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# Estate Taxation -- The Doctrine of Reciprocal Trusts

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## Estate Taxation—The Doctrine of Reciprocal Trusts

The doctrine of reciprocal trusts in the federal tax field had its humble beginning in 1940 when *Lehman v. Commissioner*<sup>1</sup> was decided.<sup>2</sup> The doctrine rests upon the principle that "a person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust was created by another."<sup>3</sup> Thus, *A* creates a trust for the life benefit of *B* with remainders over and *B* creates a trust for the life benefit of *A* with remainders over.<sup>4</sup> These trusts would escape estate tax burdens entirely but for the "reciprocal" or "crossed" trusts doctrine, which looks to the substance of the transaction and thereby regards *A* as the grantor of the trust of which *B* was the nominal grantor.

Various provisions or powers may be crossed by the settlors: powers to alter, amend, revoke or terminate;<sup>5</sup> powers of appointment;<sup>6</sup> life estates;<sup>7</sup> and reversionary interests.<sup>8</sup> Crossing of any of these provisions may give rise to estate taxation if the trust would be included in the estate of a settlor who reserved those powers to himself<sup>9</sup> and if, in fact, the trusts are found to be reciprocal.

In order for the doctrine to apply, there must be an express finding that the trusts were in "consideration" of each other, which means the giving of a quid pro quo.<sup>10</sup> The term "consideration" has given the courts much difficulty. The predominant view seems to be that circum-

<sup>1</sup> 109 F. 2d 99 (2d Cir. 1940), cert. denied 310 U. S. 637 (1940).

<sup>2</sup> New Jersey had used the doctrine in 1932. *In re Perry's Estate*, 111 N. J. Eq. 176, 162 A. 146 (1932).

<sup>3</sup> *Lehman v. Commissioner*, 109 F. 2d 99, 100 (2d Cir. 1940), cert. denied 310 U. S. 637 (1940). See Marks, *The Switching of Settlers in Inter Vivos Trusts*, 26 TAXES 622 (1948) for a criticism of the doctrine.

<sup>4</sup> Reciprocity may exist in a series of trusts benefiting three or four settlors. See *In re Jones' Estate*, 350 Pa. 120, 38 A. 2d 30 (1944) and *Commissioner v. Warner*, 127 F. 2d 913 (9th Cir. 1942).

<sup>5</sup> 68A STAT. 383, 26 U. S. C. 2038 (1954). See *Lehman v. Commissioner*, 109 F. 2d 99 (2d Cir. 1940), cert. denied 310 U. S. 636 (1940); *Hanauer's Estate v. Commissioner*, 149 F. 2d 857 (2d Cir. 1945), cert. denied 326 U. S. 770 (1945); *Newberry's Estate v. Commissioner*, 201 F. 2d 874 (3d Cir. 1953); *Commissioner v. Dravo*, 119 F. 2d 97 (3d Cir. 1941). See also *Colonial Trust Co. v. Commissioner*, 111 F. 2d 740 (2d Cir. 1940).

<sup>6</sup> 68A STAT. 385, 26 U. S. C. 2041 (1954). See *Fish v. Commissioner*, 45 B. T. A. 120 (1941). See also *Estate of Sinclair v. Commissioner*, 13 T. C. 742 (1942).

<sup>7</sup> 68A STAT. 382, 26 U. S. C. 2036 (1954). See *Orvis v. Higgins*, 180 F. 2d 537 (2d Cir. 1950), cert. denied, 340 U. S. 810 (1951); *Cole's Estate v. Commissioner*, 140 F. 2d 635 (8th Cir. 1944); *McLain v. Jarecki*, 126 F. Supp. 621 (N. D. Ill. 1955) (contingent life estates); *Eckhardt v. Commissioner*, 5 T. C. 673 (1945).

<sup>8</sup> 68A STAT. 382, 26 U. S. C. 2037 (1954). See *Estate of Hill v. Commissioner*, 23 T. C. No. 77 (1954).

<sup>9</sup> See *Tobin v. Commissioner*, 183 F. 2d 919 (5th Cir. 1950) (income tax), where *H* and *W* set up two trusts, the income of each was to be paid to the other spouse as the advisory committee should direct. See also *Commissioner v. Dravo*, 119 F. 2d 97 (3d Cir. 1941), where the corpus was to be advanced.

<sup>10</sup> *Hanauer's Estate v. Commissioner*, 149 F. 2d 857 (2d Cir. 1945), cert. denied 326 U. S. 770 (1945).

stances showing concert of action or interdependence will support the finding of consideration.<sup>11</sup> Opposed to this authority stands the Third Circuit which insists that the powers be bargained for and exchanged.<sup>12</sup> Although the commissioner's determination that the trusts were in consideration of each other is presumptively correct, the circuit courts have disagreed as to what kind of and how much evidence is needed to rebut this presumption.<sup>13</sup>

Various factors are weighed in making the necessary finding that one trust was in "consideration" of the other. In *Hanauer's Estate v. Commissioner*<sup>14</sup> the Second Circuit held that the simultaneous execution of the trust plus the wife's mental attitude of leaving investment matters in the hands of her husband were sufficient to support the Tax Court's finding that the trusts were made in consideration of each other. *Estate of Carrie S. Newberry*<sup>15</sup> also upheld the commissioner's determination where the trusts were created "after frequent consultations by decedent's husband with his financial advisors, and by the decedent and her husband with their attorney, and after discussions between themselves" even though the technical provisions and the form were determined by the lawyer.

It is particularly difficult to rebut the presumption of a tacit agreement or concert of action when the res of each trust is similar in amount, the beneficial interests are identical and the trusts are executed within a short time of each other.<sup>16</sup> In *Orvis v. Higgins*<sup>17</sup> the evidence showed that the trusts were created within six days of each other, that the two settlors consulted the same attorney within thirteen days of each other, but that neither settlor was present at the execution of the other's trust. Although all the evidence tended to show in a negative manner that neither trustor knew of the other's intention, the court held that it was error for the Tax Court to find no reciprocity since the clear inference from the facts was that there must have been a concert of action.

In those cases where the commissioner has been upheld, the courts have indicated that the presence of other motives does not affect the situation. For example, where the trusts expressed the motive of keeping the stock within the family, the court found this to be unimportant

<sup>11</sup> *Ibid.*

<sup>12</sup> *Newberry's Estate v. Commissioner*, 201 F. 2d 873 (3d Cir. 1953).

<sup>13</sup> *McLain v. Jarecki*, 126 F. Supp. 621 (N. D. Ill. 1955).

<sup>14</sup> 149 F. 2d 857 (2d Cir. 1945), *cert. denied* 326 U. S. 770 (1945).

<sup>15</sup> 1947 P-H T. C. Mem. Dec. 387, *aff'd per curiam* 172 F. 2d 220 (3d Cir. 1949).

<sup>16</sup> *Estate of John H. Eckhardt*, 5 T. C. 673 (1945). But see *Estate of Lindsay v. Commissioner*, 2 T. C. 174 (1943), where it was said that these factors were not conclusive that the trusts were interdependent and in consideration of each other. See also *Wiebolt v. Commissioner*, 5 T. C. 946 (1945) (income tax).

<sup>17</sup> 180 F. 2d 537 (2d Cir. 1950), *cert. denied* 340 U. S. 810 (1950).

as the grantors could have carried out this motive by giving the stock to their children without reserving crossed income provisions.<sup>18</sup>

Unfortunately all is not bread and gravy for the government, especially in the Third Circuit which has limited the *Lehman* doctrine to an actual consideration test.<sup>19</sup> Another court, following the position of the Third Circuit, has said: "If a person other than the nominal settlor is to be treated as the actual settlor for tax purposes he must have paid something of value to the nominal settlor."<sup>20</sup> When the court looks for an actual bargain and exchange of powers, mutual love and affection for the settlors' children is not regarded as legal consideration so as to bring the trusts within the scope of the reciprocity doctrine.<sup>21</sup>

Furthermore, when the actual consideration test is applied, the existence of other motives plays an important part in the determination of a case. The Third Circuit said that *W's* motive of assuring *H* of independent wealth had a bearing on intentions with respect to unity of purpose, interdependence and consideration or lack of it and the court held that such a motive was one of the factors showing that the trusts were not reciprocal.<sup>22</sup> In *Newberry's Estate v. Commissioner*<sup>23</sup> the motive behind the creation of the trusts was to protect the children from improvident marriages. *H's* trust was suggested by his brother and after making his decision, *H* discussed his trust with *W* as both handled the family's affairs. *W*, in creating a similar trust, told the attorney that if such an arrangement was good enough for *H*, it was good enough for her. Although the trusts contained identical securities and were executed at the same time, the court held that the reciprocal trust doctrine did not apply even though each time *H* added to his trust *W* did the same. Great stress was laid on the testimony of *H* that he would have created his trust regardless of whether *W* decided on a similar course.

<sup>18</sup> *Cole's Estate v. Commissioner*, 140 F. 2d 636 (8th Cir. 1944). See also *Orvis v. Higgins*, note 17 *supra*.

<sup>19</sup> See *In re Leuder's Estate*, 164 F. 2d 128 (3d Cir. 1947), which quotes with approval RESTATEMENT, CONTRACTS § 75 (1932): "Consideration for a promise is (a) an act other than a promise, or (b) a forbearance, or (c) the creation, modification or destruction of a legal relation, or (d) a return promise bargained for and given in exchange for the promise."

<sup>20</sup> *McLain v. Jarecki*, 126 F. Supp. 621, 625 (N. D. Ill. 1955).

<sup>21</sup> See *McLain v. Jarecki*, note 20 *supra* and *In re Leuder's Estate*, 164 F. 2d 128 (3d Cir. 1947).

<sup>22</sup> See *Estate of Ruxton*, 20 T. C. 487 (1953), where *H*, fearing that he would lose all of his property from a pending lawsuit, set up a trust which gave a life estate to his daughter and a contingent life estate to his wife with remainders over. On the same day *W* set up a trust giving *H* a life estate with remainders over. The court found that the only concert of action between *H* and *W* occurred in the final stages of the transaction. The court was further influenced by the fact that there was no quid pro quo in that, according to the court, if the trusts were uncrossed and each settlor regarded as the grantor of the trust of which he was the beneficiary, they would be placed in an untenable position in regard to the giving of quid pro quo to induce the action of the other.

<sup>23</sup> 201 F. 2d 874 (3d Cir. 1953).

Another important factor in the determination of a particular case is illustrated in *Estate of Lindsay v. Commissioner*<sup>24</sup> where *W* had told her son, who prepared the trusts, not to tell *H* that she was creating a trust similar to the one which he was creating. The court was satisfied that there was no tacit agreement or understanding between the settlors. The fact that the amounts were almost similar was explained by the testimony of the son that he suggested the amount of the res for *W*'s trust.

Thus, where the *actual* consideration test is applied, the taxpayer has more readily maintained the burden of proof that the trusts were not in consideration of each other.<sup>25</sup>

If the court holds that the trusts are reciprocal, the problem arises as to the amount includible in the estates. When the trusts are of unequal size, the general rule is that both trusts are taxable but only to the extent of the smaller trust.<sup>26</sup> When an addition is made to one of the trusts which have been found reciprocal and the addition makes the amounts of the two trusts equal, all is included even though the addition is made years after the trust was originally created unless surrounding circumstances and evidence show that the addition was a separate gift.<sup>27</sup>

It is submitted that the *actual* consideration test is a poor one. If a court has to find an act or promise bargained for and given in exchange for another act or promise,<sup>28</sup> many transfers of a testamentary nature will escape taxation. It is obvious that motives should not be an escape device because if the taxpayers want "to keep the stock in the family"<sup>29</sup> or "to protect their children from improvident marriages"<sup>30</sup> they could accomplish the same result by making a gift in trust to their children without reserving crossed powers such as life estates which under 2036 of the Code are testamentary dispositions.

<sup>24</sup> 2 T. C. 174 (1943). See also *Newberry's Estate v. Commissioner*, 201 F. 2d 874 (3d Cir. 1953) and *Estate of Ruxton*, note 22 *supra*.

<sup>25</sup> See *Estate of Arnold Resch v. Commissioner*, 20 T. C. 171 (1953), where two months before *W* set up a trust for the benefit of *H*, *H* had given her \$100,000 worth of bonds which became the corpus. No conditions were attached to the gift. *W* had requested a bank to help her invest the bonds and a trust was suggested. *W* talked this over with *H* and secured his cooperation before creating the trust that the bank had suggested. It was held that these facts did not warrant a finding that she was acting in concert with *H* so as to make him the settlor. See also *Welch v. Commissioner*, 8 T. C. 1139 (1947) (income tax).

<sup>26</sup> See *e.g.*, *Estate of Oliver*, 1944 P-H T. C. Mem. Dec. 138; *Estate of Frederick S. Fish*, 45 B. T. A. 120 (1941). See *Estate of Carolyn Peck Boardman*, 20 T. C. 871 (1953), where the settlor of the smaller trust died. Under Rule 50 his estate was taxed by multiplying the value of the cross trust at his death by the following fraction: the value of the property at the time transferred by the decedent over the value of the property at the time transferred by the other settlor. See Note, 38 A. L. R. 2d 522, 527 (1954).

<sup>27</sup> *Estate of Carolyn Peck Boardman*, 20 T. C. 871 (1953) (four years).

<sup>28</sup> This test was used in *In re Leuder's Estate*, 164 F. 2d 128 (3d Cir. 1947).

<sup>29</sup> See *Cole's Estate v. Commissioner*, 140 F. 2d 636 (8th Cir. 1944).

<sup>30</sup> *Newberry's Estate v. Commissioner*, 201 F. 2d 874 (3d Cir. 1953).

Unless the transactions are taxed in the donors' estates, the use of reciprocal trusts allows a taxpayer to rid his estate of assets at gift tax rates and at the same time receive valuable lifetime economic powers in return.<sup>31</sup> This coupled with the fact that he has, at the same time, given identical economic benefits to a member of his family, who also escapes estate taxation, should justify remedial legislation.<sup>32</sup>

The Third Circuit has recognized that the *actual* consideration test applied in that court is substantially different from the so-called *inferred* consideration test. It has suggested that the situation could be cured by legislation which would treat these transfers as a single joint transaction and thereby regard each of the settlors as a pro tanto transferor of the res over which he has control.<sup>33</sup> It is submitted that this statutory solution would be an equitable one in that the inherent nature of the normal family relationship is one of interdependence and concert of action.<sup>34</sup>

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### Gift and Inheritance Taxation of Community Property by Common Law States

Generally, when a transfer of property occurs by gift or upon the death of an individual, its taxability depends upon the policy within the taxing jurisdiction and upon the extent of the interest transferred. Granting that the problem of determining the extent of the interest transferred is often a difficult one, it becomes more complex when community property is transferred by a husband to his wife due to the prior interest of the wife which must be taken into account. It is a novel situation when this problem arises within a common law jurisdiction, and several recent decisions merit analysis.

The problem, as it relates to gift taxation, recently confronted the Virginia Supreme Court of Appeals in *Commonwealth v. Terjen*.<sup>1</sup> A

<sup>31</sup> See *Phillips v. Gnichtel*, 27 F. 2d 662 (3d Cir. 1928), *cert. denied* 278 U. S. 636 (1929), where the taxpayer argued that reciprocal trusts which were in contemplation of death should be treated as a bona fide sale. See also *Estate of Scholler v. Commissioner*, 44 B. T. A. 235 (1940).

<sup>32</sup> See Technical Changes Act of 1949, 63 STAT. 893 § 6 (1949), where Congress impliedly approved the "judicial fiction" of the *Lehman* case by allowing, for a limited time, a tax free rescission of reciprocal trusts.

<sup>33</sup> *Newberry's Estate v. Commissioner*, 201 F. 2d 874, 878 (3d Cir. 1953). It would seem that the legislation would be more equitable if it established a conclusive presumption of consideration when the trusts with crossed powers are created by members of one family within two years of each other. If the second trust is established more than two years after the first, the commissioner should be required to prove that each trust was in consideration of the other. Thus, the taxpayers would have a certain amount of freedom in disposing of their property.

<sup>34</sup> See in general Notes, 42 CALIF. L. REV. 151 (1954) and 38 A. L. R. 2d 522 (1954).

<sup>1</sup> — Va. —, 90 S. E. 2d 801 (1956).