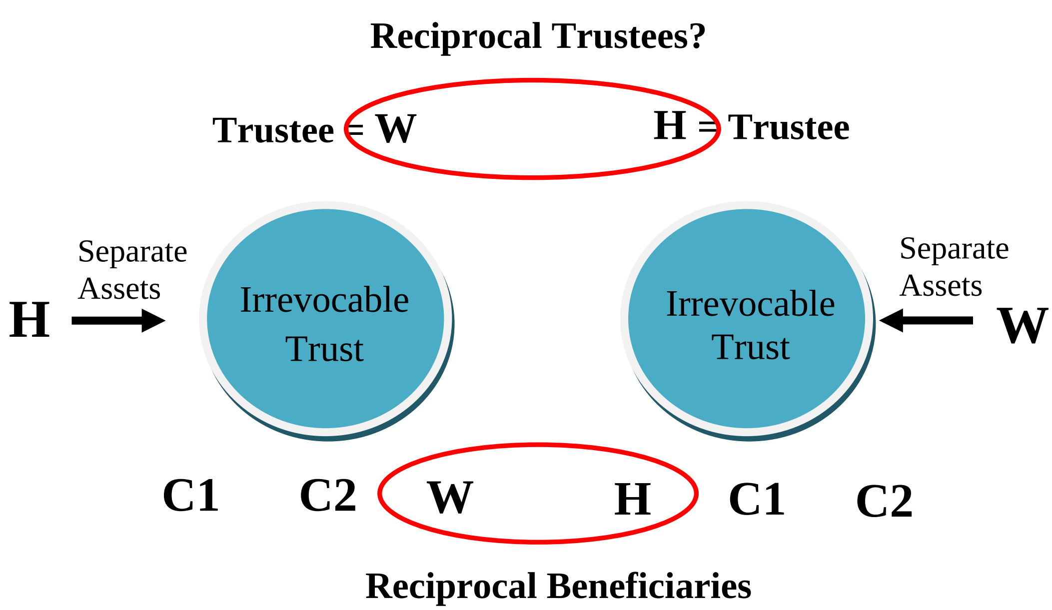
Some of the facts under PLR 200426008 are as follows:

(1) Pursuant to the same plan, husband and wife each create a trust for the benefit of their son;

(2) The husband is appointed the trustee of the trust settled by the wife, and the wife is appointed as trustee of the trust settled by the husband;

(3) The husband is a beneficiary of the trust settled by the wife, and the wife is a beneficiary of the trust settled by the husband;

(4) Husband and wife both contributed separate property.



Reciprocal Trustees

As noted in our second installment of this LISI series, it appears that in order for the reciprocal trustees doctrine to apply, husband and wife must contribute the same assets. Therefore, it may be possible that the Service did not address the reciprocal trustee issue, because it did not apply.

Reciprocal Beneficiaries

The PLR notes that since it found that the trusts were not interrelated under the second prong of the *Grace* test, it was not necessary to discuss whether husband and wife were in the same economic position under the first prong of the *Grace* test. Since I find this analysis as helpful, I will discuss this issue. While it may be uncertain whether the reciprocal trustee doctrine applied, because husband and wife each gifted separate property, there is no question that the same economic position prong of the *Grace* test has been met. The husband is a beneficiary of the trust settled by the wife, and the wife is a beneficiary of the trust settled by the husband. Further, in her capacity as trustee wife may make distributions to herself as a beneficiary of the trust settled by the husband. The same is true for the husband. Not only were husband and wife left in the same economic position, but they even had control in making distributions as a trustee to themselves.[3]

Immaterial Differences in Breaking the Substantially Identical Factor?

Through the incredibly artful drafting of these trusts, the drafting attorney was able to point to five differences between the trusts. Unfortunately, upon further review of these five differences, all of them appear to be quite minor differences and one of the differences may well be nothing more than a red herring. First, in the unlikely event that the son predeceases mom, mom is granted the following three powers:

(1) a 5x5 power;

With first marriages, it is not uncommon to grant a 5 x 5 power. I would find that this is a minor difference between the trust, most likely not being able to break the substantially identical factor.[4]

(2) an inter vivos SPA; and

In the unlikely event that son predeceases mom, she also receives a special power of appointment to appoint the trust property to husband's child, husband's descendents, or their spouses. The child is also mom's child and he is the only child of both mom and dad. When comparing the powers granted under the PLR SPA to the *Levy* SPA, the PLR SPA powers appear to be cosmetic. In *Levy*¸ husband and wife were not reciprocal beneficiaries. The *Levy* SPA gave the wife the power to appoint trust assets to the husband. Further, the *Levy* SPA gave the wife the ability to stop a corporate reorganization by gifting her shares as well as the shares subject to an SPA to a third person. The PLR SPA powers only allow mom the ability to redirect trust property to her grandchildren (and their spouses) should she not wish for it to be held equally for them in trust. Since the PLR SPA is only effective in the unlikely event that son predeceases mom, and the powers granted under the SPA merely allow a reallocation between possibly favored grandchildren, I do not find this difference to be material.

(3) a testamentary SPA.

Again, in the unlikely event that son predeceases mom, mom receives a testamentary SPA identical to the inter vivos one discussed in (2) above with the exception that mom may also appoint the property to charity. In this respect, the third purported difference appears to be nothing more than a knock off of the second difference. Again, I do not find the economic rights of adding a charity as a possible recipient as anything close to the powers granted under the SPA in *Levy,* where the SPA allowed property to come back into the family unit. Therefore, it appears that this difference is also immaterial.

The fourth and fifth differences are concerned with marital trust savings clauses. A marital trust savings clause is a savings clause where upon the death of the first spouse, if an inter vivos irrevocable trust is inadvertently included in the settlor's estate, the assets included in the settlor's estate are placed into the marital trust (which is generally the QTIP) so that the estate tax may be deferred to the death of the second spouse. Similar to the first three minor differences in trust drafting, the fourth and fifth differences are also effective only upon an unlikely event. Here, the unlikely event is that the inter vivos trusts will have been inadvertently drafted and result in some estate inclusion issue.

Both the trust settled by the husband and the trust settled by the wife have marital trust savings clauses. However, the powers granted to husband and wife under these marital trusts savings clauses differ. The fourth difference is under the wife's marital trust, where she is given a 5 x 5 power and a testamentary special power of appointment. The husband's marital savings trust clause does not provide for these powers. Both the 5 x 5 power as well as the testamentary SPA were previously discussed in differences one and three above. In this respect, the fourth proclaimed difference appears to be nothing more than a restatement of the first and third difference. For the same reasons stated above, I would find these differences to be immaterial.

The fifth purported difference is that the marital trust savings clause provided for under the trust settled by the wife does not allow the husband to be a beneficiary for three years. Further, the husband may not be a beneficiary at all if he is above a certain income level. The purpose of a marital trust savings clause is to preserve the tax deferral until the second spouse's death if an inter vivos irrevocable trust is brought back into the settlor's estate. In order to accomplish this objective, the QTIP created under the marital trust savings clause must qualify for the marital deduction under IRC § 2056(b)(7). However, under the PLR's facts, the QTIP fails to qualify from inception, because the husband does not receive income annually for three years, and possibly forever if his income is above a certain level. In this respect, it appears that the fifth purported difference has no other purpose than to serve as a red herring in an attempt to argue that the trusts are not substantially identical.

Synthesis

All of the differences between the trusts depend on either the unlikely event that the son predeceases mom or that the trust had other estate inclusion issues that brought part or all of the trust assets back into the settlor's estate. The 5 x 5 power, by itself does not appear to be material. The SPAs under the PLR do not have the economic effect or control effect that the SPA in Levy did. Furthermore, the only difference between the inter vivos SPA and the testamentary SPA is that the wife may appoint the trust property to charity under the testamentary SPA. The fourth difference appears to be nothing more than a restatement of the 5 x 5 power and the testamentary SPA. Likewise, the fifth difference appears to be nothing more than a red herring. Considering these differences, one might conclude that the only real differences are a 5 x 5 power and an SPA that does not begin to approach the powers granted under the SPA in *Levy*. Both of these differences appear to be immaterial either alone or combined. Moreover, since they depend on unlikely events, these differences appear to be even more immaterial. Therefore, some planners may well disagree with the Service's favorable ruling and find that these trusts actually are substantially identical. Conversely, some planners may take the position that very little drafting is needed to break the substantially identical factor, and agree with the Service position.

II. Drafting Reciprocal Trusts With Fundamental Differences

Due to limited case authority and the fact that a PLR may not be relied on as authority[5], it is hard for anyone to be certain how different the trusts settled by husband and wife need to be to break the substantially identical trust factor under the interrelated prong of the *Grace* test. I would suggest rather than putting much credence in PLR 200426008, that should the drafter wish to attempt to break the substantially identical factor, the trusts should be drafted with fundamental differences. In addition to the differences in PLR 200426008, planners should consider the following other possible drafting deviations:

Different Types of Estate Planning Trusts

When drafting a trust settled by the husband, the trust may be an IDIT. On the other hand, the trust settled by the wife might be a GRAT. These type of trusts function as substantially different types of trusts for estate planning purposes. Further, due to the several pages it takes to define the annuity interest, the trusts look substantially different at first glance.

On the other hand, if the trust settled by the husband is an irrevocable trust without a power to substitute property of equivalent value, and the trust settled by the wife is an IDIT, the only difference may be a paragraph that provides the wife with the power to substitute property of equivalent value. In this respect, this may not be sufficient to convince the court that the trusts are not identical.

Different Vesting Options

One trust might be a dynasty trust and the other trust might provide for distribution of the trust assets to the beneficiaries based on an age vesting schedule. The drafting for a dynasty trust typically takes a few pages and is considerably different than the paragraph used for age vesting.

Different Distribution Options

One trust might be a purely discretionary trust, and the other trust might be a support trusts based on ascertainable standards (health, education, maintenance, and support). The support trust would give the beneficiary an enforceable right to force a distribution based on the ascertainable standard. Yet, with a common law purely discretionary trust a beneficiary would not have an enforceable right to a distribution.

Different Beneficiaries Other Than Husband and Wife

Using different beneficiaries for each trust other than husband and wife may not suit the settlors objectives. For example, if husband creates a trust for wife, C1, and C2, but wife only creates a trust for husband and C1, then C2 may well not receive as much as C1 upon the death of both husband and wife. Also, if Husband creates a trust for wife and C1, and wife creates a trust for husband and C2, the service may argue that this puts the parties in the same economic position not only as to husband and wife, but also as to the children. The Service could apply the reciprocal gift analysis under *Sather*[6] and *Schuler*[7] discussed in my second installment of this series, LISI Estate Planning Newsletter 1275. Conversely, if it would fit the settlors' goals and there are three or more children, husband could settle a trust for wife, C1 and C2. Wife could settle a trust for husband, C1, C2, and C3.

Other Differences in One Trust, But Not the Other

One trust might have a marital savings clause, and the other one does not have such a provision. Further, one trust might provide that if the children beneficiaries predecease the parent, then the surviving spouse beneficiary would receive a 5 x 5 power. Since some estate planners are of the opinion that a mere SPA might break the substantially identical factor, in the event that this is a first marriage and there are not any conflicts of interest, one trust may provide a SPA. The SPA should be drafted broadly as in *Levy* so that the spouse may appoint the trust property to anyone other than to herself, her creditors, her estate, or the creditors of her estate.

Greater Number of Factors the Better

I would suggest if one is of the opinion that meticulous drafting may break this factor, the more significant contrasts the better. For example, the author would hope that that the following differences would be sufficient:

Husband settles:	**Wife Settles:**
1. IDIT	1. GRAT

2. Pure discretionary distribution standard	2. Distributions shall be made pursuant to an ascertainable standard
3. Dynasty trust	3. Age vesting
4. Marital savings clause	4. None
5. 5 x 5 power if children beneficiaries predecease parent	5. None
6. SPA	6. None
7. Different beneficiaries	7. Different beneficiaries

III. Do Not Forget the Other Design Issues

Just because the drafter may be able to break the substantially identical factor of the interrelated prong of the *Grace* test does not necessarily mean that the drafter has hit a home run. It is true that the U.S. Supreme Court only focused on the two factors when determining whether the trusts were interrelated: (1) created at the same time (i.e. pursuant to the same estate plan); and (2) whether the trusts were identical. However, as discussed in my previous LISIs, other courts have also considered whether the trusts had the same trustee as well as whether the same assets were contributed to the trust. Additionally, one must also consider the doctrine of reciprocal trustees articulated by the Tax Court and Court of Appeals since *Grace*. Therefore, I would also suggest the following additional estate planning design differences if a drafter wishes to draft around the doctrine of reciprocal trusts.

1. Do not have either spouse serve as a trustee of either trust;

2. Use a different trustee for each trust; and

3. Contribute separate assets to the trusts.

As previously noted in my prior LISI, it is very difficult to break the factor that the trusts were created pursuant to the same estate plan. It is true that the trusts may be established one to two years apart. However, any estate planning diagrams or memorandums documenting that the trusts were established as an overall plan may well negate the fact that the trusts were created at the different times.

Conclusion

There are many opinions regarding the doctrine of reciprocal trusts, and this is an area where many authorities may reasonably disagree. Many drafters will conclude that case and PLR authority is too sparse to provide adequate guidance. They also may well note that to err on the conservative side they would have to include a substantial number of drafting differences, many which they would prefer not to do. Therefore, these conservative drafters may well prefer to draft simply with one spousal access trust. For example, husband settles a trust for the benefit of wife and children. However, if wife settles a trust, then only the children will be a beneficiary, not the husband. This approach centers around drafting the trusts so that they break the second prong of the *Grace* test, the settlors are not left in the same economic position.[8] As noted in part III of this series, this is a half of loaf approach. Trust property from only one trust may be brought back into the family unit.

Some of the more daring estate planners will attempt to break the reciprocal trust doctrine by designing around the interrelated factor. There is little authority on just how one breaks the substantially identical factor of the interrelated test since *Grace*. Many planners will be a little reluctant to rely on one PLR that appears to not have any substantial differences in it. Conversely, if the trusts contain real substantial differences as detailed in this LISI, many planners may conclude that the substantially identical factor should be broken. More aggressive planners may well note that *Grace* states that the drafter need only make the trusts so that they are not substantially identical. These planners may conclude that drafting trusts with fundamental differences is overkill and not necessary.

Finally, the truly thrill seekers of the estate planning community might state the following, "So what if you have created reciprocal trusts. All that means is that they are treated as self-settled. It does not mean that they are automatically included in the settlors' estates." When applied to a domestic asset protection trust, these thrill seekers could be correct. Depending upon a number of factors a domestic asset protection trust might not be included in the settlor's estate. However, the same is probably not true for reciprocal trusts. Hence the subject of my next LISI in this series – Reciprocal Trusts and Domestic Asset Protection Trusts – Estate Inclusion Issues.

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1 The modular approach to estate planning is trademarked by Mark Merric.

2 *U.S. v. Grace,* 395 U.S. 316 (1969).

3 It should be noted that distributions were limited to "any amounts of income or principal as is necessary or advisable for their health, education, maintenance, or support," and that the son's needs needed to be satisfied before any distributions were made to a parent.

4 Most of the reciprocal trust cases with reciprocal beneficiaries prior to *Grace* contained identical terms. However, in *Estate of Carter,* 311 TC 1148 (1959) the court noted, "The trust agreements contained identical provisions with respect to many of the powers of the trustee, the treatment of income received by the trust, and the property the trust funds might be invested." In this Tax Court case, the court does not seem too concerned that the trust terms need to be substantially identical. However, this case was decided before *Grace.*

5 IRC § 6110(k)(3).

6 251 F.3d 1168 (8th Cir. 2001).

7 282 F.3d 575 (8th Cir. 2002).

8 When using this approach, please remember to address any possible reciprocal trustee issues.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1339

Date: 05-Sep-08

From: Steve Leimberg's Estate Planning Newsletter

Subject: **Estate Inclusion Issues of Reciprocal Trusts and Self Settled Estate Planning Trusts**

The Doctrine of Reciprocal Trusts – Part V

LISI Commentator Team Member **Mark Merric** is the principal in the **Merric Law Firm** which is a boutique firm emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection – first edition, The Asset Protection Planning Guide (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*.

Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, and the Asset Protection Journal. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal.

Mark speaks nationally on estate planning and asset protection and is giving an upcoming five day estate planning seminar sponsored by the University of Denver Graduate Tax Program http://www.InternationalCounselor.com/HotoffthePress.htm

This **LISI** is part of a continuing series known as the **Modular Approach to Estate Planning**.™[1]

Part I of Mark's series on Reciprocal Trusts is LISI Estate Planning Newsletter # 1281.
Part II is LISI Estate Planning Newsletter # 1273.
Part III is LISI Estate Planning Newsletter # 1283
Part IV is LISI Estate Planning Newsletter # 1332.

EXECUTIVE SUMMARY:

In my last installment of the reciprocal trust doctrine (LISI **Estate Planning Newsletter # 1332**), for the more aggressive planners, I discussed possible methods of hopefully drafting around the doctrine of reciprocal trusts. Yet, what if someone is unsuccessful when there are reciprocal beneficiaries and the doctrine of reciprocal trusts applies. Some estate planners take the position that all is not lost, the estate tax inclusion rules governing self settled trusts apply.

This **LISI** generally disagrees with this "no harm, no foul" argument. If a court finds that the trusts are reciprocal, a Delaware Chancery case, the Restatement (Third) of Trusts ("Restatement Third), and a couple of the leading treatises on asset protection take the position that any creditor can reach the deemed settlor's beneficial interest. In other words, with one caveat, there most likely is *no* asset protection for either the husband's or wife's beneficial interest if a court holds that the trusts are reciprocal. The one exception is a reciprocal trust that is also an asset protection trust ("APT") under a state that has passed a qualified disposition act or an offshore APT. In this case all three of the estate inclusion issues of IRC § 2036(a)(1) need to be analyzed to determine whether the trusts will be included in the settlor's estates.

TERMINOLOGY

Over the years, I have noticed how many planners have broadened the term "asset protection trust" ("APT"). For those of us who have been in the business since the term was first used, it has a very *specific* meaning – a self settled trust where a beneficiary's interest is protected under the governing state or nation law.

In recent years, I have seen where the term was used broadly to include typical third party trusts including discretionary dynasty trusts. With these trusts, the settlor is *not* a beneficiary.

For purposes of this article, I will use the narrow definition. An APT refers only to a self settled trust sited in a jurisdiction that protects a settlor/beneficiary's interest by statute or common law. The term domestic asset protection trust ("DAPT") refers only to a trust sited in a state that has adopted a qualified disposition statute. A qualified disposition statute is a statute that extends spendthrift protection to a self settled trust.

For more information on how a DAPT statute works see *Searching For Favorable DAPT Legislation: Tennessee Enters the Arena*, LISI Asset Protection Planning Newsletter #105, June 1, 2007. The term "offshore asset protection trust" ("OAPT") refers only to a trust sited in a nation that protects a self settled trust by statute or common law.[2]

RECIPROCAL TRUSTS

Assuming the trusts are not APTs, if a court holds the two trusts to be reciprocal, they are deemed to be self settled. Husband is deemed to be the settlor of the trust his wife created naming him as one of the beneficiaries, and wife is deemed to be the settlor of the trust her husband created naming her as one of the beneficiaries.

In the only case dealing with the creditor issue of reciprocal trusts, *Security Trust v. Sharp*[3], a Delaware chancery case, holds that creditors may reach the deemed settlor's interest in reciprocal trusts, under the theory that the trust is self settled. This case has been cited as the state of the law in a couple of the lead asset protection treatises.[4] It is also the position under the Restatement Third of Trusts.[5] Due to the common acceptance of this Delaware case as the state of the law, I would strongly suggest that most courts will follow it.

In all but the DAPT states, the general rule is that any creditor may reach the maximum amount that may be distributed to a settlor/beneficiary.[6] If this is the case, any creditor may reach the husband's or wife's beneficial interest in a reciprocal trust. If a creditor may reach a *settlor's* beneficial interest, it is included in the deemed settlor's estate.[7]

Conversely, if the reciprocal trusts are also APTs under a state qualified disposition statute, then whether there is a estate inclusion issue will require an analysis of all of the estate inclusion issues of IRC § 2036.[8] I will discuss these estate inclusion issues for DAPTs after discussing the amount of the inclusion for reciprocal trusts below.

WHAT IS THE AMOUNT INCLUDED IF RECIPROCAL BENEFICIARIES?

In the event the reciprocal trust doctrine applies and the reciprocal trusts are not DAPTs, the amount of the inclusion for each settlor was confirmed in *Grace*[9] that stated:

"Rather, we hold that the 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 the same economic position as they would have been if they had created trusts naming themselves as life beneficiaries." [Emphasis added].

This was also previously confirmed in *Estate of Cole v. Comm'r*, 140 F.2d 636 (8th Cir. 1944), where husband transferred 700 shares of stock to the trust he created naming his wife as one of the life beneficiaries and wife contributed 300 share of the same company to a trust naming husband as one of the life beneficiaries. The court held the value of the smaller trust, which was the 300 shares, at the death of each spouse was included in that spouse's estate.

Probably the most common incident where practitioners come across reciprocal trusts is with ILITs. Husband creates an ILIT naming his wife and children as beneficiaries, and the trustee of this ILIT obtains an insurance policy on the life of the husband. Wife does likewise. She creates an ILIT naming her husband and children as beneficiaries, the trustee of this ILIT obtains a life insurance on the life of the wife. Assume that husband dies and the death benefit is $2 million. At the time of his death, the cash surrender value of the insurance policy held by the trust the wife settled is $250,000. Under *Estate of Cole* the value of the wife's trust should be included in husband's estate when he dies, assuming he dies first, and the value of the wife's trust, at the time of her death will also be included in her estate.

SELF SETTLED ESTATE PLANNING TRUST ESTATE INCLUSION ISSUES

If one is able to draft around the doctrine of reciprocal trusts, husband and wife have access to the property gifted to both trusts. The amount that might be accessed depends upon the distribution standards as well as any savings clauses.[10]

Planning with trusts that have reciprocal beneficiaries generally requires both a husband and wife. Furthermore, to access trust assets, one must do so through the other spouse.

Is there a possibility that a trust could be designed where a settlor could also be a beneficiary of a trust and the trust property might be *excluded* from the estate? This type of trust has been referred to as a self settled estate planning trust (i.e. "rainy day trust™"[11]). A typical design for this type of trust has the following components.

- The settlor as well as his spouse and descendants are named as beneficiaries.

- An independent trustee is appointed within the meaning of IRC § 672(c).

- The settlor may remove the independent trustee without cause and appoint another independent trustee within the meaning of IRC § 672(c).

- The Trustee may make discretionary distributions (i.e., a common law discretionary trust[12]) of any amount of income or corpus to any beneficiary – including the settlor.

In essence, if such an estate planning tool works, the Settlor would be able to gift property away, and get back part of the trust property if ever needed, and still have the remaining trust property excluded from the settlor's estate. This type of a tool would also be "full loaf" planning. Also, it would not require the additional step of receiving distributed trust assets through a spouse.

GIFT TAX RULES

As explained by that esteemed estate planner **Richard Nenno** of the **Wilmington Trust Company**, whether a transfer to a self settled estate planning trust will be classified as a completed gift depends on whether or not a creditor may reach the beneficiary's interest in the trust.[13] Since whether a creditor can reach the settlor/beneficiary's assets is also an estate inclusion issue, it will be discussed in the upcoming Part VI.

ESTATE INCLUSION ISSUES AND THE ESTATE PLANNING OCTOPUS™[14]

The estate tax is broader than the gift tax. Just because the settlor completed a gift, possibly used all or part of his or her applicable exclusion, and even possibly paid some gift tax, does not mean the property is excluded from the settlor's estate.

As noted, in the Modular Approach to Estate Planning, one may view the estate tax similar to an octopus. The head of the octopus is IRC § 2033, which means that the client owns the asset. In order to get away from an octopus from devouring you, you must severe all eight arms. The eight arms are represented by IRC sections where generally the client does not own the property, but has retained some string of control over such property.

THREE TENTACLES TO IRC § 2036

The biggest and most deadly arm of this estate planning octopus is IRC § 2036. It is the biggest arm of the octopus for estate tax inclusion, because the arm breaks down into three tentacles, and one of the three tentacles further breaks down into three more sub-tentacles. All of these tentacles and sub-tentacles bring trust property back into the estate using different rules.

The three main tentacles are:

1. IRC § 2036(a)(1) – dealing with retained life interests;

2. IRC § 2036(a)(2) – which is generally concerned with the ability of a trustee to designate who receives what; and

3. IRC § 2036(b) – concerned with voting rights in closely held corporations.

By case law, IRC § 2036(a)(2) and IRC § 2038 have an external standard (i.e. ascertainable standard) exception to their application.[15]

The same is not true for IRC 2036(a)(1), there is no external or ascertainable standard exception. It is under IRC § 2036(a)(1) tentacle where three potential estate tax inclusion issues of a self-settled trust surface.

IRC § 2036(a)(1)'s Three Sub-Tentacles are:

1. retained life interest;

2. implied promise;[16] and

3. whether a creditor may reach the assets of a trust in satisfaction of a legal obligation.[17]

IRC § 2036(A)(1) – LIFE INTEREST RULE

In order to determine whether there is an estate inclusion issue under IRC § 2036(a)(1) for an APT, one must look to the common law classification of trusts to determine whether a beneficiary holds an enforceable right to a distribution.

Generally, in determining whether a beneficiary had an enforceable right to a distribution, there are primarily three classifications of trusts: (1) mandatory interest[18]; (2) support interest; and (3) a discretionary interest.

Mandatory Distribution Interest

Usually, a mandatory distribution standard requires that a fixed amount, percentage, or definition of income be paid out annually. For tax purposes, a QTIP, which requires all income to be paid to the surviving spouse, is a mandatory distribution. The same for the annuity or uni-trust interest in a GRAT or CRUT. Similarly, a $100,000 distribution to a certain beneficiary that is required to be made each year is a mandatory distribution.

If the settlor holds a mandatory distribution interest, there is an estate inclusion issue under IRC § 2036(a)(1).[19]

Support Distribution Interest

Under common law, the term support trust means that the distribution creates an enforceable right in a beneficiary based on a standard. Generally, a support trust is created with mandatory words such as "shall" or "must" combined with a standard that is capable of judicial interpretation. For example, Courts have determined the following language to create a support trust:

> "[T]he trustee <u>shall</u> pay…[to the settlor's] daughters such reasonable sums as shall be needed for their <u>care, support, maintenance, and education</u>" [emphasis added] was determined to be a support trust.[20]
>
> "[T]he Trustee <u>shall</u> use a sufficient amount of the income to provide for the grandchild's <u>support, maintenance and education</u>" [emphasis added] was held to be a support trust. [21]

If the settlor/beneficiary has an enforceable right to a distribution, again there is an estate inclusion issue.[22]

Discretionary Interest

It is only if a settlor hold a discretionary interest where he or she holds neither an enforceable right to a distribution nor a property interest that there is not an estate inclusion issue under the IRC § 2036(a)(2) tentacle. [23]

For purposes of this article, the term common law discretionary trust refers to a trust where a beneficiary has neither an enforceable right to compel a distribution nor a property interest, and no creditor may attach such interest.

At this point the author needs to clarify an area of confusion among some practitioners. Under common law, the term "purely discretionary trust" or "wholly discretionary trust" under common law did not require that the distribution interest not have any standards. Rather, in the hundreds of cases on point, almost all common law discretionary trusts contained a standard for making distributions.

However, as discussed in detail in my **LISI** Series on Spousal Access Trusts, the Restatement Third rewrites the definition of a common law discretionary trust creating an enforceable right in almost all discretionary trusts.

The *good* news, it does not appear that the courts are adopting the Restatement Third in this area of law.

The *bad* news is that there is nothing other than a state a statute codifying the Restatement Second that will prevent a judge from doing so.

Therefore, unless the trust is to be sited in a jurisdiction that has addressed this enforceable right issue[24], I would suggest the following distribution language:

My Trustee may distribute as much of the net income and principal as my Trustee, in its sole, absolute, and unfettered discretion, determine to any beneficiary listed in Section 1.07. My Trustee, in its sole, absolute, and unfettered discretion, at any time or times, may exclude any of the beneficiaries or may make unequal distributions among them. Also, my Trustee, in its sole discretion may distribute all of the income and principal of this Trust to one of the beneficiaries and exclude all other beneficiaries from any of the Trust Property. When making distributions, my Trustee may, in its sole, absolute, and unfettered discretion may, but need not, consider a beneficiary's income or other resources that are available to the beneficiary outside of the trust and are known to the Trustee. The power to make a distribution in my Trustee's sole, absolute, and unfettered discretion includes the power to withhold making a distribution to any beneficiary in my Trustee's sole, absolute, and unfettered discretion.

In keeping with the wholly discretionary nature of this trust and all separate trusts created hereunder, no beneficiary, except as regards to any irrevocable vesting in the beneficiary's favor, shall have any ascertainable, proportionate, actuarial or otherwise fixed or definable right to or interest in all or any portion of any trust or its property. It is my intent that the trustee have all of the discretion of a natural person, and that a distribution beneficiary holds nothing more than a mere expectancy. It is also my intention that the above language be interpreted as to provide my Trustee with the greatest discretion allowed under law.

Distributions made to a beneficiary under this Article shall not be considered advances and shall not be charged against the share of such beneficiary that may be distributable under other provisions of this agreement. Any undistributed net income shall be accumulated and added to the principal of the trust."

The author is hopeful that the above language would create neither an enforceable right to a distribution nor a property right under even a Restatement Third analysis. This being the case, the first estate planning sub tentacle of IRC § 2036(a)(1) does not create an estate inclusion issue.

CONCLUSION

While it may be possible to design and operate a self-settled asset protection trust and avoid estate planning inclusion issues, the same does not appear to be true for reciprocal trusts that have reciprocal beneficiaries. The case of *Security Trust v. Sharp* as well as the Restatement Third takes the position that any creditor may reach a beneficiary's interest in a reciprocal trust. This being the case, the sub-tentacle that a creditor may reach the settlor/beneficiary's interest of the trust will pull the value of the smaller trust back into the deemed settlor's estate.

The exception to this statement would be a reciprocal trust that also was a DAPT, and in that case, one must be able to escape from the three estate planning sub tentacles of IRC § 2036(a)(1): (1) life interest rule; (2) implied promise; (3) or creditor can reach the settlor/beneficiary's interest.

A common law discretionary interest that creates neither an enforceable right to a distribution nor a property interest that no creditor may attach prevents the first sub tentacle of IRC § 2036(a)(1) from applying.

The second sub tentacle regarding an implied promise and the third sub tentacle of whether a creditor can reach the settlor/beneficiary's interest will be discussed in the upcoming series on self settled estate planning trusts.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

CITE AS:

CITES:

[1] The modular approach to estate planning is trademarked by Mark Merric.

[2] Some of the first common law asset protection trusts were Isle of Man, Jersey, and Guernsey (the last two being Channel Islands between England and France). These jurisdictions continue to protect a settlor/beneficiary's interest in trust by case law.

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

[4] Elizabeth G. Deleery chapter titled *Trusts in Which A Settlor Retains an Interest*, in Duncan Osborne's and Elizabeth Schurig's treatise, *Asset Protection: Domestic and International Law and Tactics*, § 14:26; and Peter Spero, *Asset Protection: Legal Planning, Strategy & Forms*, P. 6.08, Self Settled Trusts.

[5] *Restatement (Third) of Trusts*, Section 58; comment f and Reporter Note's comment f.

[6] *Restatement (Second) of Trusts § 156(b); Restatement (Third) of Trusts § 60, comment f; Uniform Trust Code § 505.*

[7] Treas. Reg. § 20.2036-1(b)(2)

[8] As Richard Nenno notes in his chapter titled *Delaware Asset Protection Trusts*, in Duncan Osborne's and Elizabeth Schurig's treatise, *Asset Protection: Domestic and International Law and Tactics*, § 14A:134, the estate inclusion issues of IRC § 2038 are the same for a non-self settled trust. Therefore, they are not within the scope of this article.

[9] *U.S. v. Grace*, 395 U.S. 316 (1969).

[10] Limitations on distributions when someone uses a support trust will be discussed in detail in the upcoming series on Spousal Access Trusts.

[11] The term "Rainy Day Trust" is a service mark of Alaska Trust Company.

[12] The term common law discretionary trust refers to the Second Restatement where a beneficiary does not has neither an enforceable right to a distribution or a property interest. It does not refer to the new view of law articulated by the Restatement Third of Trusts.

[13] Richard Nenno's chapter titled *Delaware Asset Protection Trusts*, in Duncan Osborne's and Elizabeth Schurig's treatise, *Asset Protection: Domestic and International Law and Tactics*, § 14A:134. Richard Nenno provides an extensive paragraph of cites. A few of these cites follow: *Outwin v. Commr.*, 76 TC 153 (1981); Rev. Rul. 77-378; Rev. Rul. 76-103; and TAM 199917001.

[14] The "estate planning octopus" is trademarked by Mark Merric.

[15] *Estate of McTighe*, TC Memo 1977-410, *Jennings v. Smith*, 161 F.2d 74 (2nd Cir. 1947); *Estate of Pardee*, 49 TC 140 (1967); PLR 9347014.

[16] Treas. Reg. § 20.2036-1(a)(1).

[17] Treas. Reg. § 20.2036-1(b)(2).

[18] For creditor purposes, the Restatement Second provided spendthrift protection to both mandatory and support trusts, and therefore does not make a distinction between these two types of trust. The Restatement Third and the Uniform Trust Code do not provide protection for a mandatory distribution that has become overdue, thereby reducing the asset protection under common law and creating a third classification for creditor purposes.

[19] *Estate of Uhl*, 241 F.2d 867 (7th Cir. 1957) as to the $100 mandatory income distribution that resulted in estate inclusion of the corpus necessary to produce the $100 payment.

[20] *In re Carlson's Trust*, 152 N.W.2d 434 (SD 1967).

[21] McElrath v. Citizens and Southern Nat. Bank, 189 S.E.2d 49 (GA. 1972).

[22] *Estate of Boardman v. Comm'r*, 20 T.C. 871 (1953); *Estate of John J. Toeller,* 165 F.2d 665 (7th Cir. 1946); and *Blunt v. Kelly,* 131 F.2d 632 (3rd Cir. 1941). For creditor purposes when a beneficiary has an enforceable right to a distribution, it is referred to as a "support trust."

[23] *Estate of Uhl*, 241 F2d 867 (7th Cir. 1957), as to the principal that was wholly in the discretion of the trustee "the settlor reserved no right to compel the trustee to pay him any sums . . . ." Both the *Estate of German,* 7 Cl. Ct. 641 (1985) and *Estate of Wells,* 475 F2d 1142 (Ct. of Claims 1964) are self settled discretionary trust cases where the court held in favor of the taxpayer, and it appears the Service did not attempt to argue that there was an enforceable right in a discretionary trust.

[24] There are three parts to codifying the discretionary asset protection provided by the Restatement Second: (1) defining a discretionary trust interest; (2) stating the legal effect of a discretionary interest (i.e. the beneficiary does not have an enforceable right or a property interest); and (3) providing a judicial review standard that does not create an enforceable right. South Dakota does this in SDCL § 55-1-23 through § 55-1-43. The proposed Michigan UTC does all of this. The Missouri UTC only covers the second issue, which is the most important of the three issues.