

6-1-1997

Taxing Reciprocal Trusts: Charting a Doctrine's Fall from Grace

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Recommended Citation

Elena Marty-Nelson, *Taxing Reciprocal Trusts: Charting a Doctrine's Fall from Grace*, 75 N.C. L. REV. 1781 (1997).Available at: <http://scholarship.law.unc.edu/nclr/vol75/iss5/4>

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TAXING RECIPROCAL TRUSTS: CHARTING A DOCTRINE'S FALL FROM GRACE

ELENA MARTY-NELSON*

No area of tax law more vividly illustrates the dichotomy between substance and form than the reciprocal trust doctrine. When settlors began creating "crossed trusts" to evade estate tax liability, the Internal Revenue Service obtained Supreme Court precedent in United States v. Estate of Grace allowing it to tax the "economic reality" of such trusts. But subsequent cases have cast aspersion on this "substance-over-form" rationale, which becomes even more problematic when extended to income and gift taxation of such trusts. In this Article, Professor Marty-Nelson revitalizes Grace, urging that courts refrain from further dismantling a doctrine that serves useful purposes even outside tax law.

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I. INTRODUCTION

The Internal Revenue Service (the "Service") has long maintained that it is entitled to strip away the legal "form" of a transaction in order to reveal the transaction's "substance" for pur-

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poses of calculating the proper tax.¹ As the Supreme Court observed in the context of a tax-free corporate reorganization, to allow form to govern taxability would "exalt artifice above reality" and thwart the intended purpose of statutory provisions.² This lofty endorsement notwithstanding, the Service's cherished "substance-over-form" view has, in litigation, achieved no better than mixed success depending on the particular corollary principle (such as "step transaction,"³ "sham transaction,"⁴ "business purpose,"⁵ and "implied agreement"⁶)

1. See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). The author is well aware of the current controversy surrounding the appropriateness of the use of any type of purposive approach, including the application of anti-abuse rules such as substance-over-form, in statutory interpretation. Justice Scalia's textualist approach to statutory interpretation is credited as a catalyst for this debate. See Bradley C. Karkkainen, "Plain Meaning": Justice Scalia's Jurisprudence of Strict Statutory Construction, 17 HARV. J.L. & PUB. POL'Y 401, 401-02 (1994). The discussion also has permeated the tax literature. See, e.g., Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445 *passim* (1993); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1 *passim* (1993). Professor Daniel Halperin recently described the reasoning of the two tax camps on this issue. See Daniel Halperin, *Compendium on Anti-Abuse Rules, Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW. 807 (1995). In one camp, Professor Halperin notes, are those who insist that "taxpayers are entitled to take the benefit of unintentional . . . glitches in the law . . . until the government somehow stops them." *Id.* at 807 (quoting Lee A. Sheppard, *Partnership Antiabuse Rule: Dirty Minds Meet Mrs. Gregory*, 64 TAX NOTES, July 18, 1994, at 295, 296). In the other camp, according to Professor Halperin, are those who believe "that a purposive approach is required if we are to maintain confidence in the equitable implementation of the tax law and avoid the idea that it is all just a game which is to be won by the most clever and the best advised." *Id.* Professor Halperin sides with the latter view. See *id.*

This Article is confined to an examination of the reciprocal trust doctrine, a corollary principle to the "anti-abuse" substance-over-form rule. In examining the reciprocal trust doctrine, the Article does not address the arguments against application of judicial or regulatory anti-abuse rules. Rather, an underlying premise of the Article is that purposive analysis, including application of anti-abuse rules, is necessary for proper administration of the tax laws.

2. *Gregory*, 293 U.S. at 470.

3. Under the "step transaction" doctrine, each step in the transaction is collapsed into one transaction, consequently ensuring that the substance of the transaction controls over its form. See Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153, 187 n.235 (1995). For an interesting article comparing the use of the step transaction doctrine for tax purposes in the United States and the United Kingdom, see Karen B. Brown, *Applying Circular Reasoning to Linear Transactions: Substance over Form Theory in U.S. and U.K. Tax Law*, 15 HASTINGS INT'L & COMP. L. REV. 169 (1992).

4. "Sham transaction" has been defined by the Tax Court as "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985). For an article criticizing the lack of analysis utilized by certain courts applying the sham transaction doctrine, see Karen Nelson Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659 (1989).

subject to review.⁷ This Article focuses on the struggle for judicial acceptance of yet another variant on the "substance-over-form" principle—the reciprocal trust doctrine.

The reciprocal trust doctrine, which reached its high-water mark in the landmark Supreme Court case of *United States v. Estate of Grace*,⁸ represents the Service's effort to ensure that when two crossed⁹ trusts¹⁰ are simultaneously created, the tax consequences re-

5. The "business purpose" doctrine is used by the courts to determine whether the transaction entered into had a purpose other than obtaining tax benefits. See *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985).

6. Courts have used the "implied agreement" doctrine where the form would not cause taxation, but an "understanding, express or implied" among the parties suggests that the taxpayer should be taxed. See, e.g., *Estate of Paxton v. Commissioner*, 86 T.C. 785, 808-14 (1986).

7. The substance-over-form doctrine's success in recharacterizing transactions is also somewhat dependent on which party, the Service or the taxpayer, is asserting the doctrine. The Service is typically more successful in asserting it than the taxpayer because courts have reasoned that the taxpayer chose his form and thus should not subsequently be allowed to disavow it. See Michael E. Baillif, *The Return Consistency Rule: A Proposal for Resolving the Substance-Form Debate*, 48 TAX LAW. 289, 289 (1995). For a listing of areas of the tax law affected by the substance-over-form doctrine, see 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 4.3.3 (2d ed. 1989). This Article is limited to an examination of the reciprocal trust doctrine, a corollary to the common-law substance-over-form anti-abuse rule. There are also specific anti-abuse rules in the Code and regulatory anti-abuse rules. For example, § 482 of the Code provides that:

[i]n any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the [Service] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations . . . if [it] determines that such distribution . . . is necessary in order to prevent evasion of taxes.

I.R.C. § 482 (1994). Similarly, § 1.701-2 of the regulations permit the Service to recast partnership transactions that make inappropriate use of subchapter K. See *Treas. Reg. § 1.701-2(a)* (1996). Both of those rules have been the subject of various articles and commentaries. See, e.g., Halperin, *supra* note 1, at 812-14.

8. 395 U.S. 316 (1969).

9. For a discussion of when trusts are deemed to be crossed, see *infra* text preceding note 34. Although the trusts need not be mirror images of one another, they must be "interrelated." See *Grace*, 395 U.S. at 322.

10. The *Restatement (Second) of Trusts* defines a trust as a "fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person." *RESTATEMENT (SECOND) OF TRUSTS* § 2 (1959). The Restatement provides that where "the term 'trust' is used without any qualifying adjective it denotes a . . . [private] express trust." *Id.* § 2 cmt. a. Generally, a private express trust is a private trust that does not qualify as a private charitable trust. See *id.* In addition to express trusts, there are also constructive trusts and resulting trusts. For a detailed discussion of constructive and resulting trusts, see V-VA AUSTIN WAKELAND SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS*, §§ 461-552 and §§ 404-60, respectively, (4th ed. 1987). This Article is limited to

flect the "economic reality" of the situation and not the artificial effects of the nominally created trust arrangements.¹¹ Prior to *Grace*, in a prototypical crossed-trust arrangement, taxpayer A, in order to shelter some of his assets from estate tax liability, placed those assets in a trust for which he named B, his spouse, as the beneficiary. Simultaneously, an identical trust was funded with B's assets, naming A as the beneficiary. In addressing these and like arrangements, the *Grace* Court held that the reciprocal trust doctrine should apply to "uncross" the trusts (and to "return" the assets to their respective estates for purposes of estate tax liability) when two conditions are met: (1) the trusts are "interrelated," and (2) "the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."¹²

The *Grace* test has since been criticized.¹³ The first prong of the test suffers from an insurmountable vagueness: *Grace* offers little guidance on how to determine when two trusts are "interrelated"—an oversight that makes the test hard for courts to apply and easy for creative taxpayers to evade.¹⁴ The second prong of the test fares little better. Post-*Grace* interpretations have read the "mutual benefit" requirement so narrowly as to render it virtually inapplicable to all but the precise facts of the *Grace* decision.¹⁵ A prime example of this phenomenon, the Sixth Circuit's decision in *Estate of Green v. United States*,¹⁶ restores full license to reciprocal trusts—so long as the settlor/taxpayer's retained economic interest is anything other than the benefit specifically disallowed by *Grace*.¹⁷

Since the majority of the cases dealing with crossed trusts in-

exploring private express trusts.

As developed below, the doctrine could apply even if the arrangement was less than a formal trust. See *Exchange Bank & Trust Co. v. United States*, 694 F.2d 1261, 1267 (Fed. Cir. 1982) (applying the reciprocal trust doctrine to uncross a custodial arrangement under the Uniform Gifts to Minors Act).

11. See *Grace*, 395 U.S. at 320-21.

12. *Id.* at 324.

13. See, e.g., *Bischoff v. Commissioner*, 69 T.C. 32, 45-46 (1977); cf. *Exchange Bank*, 694 F.2d at 1268 (refusing to accept the taxpayer's literal reading of the *Grace* decision because the Supreme Court did not intend to close one loophole while leaving open a related one).

14. See *infra* text accompanying notes 66-91.

15. See, e.g., *Estate of Green v. United States*, 68 F.3d 151, 156 (6th Cir. 1995); Jonathan G. Blattmachar & Georgiana J. Slade, *Partial Interests—GRATs, GRUTs, and QPRTs*, 836-1st Tax Mgmt. (BNA), at A-1, A-19 to A-20 (1995); see also *infra* text accompanying notes 34-65 (discussing *Grace* and its weaknesses).

16. 68 F.3d 151 (6th Cir. 1995).

17. See *id.* at 154.

volve attempts to avoid estate tax inclusion of transferred assets,¹⁸ Part II explores in detail the estate tax implications of the reciprocal trust doctrine.¹⁹ This portion of the Article examines how, since *Grace*, several significant decisions apparently allow crossed trusts to flout the estate tax system once again. Crossed trusts also can be used to avoid certain federal income and gift tax rules.²⁰ Part III examines the reciprocal trust doctrine's role when crossed trusts are used to avoid the grantor trust rules²¹ for income tax purposes,²² an area in which application of the doctrine is particularly problematic in light of Congress's near dominance of the grantor trust rules and courts' hesitancy to vary the intricate legislative scheme. Part IV of the Article analyzes the use of crossed trusts to skirt the federal gift tax,²³ with particular attention devoted to efforts to use crossed trusts to stretch the annual \$10,000-per-donee gift tax exclusion.²⁴

Part V of the Article offers a fuller explanation of the demise of the reciprocal trust doctrine and discusses a variety of policy concerns raised by the doctrine's collapse.²⁵ The Article concludes that a revitalization of the substance-over-form doctrine in this area, via a more liberal application of the reciprocal trust doctrine, would better advance the proper application of the tax laws.

II. CROSSED TRUSTS TO AVOID ESTATE TAX INCLUSION

When a grantor establishes a trust and retains no interest (beneficial or otherwise) in the trust assets, she generally has removed those assets from her gross estate for federal tax purposes.²⁶

18. See, e.g., *United States v. Estate of Grace*, 395 U.S. 316 (1969); *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940).

19. See *infra* notes 26-133 and accompanying text.

20. See *infra* notes 134-220 and accompanying text.

21. Sections 673 through 679 of the Internal Revenue Code (the "Code") contain the rules for determining when a trust is a "grantor trust" subjecting the grantor to tax liability. Unless otherwise noted, all references to sections herein are to the Internal Revenue Code of 1986, as amended.

22. See *infra* notes 134-66 and accompanying text.

23. See *infra* notes 167-220 and accompanying text.

24. Section 2503(b) provides that "[i]n the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first \$10,000 of such gifts to such person shall not, for purposes of subsection (a) [regarding taxation of gifts], be included in the total amount of gifts made during such year." I.R.C. § 2503(b) (1994). The annual exclusion is \$20,000 if the donor spouse and the non-donor spouse consent. See Treas. Reg. § 25.2513-1 (1996).

25. See *infra* notes 221-50 and accompanying text.

26. See Joseph M. Dodge, *Transfers with Retained Interests and Powers*, 50-5th Tax Mgmt. (BNA), at A-1, A-2 (1992).

Put another way, if a grantor of a trust transfers assets during her lifetime to an irrevocable trust managed by a third-party trustee for the benefit of others with no strings attached, the transferred assets are not included in the grantor's estate for estate tax purposes at the time of death.²⁷

Where, however, the grantor retains certain prohibited interests, controls, or powers over the transferred assets, the ostensibly transferred assets are included in the grantor's estate for estate tax purposes.²⁸ Sections 2036, 2037, and 2038 of the Internal Revenue Code (the "Code")—referred to as the "retained interests and powers sections"²⁹—set forth the types of "strings" that could require an irrevocable lifetime transfer to be includible in the transferor's estate.³⁰

The majority of estate tax cases addressing crossed trusts involve application of § 2036, which provides in pertinent part:

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . , by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death . . . -

- (1) the possession or enjoyment of, or the right to the income from, the property, or
- (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or

27. See *id.* There could, of course, be a gift tax due on the transfer. The gift tax could be ameliorated or eliminated, however, by virtue of the unlimited marital deduction, any remaining unified credit, or even by the annual exclusion for any present interest under the \$10,000 annual exclusion amounts. See generally I.R.C. § 2523 (providing for unlimited marital deduction); *id.* § 2501 (describing the gift tax); *id.* § 2503 (setting forth \$10,000 annual exclusion); *id.* § 2010 (setting forth the estate tax credit).

Section 2035, which includes transfers within three years of death, is not implicated in these cases. See *id.* § 2035. Generally, § 2035 includes in the estate transfers made within three years of death if those interests would have been included in the decedent's gross estate under §§ 2036, 2037, or 2038. See *id.* § 2035. For a thorough discussion of the effects of § 2035, see generally Peter S. Cremer, *The 1981 Act and Section 2035: Problems and Possibilities*, 35 TAX LAW. 389 (1982).

28. See generally RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶¶ 4.08-10 (Warren, Gorham & Lamont ed., 6th ed. 1991) (discussing §§ 2036, 2037 and 2038).

29. Dodge, *supra* note 26, at A-3.

30. See Dennis I. Belcher & James D. Bridgeman, *Defective May Be More Effective: The Tax Advantages of Intentional Grantor Trusts*, PROBS. & PROP., Mar.-Apr. 1993, at 24, 25.

enjoy the property or the income therefrom.³¹

Section 2036(a)(1) essentially pulls back into a transferor's gross estate property he transferred into a trust during his lifetime to the extent he retains possession, enjoyment, or the right to income from the property. In operation, § 2036(a)(1) requires, for example, inclusion of assets in the grantor/decedent's estate when a grantor transfers assets to an irrevocable trust for the benefit of his lineal descendants but retains a life estate for himself. In such a case, the value of the entire trust—not just the value of the retained life income—must be included in the estate of the grantor/decedent for estate tax purposes.³² Section 2036(a)(2), by contrast, governs situations in which the grantor/decedent—while not retaining an income interest—continues to have a measure of control over the property.³³

A crossed trust occurs when a grantor receives a life income interest not from a trust that he has created (which would make it subject to § 2036(a)(1)), but from a trust created by another grantor (often a spouse or other close relative). The designation "crossed trust" derives from the first trust's life income beneficiary's simultaneous creation of an identical trust that provides the first trust's grantor with a life income interest of a like amount. The amount transferred by the grantor to the crossed trust is not pulled back into his estate as a matter of course by § 2036(a)(1), because the grantor did not retain an income interest in the assets that he himself transferred. Indeed, the grantor in the crossed trust situation appears at first blush to have neatly sidestepped § 2036(a)(1) because the income in his trust goes not to himself but to another (i.e., the relative) and, in turn, the life interest he receives is from a source (i.e., the relative's trust) other than a trust he set up.

The facts in the seminal case on reciprocal trusts, *United States v. Estate of Grace*,³⁴ essentially involved such an arrangement. The settlors of two crossed trusts in *Grace* were husband and wife.³⁵ The trusts, executed a mere two weeks apart, contained nearly identical

31. I.R.C. § 2036.

32. *See id.* § 2036(a)(1).

33. *See id.* § 2036(a)(2). Along the same lines, § 2037 applies to haul transferred property back into a decedent's gross estate if the decedent/transferor retained a reversionary interest valued at more than five percent. *See id.* § 2037(a). In addition, § 2038 applies to increase the gross estate when the decedent retained the power to reshuffle beneficial interests created by the transfer even when he himself has no beneficial interest. *See id.* § 2038(a).

34. 395 U.S. 316 (1969).

35. *See id.* at 318.

terms.³⁶ The husband's trust named the wife as the income beneficiary, and the wife's trust named the husband as the income beneficiary.³⁷ As described above, if each trust had named its own settlor as the life beneficiary, the trust assets clearly would have been includible in the estate of the respective settlor under the language of the predecessor of § 2036(a)(1) then in effect, since each trust settlor would have "retained" an "income" interest from the transferred assets.³⁸ The issue in *Grace* was whether the government could utilize the reciprocal trust doctrine to "uncross" the trusts and include the value of the trust set up by the wife in the husband's estate.³⁹

The Supreme Court granted certiorari in *Grace*, in part because of a purported "conflict" in the lower courts involving proper application of the reciprocal trust doctrine.⁴⁰ The conflict derived from a pre-*Grace* formulation developed in *Lehman v. Commissioner*,⁴¹ in which the Second Circuit determined that trusts should be uncrossed only upon a showing by the Service of a specific quid pro quo—i.e., that the trusts were made "in consideration" for each other.⁴² Circuit courts after *Lehman*, however, disagreed on just how the quid pro quo showing could be met. Under one line of cases, quid pro quo was purely a question of the subjective intent of the parties: did each party intend for the two trusts to be set up "in consideration" for each other?⁴³ The evidentiary inquiry generally was not permitted to

36. *See id.* at 319.

37. *See id.*

38. *See id.* at 320.

39. *See id.* at 317.

40. *See id.* at 318. The Court also granted certiorari because of "the importance of the issue presented to the administration of the federal estate tax laws." *Id.*

41. 109 F.2d 99 (2d Cir. 1940). In *Lehman*, two brothers had simultaneously created trusts for the benefit of each other for life, with remainders to the other brother's issue. *See id.* at 100. Moreover, each trust allowed the beneficiary brother to withdraw \$150,000 from the trust corpus. *See id.* The *Lehman* court acknowledged that had each brother simply retained the right to withdraw the \$150,000 from his own trust, the settlor's estate would have been taxable to the extent of the withdrawal power under the predecessor of § 2038. *See id.* Under § 302(d) of the Revenue Act of 1926, the gross estate of a decedent for purposes of estate tax included property "[t]o the extent of any interest therein of which the decedent has at any time made a transfer by trust or otherwise where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power either by the decedent alone or in conjunction with any person . . ." Revenue Act of 1926, Pub. L. No. 69-20, § 302(d), 44 Stat. 9, 71 (codified as amended at 26 U.S.C. § 811 (1939)). The court "uncrossed" the trusts after determining that the trusts had each been created in "consideration" for the other. *See Lehman*, 109 F.2d at 100.

42. *See Lehman*, 109 F.2d at 100.

43. *See, e.g., Estate of Moreno v. Commissioner*, 28 T.C. 889, 891-92 (1957).

extend far beyond the parties' own testimony on the point.⁴⁴ The other line of cases, which might be referred to as exemplifying the "collateral evidence" analysis, allowed the government greater latitude to use objective factors such as simultaneity in the execution of the trusts, substantial similarity of terms, and the use of the same attorney to draft both trust instruments, to establish a quid pro quo.⁴⁵ Considering that the "conflict" among the circuits appeared in reality to amount to little more than a disagreement over the appropriate weight to give circumstantial evidence of an individual's mental state (in this case, intent), the assertion that the grant of certiorari in *Grace* was, in part, to resolve a conflict is in retrospect a bit curious.

Grace provided the Supreme Court with the opportunity to address more serious flaws in the *Lehman* quid pro quo formulation. In *Grace*, the husband had been a very wealthy man at the time of his marriage.⁴⁶ His wife, however, entered the marriage with no assets of her own.⁴⁷ Over the course of the marriage, the husband transferred substantial assets to his wife's name.⁴⁸ The husband, however, always controlled the family fortune and managed the financial affairs.⁴⁹ The husband also was the driving force behind the reciprocal trust arrangement in question, and entered into the arrangement as part of an overall tax planning strategy.⁵⁰

The lower court in *Grace* considered the circumstances surrounding the establishment of the two trusts under both the "subjective intent" and the "collateral evidence" analyses before satisfying itself that no quid pro quo had existed.⁵¹ Under a subjective intent analysis, the court found no proof that the wife executed her trust for her husband solely "in consideration" of his executing a like trust for her.⁵² Rather, the court determined that the wife executed her trust simply because her husband asked her to do so.⁵³ Under the collateral evidence analysis, by employing extraneous

44. In *Estate of Carter v. Commissioner*, 31 T.C. 1148 (1959), the court explained that the parties had relied completely on the testimony of the decedent's son-in-law to demonstrate the alleged lack of consideration on the part of the grantor. *See id.* at 1152.

45. *See, e.g., Orvis v. Higgins*, 180 F.2d 537, 540 (2d Cir. 1950).

46. *See United States v. Estate of Grace*, 395 U.S. 316, 318 (1969).

47. *See id.*

48. *See id.*

49. *See id.*

50. *See id.* at 319.

51. *See id.* at 321-22.

52. *See id.* at 322.

53. *See id.* at 324 n.9.

objective factors, the court came to the same conclusion.⁵⁴ The court reasoned that the collateral evidence approach provided only a rebuttable presumption of a quid pro quo.⁵⁵ Accordingly, while objective factors help to determine subjective intent, they would not be used to vitiate a clear finding to the contrary.⁵⁶ Thus, although the timing of the trusts and the identity of the terms and advisors suggested the possibility of a quid pro quo, the court found that the evidence that the wife was not motivated by a quid pro quo carried the day.⁵⁷

Justice Marshall, writing for the Supreme Court, declined to use either the pure subjective intent or the collateral evidence analysis.⁵⁸ The Court reasoned that “[e]mphasis on the subjective intent of the parties in creating the trusts, particularly when those parties are members of the same family unit, creates substantial obstacles to the proper application of the federal estate tax laws.”⁵⁹ Quoting from its prior decision in *Estate of Spiegel v. Commissioner*,⁶⁰ the *Grace* Court noted that “‘taxability of a trust corpus . . . does not hinge on a settlor’s motives, but depends on the nature and operative effect of the trust transfer.’”⁶¹

In addition, the Court noted that the search for consideration was particularly vulnerable to abuse in the context of reciprocal trusts: “[I]t is unrealistic to assume that the settlors of the trusts, usually members of one family unit, will have created their trusts as a bargained-for exchange for the other trust. ‘Consideration,’ in the traditional legal sense, simply does not normally enter into such intrafamily transfers.”⁶² Thus, the Court held that application of the reciprocal trust doctrine is “not dependent upon a finding that each

54. *See id.* at 322.

55. *See id.*

56. *See id.*

57. *See id.*

58. *See id.* at 324.

59. *Id.* at 323. Professor Stephen Cohen of Georgetown recently wrote an essay analyzing various tax opinions written by Justice Thurgood Marshall. *See* Stephen B. Cohen, *Thurgood Marshall: Tax Lawyer*, 80 GEO. L.J. 2011 (1992). Professor Cohen concluded that Justice Marshall wrote some of the most influential and well-reasoned recent opinions in the tax area. *See id.* at 2040. Although *Grace* is not discussed in Professor Cohen’s essay, and is criticized slightly in this Article, *Grace* also is a daring and brilliant decision in that it demonstrates Justice Marshall’s skepticism regarding courts’ use of the taxpayer’s motive in determining taxation, a quality noted by Professor Cohen with respect to some of Justice Marshall’s other opinions. *See id.* at 2012.

60. 335 U.S. 701 (1949).

61. *Grace*, 395 U.S. at 323 (quoting *Spiegel*, 335 U.S. at 705).

62. *Id.* at 324.

trust was created as a quid pro quo for the other" because such a requirement necessarily involves "a difficult inquiry into the subjective intent of the settlors."⁶³ The *Grace* Court set forth its new, now infamous formulation of the reciprocal trust doctrine: "[A]pplication of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."⁶⁴

This formulation, intended to supplant subjective inquiry with a purportedly "objective" test, has proven as unworkable as its predecessor, and has been criticized and sidestepped by courts in subsequent decisions.⁶⁵ The *Grace* Court's point is well taken that, in a family setting, the notion of "consideration" as a yardstick for application of the reciprocal trust doctrine is essentially anomalous and irrelevant. However, the proffered replacement test suffers from as many, if not more, defects as the *Lehman* formulation it attempted to improve.

A. Weakness of the "Interrelatedness" Test

The "interrelatedness" test purportedly is designed to be objective, but its conclusory application in *Grace* provides little guidance for subsequent cases. The *Grace* Court concluded curtly that under the facts, it was "undisputed that the two trusts are interrelated. They are substantially identical in terms and were created at approximately the same time."⁶⁶ No further elucidation of the test was provided,⁶⁷ and the elastic categories of "substantially identical" and

63. *Id.*

64. *Id.* It was widely believed at the time that the Supreme Court's 1969 decision in *Grace* would be the death knell for the use of reciprocal trusts to avoid taxation. See, e.g., C. Earl Ledden, *Recent Decisions*, 21 SYRACUSE L. REV. 357, 365 (1969) ("[O]ne may reasonably conclude that the reciprocal trust is no longer a viable device for intended or incidental tax savings."). Interestingly, the same was said about *Lehman*, the previous major decision involving crossed trusts. See Howard O. Colgan, Jr. & Robert T. Molloy, *Converse Trusts—The Rise and Fall of a Tax Avoidance Device*, 3 TAX L. REV. 271, 273 (1947-48).

65. See *Estate of Green v. United States*, 68 F.3d 151, 155-56 (6th Cir. 1995); *Estate of Levy v. Commissioner*, 46 T.C.M. (CCH) 910, 912-14 (1983).

66. *Grace*, 395 U.S. at 325.

67. Even more troubling perhaps is that the Court included a footnote that seemed to reinsert "consideration" into the mix:

We do not mean to say that the existence of "consideration," in the traditional legal sense of a bargained for exchange, can ever [sic] be relevant. In certain cases, inquiries into the settlor's reasons for creating the trusts may be helpful in

"approximately the same time" seem poorly crafted to bring certainty and precision to the area.

Not surprisingly, the vague notion of "interrelatedness" has since induced taxpayers to push the envelope with a variety of techniques: executing the two crossed trusts several weeks or months apart; varying several terms of arguable significance in the trusts; or using two different attorneys to draft the trust instruments.⁶⁸ The Tax Court has provided taxpayers with at least tacit support for such attempts. In *Estate of Levy v. Commissioner*,⁶⁹ the Service argued unsuccessfully that under the reciprocal trust doctrine, the value of a trust created by the decedent's wife for his benefit was included in the decedent's estate, in light of a similar trust created by the decedent for the benefit of his wife.⁷⁰ Like *Grace*, *Levy* involved trusts created by a husband and wife.⁷¹ The *Levy* trusts were created on the same date and by the same attorneys, involved equivalent trust corpora (an identical number of shares of corporate stock), and named the same residuary beneficiary (the couple's son).⁷² In addition, the wife was named the trustee of the husband's trust and the husband was named trustee of the wife's trust.⁷³ The Tax Court concluded that the trusts were not interrelated and refused to uncross them.⁷⁴

In finding that the trusts were not interrelated, the Tax Court focused on a single term of the husband's trust that was not contained in the wife's trust.⁷⁵ The husband's trust granted the wife an inter vivos special power of appointment in the trust income and corpus.⁷⁶ No corresponding power of appointment was granted to the husband by the wife's trust.⁷⁷ The court reasoned that as a result of the special power of appointment only in the wife, the parties had "markedly different interests in, and control over, the trusts created

establishing the requisite link between the two trusts. We only hold that a finding of a bargained-for consideration is not necessary to establish reciprocity.

Id. at 324 n.10.

68. These techniques were also available to avoid the rule in *Lehman*. See Colgan & Molloy, *supra* note 64, at 296-97.

69. 46 T.C.M. (CCH) 910 (1983).

70. See *id.* at 911.

71. See *id.* at 910.

72. See *id.*

73. See *id.* at 911.

74. See *id.* at 914.

75. See *id.* at 911, 914.

76. See *id.* at 911. The power allowed the wife to appoint the income or the corpus to any person or persons other than herself, her creditors, her estate, or the creditors of her estate. See *id.*

77. See *id.*

by each other.”⁷⁸

Interestingly, the Service in *Levy* conceded that if the special power of appointment had been a valid power, its inclusion in only one of the trusts would have prevented the two trusts from being interrelated.⁷⁹ The Service’s position, however, was that the power granted to the wife was “subjectively worthless because [the wife] was not likely to exercise her power of appointment . . . to appoint to anyone other than her son.”⁸⁰ Thus, according to the Service, that term did not warrant distinguishing the two trusts.⁸¹ The *Levy* court declined to venture into the subjective intent quagmire. Citing the *Grace* Court’s rejection of subjective intent in the crossed trust area, the Tax Court ruled that taxability does not hinge on a settlor’s motives, and that “[t]he subjective likelihood of [the wife] exercising her power of appointment, whether due to her age, her love for her husband, or some other motive, is completely irrelevant.”⁸² The *Levy* court did not have to determine, however, if an “objectively worthless” power would justify ignoring the power for purposes of the reciprocal trust doctrine.⁸³ Rather, the court noted that the power in question had “objective” value.⁸⁴

Professor Joseph Dodge suggests that *Levy* “might be taken to mean that a slight difference in the dispositive terms of the two trusts is enough to avoid the reciprocal trust doctrine.”⁸⁵ Professor Dodge’s admonition regarding *Levy* has proven prophetic, and the implications of the decision have not been lost on the bar. Recently, a practitioner advised that “[w]hen drafting trusts in [the mutual trust] situation, the drafter should be sensitive to [the reciprocal trust] rule and vary the terms of the two trusts to the extent necessary to avoid an argument by the Internal Revenue Service that the trusts are re-

78. *Id.* at 912.

79. *See id.*

80. *Id.* at 913.

81. *See id.* First, the Service challenged the validity of the special power of appointment under the local state law. *See id.* The court analyzed the applicable local law and disagreed with the Service’s interpretation of it. *See id.* The court reasoned that when the New Jersey trustee is given power to appoint to an infinite class other than himself, the appointment is made in the discretion of the trustee. *See id.*

82. *Id.*

83. *See id.* at 914.

84. *See id.* at 913.

85. Dodge, *supra* note 26, at A-60. Professor Dodge qualifies this observation, however, by noting that the Tax Court in *Levy* emphasized the “value and significance of the power of appointment.” *Id.*

ciprocal.”⁸⁶

Other practitioners have recently observed that if a husband and wife yearn to settle personal residence trusts for each other, “and both wish to have interests in each other’s trust after the retained term, it may be possible for the practitioner to draft the trust instruments so that they will not be found to be ‘interrelated.’”⁸⁷ Citing *Levy*, these practitioners note that the Tax Court has already determined that a special power of appointment in one trust “was a significantly different interest in the property, causing the trusts not to be interrelated.”⁸⁸ The authors suggest that “[to] make a finding that the personal residence trusts are interrelated less likely, the practitioner also could vary the interests in and control over the personal residence trusts.”⁸⁹ The following illustrations are provided:

For example, one trust could give the nongrantor spouse an unrestricted discretionary interest in income and/or principal after the retained term In addition, one trust could have beneficiaries in addition to the spouse, with all interests subject to the exercise of a third-party trustee’s discretion to allocate benefits under the trust. Moreover, each trust could have a different trustee, but this difference alone probably will not prevent a finding of interrelationship. Finally, if the trusts are not created simultaneously, they are less likely to be found to be interrelated.⁹⁰

The interrelatedness test, which seemed at the time of its pronouncement to invite taxpayer challenges, has not disappointed in this regard. Challenges have been frequent and successful.⁹¹

B. *Narrow Interpretation of Mutual Economic Value*

The second prong of the reciprocal trust doctrine, the requirement of a mutual economic value, has proven at least as problematic as the interrelatedness test. The *Grace* Court explained the “mutual economic value” requirement as leaving the taxpayers in the same position as if they had “created trusts naming themselves as life

86. Leonard Wertheimer, III, *Superior Estate Planning Documents: Going the Extra Mile*, 56 ALA. LAW. 150, 154 (1995).

87. Blattmachar & Slade, *supra* note 15, at A-19.

88. *Id.*

89. *Id.*

90. *Id.* at A-19 to A-20.

91. See *Estate of Levy v. Commissioner*, 46 T.C.M. (CCH) 910, 911-14 (1983); Dodge, *supra* note 26, at A-60.

beneficiaries.”⁹² Read literally, the doctrine would seem to track only the prohibition of § 2036(a)(1) (retained income interests) and leave taxpayers free to use crossed trusts to circumvent § 2036(a)(2) (retained powers).

This anomalous result was rejected by the Tax Court in *Estate of Bischoff v. Commissioner*,⁹³ in which the Tax Court applied the reciprocal trust doctrine to uncross trusts where taxability hinged on § 2036(a)(2).⁹⁴ In *Bischoff*, a husband and wife each created irrevocable trusts for the benefit of their four grandchildren.⁹⁵ The trusts’ terms were identical except that the husband was named trustee of the wife’s trusts and the wife was named trustee of the husband’s trusts.⁹⁶ The trustees in each case were granted the power to “apply income and principal for the benefit of the beneficiary and to accumulate income not so applied.”⁹⁷ As in *Grace*, if the grantors of the mutual trusts simply retained the rights given to the other grantor, there would have been no question that the corpora of the trusts would be includible in the grantor/decedent’s gross estate under § 2036(a) (albeit, in this case under § 2036(a)(2) dealing with retained powers, rather than under (a)(1) which deals with retained income).⁹⁸ The question in *Bischoff* was whether the trusts would be uncrossed so as to cause inclusion under § 2036(a)(2).⁹⁹

The Tax Court in *Bischoff* struggled with the awkward language in *Grace* and reasoned that “[w]e simply are not convinced that the Supreme Court intended to close a perceived loophole under section 2036(a)(1) and, at the same time, permit one to flourish under section[] 2036(a)(2).”¹⁰⁰ The Tax Court explained that the purpose of the reciprocal trust doctrine is “merely to identify the transferor of property” where the trusts are interrelated, and that the mutual eco-

92. *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969).

93. 69 T.C. 32 (1977).

94. *See id.* at 42-50.

95. *See id.* at 37.

96. *See id.*

97. *Id.*

98. The applicable provision was § 2036(a)(2) of the 1954 Code. *See* I.R.C. § 2036(a)(2) (1954). The language of § 2036(a)(2) is identical to the language found in the current version of § 2036(a)(2) of the Code. *See* I.R.C. § 2036.

99. *See Bischoff*, 69 T.C. at 32.

100. *Id.* at 47. The court also mentioned that the loophole would allow taxpayers to escape taxation under § 2038(a)(1). *See id.* The version in effect at the time was § 2038(a)(1) of the Internal Revenue Code of 1954. Its language is identical to the current version in § 2038(a)(1) of the Code except for a revision in 1976 which substituted “during the 3-year period ending on the date of the decedent’s death” for “in contemplation of the decedent’s death.” *See* Pub. No. 94-455, 90 Stat. 1520 (1976).

conomic value portion of the analysis is satisfied when there is a basis of taxation of the uncrossed trusts.¹⁰¹ The court reasoned that "the doctrine's application is only part of a two-step process of taxation, i.e., it is not enough merely to 'uncross' the trusts, there must also exist a basis for their taxation."¹⁰² According to the *Bischoff* court, the *Grace* Court's reference to "the 'same economic position . . . as life beneficiaries' was merely its formulation of the basis of taxation on the facts before it."¹⁰³

In a footnote, the Tax Court provided an alternative method for reading the mutual economic value test as applicable in the context of retained powers under § 2036(a)(2).¹⁰⁴ The *Bischoff* court noted that "were the level of 'economic' retention a relevant factor . . . it could not be denied that a power to control the 'purse strings' in many an instance would be just as gratifying as a retained life estate."¹⁰⁵

Interestingly, while avoiding the second prong of the reciprocal trust doctrine has been, for practitioners in the area, as fertile a topic as eluding the "interrelatedness" test, their interpretation of the "mutual economic value" test generally appears to be consistent with the Service's and Tax Court's interpretation in *Bischoff*. Recently, noted tax specialists have reasoned that "[f]or the reciprocal trust doctrine to cause adverse estate tax consequences, there not only must be a finding that the trusts are interrelated, there must also be a finding that the trust property [when uncrossed] is subject to estate tax."¹⁰⁶ These practitioners explain that the only interests that may be safely cross-granted are those such as purely discretionary interests that, even if uncrossed, would not require inclusion under the retained interests and powers provisions of the estate tax laws.¹⁰⁷

101. *Id.* at 46.

102. *Id.*

103. *Id.*

104. *See id.* at 46 n.16.

105. *Id.* (quoting *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969)).

106. Blattmachar & Slade, *supra* note 15, at A-20.

107. *See id.* Conventional wisdom with regard to the estate tax is that a settlor can be included in the class of beneficiaries of a purely discretionary trust without causing the assets to be pulled into his gross estate under § 2036. *See Dodge, supra* note 26, at A-23 to A-24. This holds true as long as there is no implied agreement between the trustee and the settlor requiring the payment of income to the settlor. This outcome relies on interpretations of the terms "retained" and "income" found in § 2036. In essence, the Service and the courts have reasoned that a settlor/beneficiary's stake in a purely discretionary trust is a "mere expectancy" and does not rise to the level of a "retained" right to income. *See id.* The logic behind the exclusionary rule is similar to gift-back theory. An example of a true gift-back illustrates the rationale that the grantor of a discretionary trust has not

Notwithstanding the fundamental logic of the *Bischoff* "basis of taxation" analysis and its apparent acceptance by the practicing bar, the Sixth Circuit, in *Estate of Green v. United States*,¹⁰⁸ soundly rejected *Bischoff* and refused to uncross trusts to cause inclusion under § 2036(a)(2).¹⁰⁹ The *Green* case involved facts very similar to those in *Bischoff*.¹¹⁰ In *Green*, the husband settled a trust for the benefit of one of the couple's granddaughters, naming his wife as trustee.¹¹¹ That same day, the wife settled a trust for the benefit of the couple's other granddaughter, naming her husband as trustee.¹¹² The terms of the trusts, except for the identity of the beneficiaries, were virtually identical.¹¹³ In each trust, the trustee was given the discretion to distribute or accumulate income from the trust until the respective

"retained" the income. For example, assume Sister gives Brother Blackacre. Without any prearrangement, Brother subsequently gives part of the rents or occupancy to Sister. Section 2036 does not apply because there is no "retention" of benefits. What Sister got back was the result of an independent act of another.

This example is an adaptation of one provided by Professor Dodge in his portfolio on retained interests and powers. See *id.* at A-23. A discretionary trust that specifically includes the settlor among the ranks of beneficiaries is distinguishable, however, from a true gift-back where the donor has no knowledge or expectation of a return from his gift. See *id.* By naming himself as a beneficiary, the settlor distances the transaction from the true gift-back situation. Moreover, a self-settled discretionary trust is unlike a true gift-back because in the trust context the party making distributions to the settlor (i.e., the trustee) does so without any personal economic sacrifice. See *id.* Despite these distinctions, however, a self-settled discretionary trust is deemed not to be caught by the actual language of § 2036.

There is, however, a negative side to the interpretation of the settlor/beneficiary's interest in a discretionary trust as only a *mere expectancy*. That is, the settlor's beneficial interest is viewed as something less than an "interest" capable of valuation. See *id.* at A-24. Accordingly, for gift tax purposes, the gift is considered complete as to the entire amount transferred with no reduction for any possible retained benefit or interest by the settlor. See *id.* Moreover, if the trustee of the discretionary trust were, in fact, to make distributions to the settlor/beneficiary, such distributions would be counted in the settlor's gross estate under § 2033 even though the settlor had already paid a gift tax on the transfer and no credit would be given to the settlor for the amount of the tax paid. See *id.* This, of course, would be the same double tax result that would obtain under a true "gift-back." See *id.* For a discussion of how local law creditor access rules could affect this conclusion, see Elena Marty-Nelson, *Taxing Offshore Asset Protection Trusts: Icing on the Cake?*, 15 VA. TAX REV. 399, 427-39 (1996).

108. 68 F.3d 151 (6th Cir. 1995).

109. See *id.* at 153.

110. See *id.* at 151; *supra* notes 95-98 and accompanying text. One difference between the facts of *Green* and *Bischoff* is that the beneficiaries of the *Green* trusts were not identical. This factual distinction, as the dissent in *Green* notes, should not bar application of the *Grace* reciprocal trust doctrine since in *Grace* itself the beneficiaries were not identical. See *Green*, 68 F.3d at 154 (Jones, C.J., dissenting).

111. See *Green*, 68 F.3d at 152.

112. See *id.*

113. See *id.*

beneficiary reached the age of twenty-one.¹¹⁴ As in *Bischoff*, had the settlor named himself as the trustee of his own trust and retained powers to accumulate and distribute income, the corpora of the trusts certainly would have been includible under § 2036(a)(2). The *Green* court determined, however, that “[a]ssuming, arguendo, that contrary to the district court’s conclusion, the trusts in the instant case were interrelated . . . , the reciprocal trust doctrine would nevertheless be inapplicable.”¹¹⁵

According to the majority in *Green*, the reciprocal trust doctrine could not apply in that case for the simple reason “that 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 do[es] not constitute a retained economic benefit that satisfies the core mandate of *Grace*.”¹¹⁶ As articulated by the majority in *Green*, the crux of *Grace* was that “ ‘the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.’ ”¹¹⁷

The majority in *Green* dismissed the Tax Court’s decision in *Bischoff* as a “strained and attenuated interpretation” of the mutual economic value language of *Grace*.¹¹⁸ Without citing any cases, the court in *Green* referred to *Bischoff* as “a decision rejected by every circuit which has considered the application of the reciprocal trust doctrine.”¹¹⁹

This attempt to dispose of *Bischoff* summarily is curious, not only because of the lack of substantiation for the claim regarding *Bischoff*’s universal rejection by appellate courts,¹²⁰ but also because such a curt dismissal fails to address the two arguments in favor of

114. *See id.*

115. *Id.* at 153 n.2. The lower court in *Green* had determined that the trusts were not interrelated even though they were created on the same date, the terms were substantially identical, and the authority vested in each trustee was the same. *See id.* at 152.

116. *Id.* at 154.

117. *Id.* (quoting *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969)).

118. *Id.* at 153.

119. *Id.*

120. No circuit court has explicitly rejected *Bischoff*. Moreover, the Federal Circuit in *Exchange Bank & Trust Co. v. United States*, 694 F.2d 1261 (Fed. Cir. 1982), relied on the *Bischoff* court’s analysis in applying the reciprocal trust doctrine to crossed custodial powers under the Florida Gift to Minors Act. *See id.* at 1267-69. The Federal Circuit Court in *Exchange Bank* expressly stated: “We agree with the majority in *Bischoff* and the appellee in this action that the reciprocal trust doctrine merely identifies the true transferor, but the actual basis for taxation is founded upon specific statutory authority.” *Id.* at 1269.

application of the reciprocal trust doctrine articulated in *Bischoff*. The Tax Court in *Bischoff* reasoned that the power to "control the 'purse strings'" could amount to an economic value that in some cases would be equal to or greater than a retained income interest.¹²¹ The *Bischoff* court's other rationale for application of the reciprocal trust doctrine in the case of crossed powers was that the Supreme Court in *Grace* would not have wanted to close the loophole in § 2036(a)(1), while leaving open the loophole in § 2036(a)(2).¹²²

The majority in *Green* alluded to the economic value argument of retained powers but, without explanation, classified such powers as "non-economic."¹²³ The majority concluded that it would not "extend the reciprocal trust doctrine to include retained *non-economic* discretionary fiduciary powers including powers to reinvest and time distribution of trust income and corpus until the core mandate of retained economic benefits by the settlor/trustee has been satisfied."¹²⁴

The majority's conclusion that the discretionary power to accumulate income is not an economic power ignores the persuasive reasoning of *Bischoff*. As the court in *Bischoff* recognized, Congress has determined that when a grantor retains certain powers (whether technically classified as "economic" or not), the trust assets are includible in the grantor/decedent's estate.¹²⁵ This principle was given life in *Bischoff* under the "basis of taxation" rubric: once trusts are found to be interrelated, they will be uncrossed if there exists a "basis of taxation."¹²⁶ The *Bischoff* court recognized that the basis of taxation could be derived under § 2036(a)(2) as easily as under § 2036(a)(1).¹²⁷ Thus, a power need not be classified as an "economic" power to be the foundation for estate tax inclusion, and the *Green* majority's preoccupation with that issue was misplaced.

The majority in *Green* failed to explain the weaknesses, if any, in the *Bischoff* "basis of taxation" answer to the § 2036(a)(2) loophole. Rather, the majority simply noted that previous cases had not applied the reciprocal trust doctrine to "non-economic" crossed powers.¹²⁸ In a footnote, the *Green* majority asserted that virtually

121. See *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 46 n.16 (1977).

122. See *id.* at 47.

123. See *Green*, 68 F.3d at 154 n.3.

124. *Id.* (emphasis added).

125. See *Bischoff*, 69 T.C. at 46.

126. *Id.*

127. See *id.* at 46-47.

128. See *Green*, 68 F.3d at 154 n.3.

every case applying the reciprocal trust doctrine, other than *Bischoff*, did so under facts where the grantors of the trusts retained what amounted to life interests or " 'substantial economic benefits.' " ¹²⁹

The dissent in *Green* stopped short of embracing the *Bischoff* "basis of taxation" argument. While not insisting on a "substantial economic value," the dissent seemed to require an economic value of some sort. The dissent conceded that "[i]n *Grace*, the Supreme Court concluded that application of the reciprocal trust doctrine was appropriate because the transactions left the parties in the same economic position as they were before the creation of the trusts." ¹³⁰ The dissent noted, however, that "[t]he same has occurred with the Greens." ¹³¹ According to the dissent, the "[p]arties in *Grace* maintained their economic positions through retention of a life estate, where the Greens' [sic] maintained their economic positions through retention of the power to designate whom would enjoy the trust assets." ¹³²

The dissent's interpretation in *Green* of the second prong of the reciprocal trust doctrine, consistent with the *Bischoff* court's approach, restored the primacy of substance in analyzing the transfers. However, the dissent unfortunately left open the question as to what amounts to an "economic" position. The *Bischoff* court's interpretation, by contrast, set the judiciary's role where it belongs. Under the "basis of taxation" theory, it is Congress's role to decide what is taxable, and the court's function in applying the reciprocal trust doctrine is simply to determine the true grantor under the facts of particular trusts.

III. CROSSED TRUSTS TO AVOID THE INCOME TAX GRANTOR TRUST RULES

In the income tax area, much more so than in the estate tax area, Congress has passed legislation to ensure that the substance of a trust arrangement is properly taxed. For example, the grantor trust rules are designed to prevent taxpayers from shifting income to lower tax bracket taxpayers when the grantors do not actually relinquish control of the trust property. ¹³³ Congress determined that the

129. *Id.* at 154 n.1 (quoting *Bischoff*, 69 T.C. at 45).

130. *Id.* at 156 (Jones, J., dissenting) (citing *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969)).

131. *Id.* (Jones, J., dissenting).

132. *Id.* (Jones, J., dissenting).

133. See *Belcher & Bridgeman*, *supra* note 30, at 24.

trust vehicle should be respected for income tax purposes only when the grantor actually parts with dominion and control of the property.¹³⁴

Section 671 is the operative provision of the grantor trust rules set forth in §§ 671 through 679 of the Code.¹³⁵ It provides that when a trust is deemed a grantor trust, the trust is ignored for tax purposes as a separate tax entity and all items of income, deductions, and credits are includible in the grantor's income tax return.¹³⁶ Sections 673 through 679 of the Code contain detailed rules for determining when a trust is a "grantor trust" subjecting the grantor to income tax liability.¹³⁷ Generally, those sections deem a grantor to be the owner of trust assets when: (1) the trust is revocable;¹³⁸ (2) trust income can be used to benefit the grantor;¹³⁹ (3) the grantor enjoys self-serving administrative powers over the trust;¹⁴⁰ (4) the grantor retains the

134. See Robert A. Parr, *Combining Defective Grantor Trusts with Other Types of Trusts*, 21 EST. PLAN. 82, 82 (1994).

135. See I.R.C. §§ 671-79 (1994). The grantor trust rules are set forth in subpart E of Part I of subchapter J of the Code. See *id.* Trusts not covered by the grantor trust rules are governed by subparts A through D of subchapter J. See *id.* §§ 641-68.

136. See Belcher & Bridgeman, *supra* note 30, at 24. If the grantor trust rules do not apply, the income accumulated in the trust is taxed to the trust as the technical owner of the property under the rules of subparts A through D of subchapter J of the Code. See I.R.C. §§ 641-68. It is important to note that not all violations of the grantor trust rules would require the entire trust to be ignored for tax purposes. For example, if the grantor retained only an interest in the income, only the portion of the trust related to income would be affected. See Howard M. Zaritsky, *Grantor Trusts: Sections 671-679*, 2d. Tax Mgmt. Rep. (BNA) No. 452, at A-8 to A-9 (1996).

137. See I.R.C. §§ 673-79. Section 679, applicable to foreign trusts, considers a foreign trust to be a grantor trust if it has a United States beneficiary, even if the grantor retains no control. See *id.* § 679.

138. See *id.* § 676(a). Section 676, entitled "Power to revoke," provides in subsection (a) that

[t]he grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

Id. Subsection (b) provides that the power to revoke will not cause inclusion under the grantor trust rules if such power generally may not be exercised any time before an event that has a five percent or less probability of occurring. See *id.* § 676(b).

139. See *id.* § 677(a). Section 677 applies if the income from the trust may be distributed to, held for the future use of, or used to pay insurance premiums for the benefit of the grantor or the grantor's spouse, unless the power to exercise such income for such uses cannot arise prior to an event that has a five percent or less probability of occurring or unless the consent of an adverse person is necessary. See *id.* In addition, § 677(b) provides that income that may be used to discharge a legal obligation of support of the grantor is deemed available for the use of the grantor but only to the extent that the income is so used. See *id.* § 677(b).

140. See *id.* § 675. Section 675 provides generally that the grantor shall be treated as

power to designate recipients of trust income or principal, unless that power is duly confined;¹⁴¹ or (5) the grantor keeps a reversionary interest worth over five percent of the value of the trust at its inception.¹⁴²

In *Krause v. Commissioner*,¹⁴³ trust income was deemed taxable under the grantor trust rules then in effect based on application of the reciprocal trust doctrine.¹⁴⁴ Although the tax scheme in *Krause* has been overruled by subsequent legislative changes to the grantor trust rules,¹⁴⁵ *Krause* remains instructive for application of the reciprocal trust doctrine outside the estate tax area.

In *Krause*, the taxpayers, husband and wife, had simultaneously created six trusts.¹⁴⁶ The husband's trusts were funded with fifty

the owner of any portion of the trust in respect of which he: (1) retains a power to deal for less than adequate and full consideration; (2) retains a power to borrow without adequate interest or security; (3) borrows, and the borrowing extends over one taxable year; or (4) retains a power of administration that allows him to (a) vote stock of a controlled corporation held in the trust; (b) control investment of trusts funds in a controlled corporation; or (c) reacquire trust assets by substituting property of equivalent value. See *id.* § 675(1)-(4).

141. See *id.* § 674. Section 674(a) provides, as a general rule, that a grantor is taxed on the portion of the trust over which the grantor or a non-adverse party has the power to dispose of the beneficial enjoyment of income or principal without the consent of an adverse party. See *id.* § 674(a). However, § 674(b) provides that the following powers do not require inclusion under the general rule: (1) a power to apply income for the support of a dependent; (2) a power affecting the enjoyment only after the occurrence of an event that has a five percent or less probability of occurring; (3) a power exercisable only by will; (4) a power to allocate among charities; (5) a power to distribute corpus under an ascertainable standard; (6) a power to withhold income temporarily; (7) a power to withhold income during disability; (8) a power to allocate between income and corpus; (9) a power to distribute, apportion, or accumulate income or corpus among a class of beneficiaries held by an independent trustee; and (10) a power to distribute, apportion, or accumulate income among beneficiaries that is limited by an ascertainable standard. See *id.* § 674(b)-(d).

142. See *id.* § 673(a). Section 673 provides that the grantor is treated as the owner of a trust in which she has a reversionary interest in corpus or income, at the trust's inception, which exceeds five percent of the value of such portion. See *id.* The two exceptions to this rule apply if the beneficiary is a lineal descendant of the grantor or the reversionary interest does not take effect unless the beneficiary dies prior to reaching age 21. See *id.* § 673(b).

Under current grantor trust rules, a grantor is also deemed to be the owner of trust assets if the grantor's spouse holds such trust powers or interests. See *id.* § 672(e). In addition, if an individual who is not "adverse" to the grantor or who is "related" or "subordinate" to the grantor possesses the administrative powers of § 674 or § 675, or the distributive powers of § 677, the grantor would be deemed the owner of the trust. See Thomas W. Abendroth, *Grantor Trusts Are Now Useful Planning Tools*, 47 TAX'N FOR ACCT. 240, 241 (1991).

143. 497 F.2d 1109 (6th Cir. 1974).

144. See *id.* at 1111.

145. The grantor trust rules in effect were I.R.C. §§ 671 and 678 (1954).

146. See *Krause*, 497 F.2d at 1110.

shares of certain corporate stock and the wife's trusts were funded with twenty-five shares of the same corporate stock.¹⁴⁷ The six trusts named the same non-beneficiary, non-grantor persons as trustees.¹⁴⁸ The husband's three trusts named the couple's children as primary beneficiaries.¹⁴⁹ The wife's three trusts designated the couple's grandchildren as primary beneficiaries.¹⁵⁰ Under each trust, however, the trustees had discretionary power to accumulate trust income, to terminate the trusts within twelve years of their creation, and to apply any or all principal and accumulated income at termination either to the primary beneficiaries or to the grantor's spouse.¹⁵¹ Thus, in effect, the husband was a beneficiary of the wife's three trusts and the wife was a beneficiary of the husband's three trusts.

Under current grantor trust rules, a grantor is taxed as the owner of any portion of a trust whose income may be distributed to his or her spouse.¹⁵² However, the grantor trust rules then in effect dictated grantor trust treatment only when the trust income could be applied for the grantor directly.¹⁵³ The Service argued that once the reciprocal trust doctrine uncrossed the trusts, each grantor would be taxable under the applicable rules because the income could be used to benefit the grantor.¹⁵⁴

The taxpayers in *Krause* argued that the statutory scheme of the grantor trust rules precluded application of any anti-tax avoidance doctrines such as the reciprocal trust doctrine.¹⁵⁵ The Tax Court acknowledged that § 671 of the grantor trust rules provides that "[n]o items of a trust shall be included in computing the taxable income . . . of the grantor . . . under section 61 (relating to [the] definition of gross income) or any other provision of this Title except as specified in this subpart."¹⁵⁶ The court reasoned, however, that such language in "section 671 merely precludes the applicability of any other [Code] section in taxing the grantor on the income of the trust," and "does not prevent the use of the reciprocal-trust doc-

147. *See id.* The children's and the grandchildren's trusts were also funded with \$100. *See id.*

148. *See id.*

149. *See id.*

150. *See id.*

151. These facts were developed in the lower court. *See Krause v. Commissioner*, 57 T.C. 890, 893 (1972), *aff'd*, 497 F.2d 1109 (6th Cir. 1974).

152. *See* I.R.C. § 677 (1994).

153. *See supra* note 145.

154. *See id.*

155. *See Krause*, 57 T.C. at 899.

156. *Id.* at 901 (quoting I.R.C. § 671 (1954)).

trine.”¹⁵⁷

The taxpayers also argued that by subsequently changing the grantor trust rules to tax grantors where trust income could benefit the grantor's spouse, Congress sanctioned crossed trusts for such purposes prior to the legislative change.¹⁵⁸ Unpersuaded, the Tax Court reasoned that when Congress amended the grantor trust rules to include instances where the grantor's spouse could benefit from income, it “clearly was not attempting to deal with a reciprocal trust [since t]he reciprocal-trust doctrine covers not only husband and wife, but brother and sister, parent and child, and very possibly two complete strangers.”¹⁵⁹

Having determined that there was no barrier inherent in the grantor trust legislative scheme to application of the doctrine, the Tax Court applied the doctrine to the Krause trusts. First, the trusts were interrelated in that “all were created on the same day, named the same trustees and contained identical provisions.”¹⁶⁰ The Tax Court then appeared to utilize a precursor to the “basis of taxation” analysis for application of the reciprocal trust doctrine—an analysis on which it would later expand in *Bischoff*.¹⁶¹ The *Krause* court reasoned that “the reciprocal-trust doctrine is applied only so that this Court can determine whether in fact petitioners are taxable under the grantor trust provisions.”¹⁶² After uncrossing the trusts and “treating each petitioner as the grantor of the trust created by his or her spouse,”¹⁶³ the court held that each grantor was taxable under the

157. *Id.* The last sentence of § 671 provides:

No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

I.R.C. § 671. The *Krause* court's rationale for dismissal of the argument based on the statutory language sidestepped the fact that grantor trust rules were designed in part to supersede the “dominion and control” principles developed out of *Helvering v. Clifford*, 309 U.S. 331, 334 (1940). The reciprocal trust doctrine, however, clearly would not be caught by the language of the last sentence of § 671, because that doctrine neither relies on “dominion and control” nor rests in another provision of “this Title.”

158. *See Krause*, 57 T.C. at 901.

159. *Id.* at 901 n.8. The court's reference to “and very possibly two complete strangers,” *id.*, went beyond the extent of the grantor trust rules as conceived by any prior case or administrative ruling.

160. *Id.* at 900.

161. *See Bischoff v. Commissioner*, 69 T.C. 32, 45-46 (1977).

162. *Krause*, 57 T.C. at 901.

163. *Id.*

applicable grantor trust rules.¹⁶⁴

Interestingly, the Sixth Circuit in *Krause*, the same court that later rejected application of the reciprocal trust doctrine in *Green*, affirmed the Tax Court's holding that the taxpayers were taxable on the trust income to the extent of mutual value (i.e., to the extent of the income on the twenty-five shares of stock per trust).¹⁶⁵ Moreover, the Sixth Circuit in *Krause* adopted the Tax Court's reasoning with regard to application of the reciprocal trust doctrine in the grantor trust situation in its entirety: "After careful consideration of the relevant trust provisions and the authorities cited by taxpayers, we hold that the Tax Court correctly decided this issue for the reasons set forth in its opinion."¹⁶⁶

IV. CROSSED TRUSTS TO BENEFIT FROM GIFT TAX RULES

One reason reciprocal trusts enjoyed such popularity in the early part of this century was that, if the trusts were not "uncrossed"—that is, if the taxpayers could avoid application of the reciprocal trust doctrine—not only was estate tax avoided for the assets in trust, but there was no gift tax on the transfer to the trust.¹⁶⁷ That advantage was of course reduced with the reintroduction of a gift tax in 1932.¹⁶⁸ However, between 1932 and 1976, the gift tax rates were significantly lower than the estate tax rates.¹⁶⁹ Accordingly, reciprocal trusts were utilized to take advantage of the lower rates.

Even today, however, with the uniform gift and estate tax rates

164. See *id.* at 902. The court determined that the taxpayers were taxable under then-§ 677(a)(2), which provided that a grantor is taxable under a trust "held or accumulated for future distribution to the grantor or the grantor's spouse." *Id.* The uncrossing was necessary, despite the language referring to the grantor's spouse in § 677(a)(2), to refute the last sentence of § 677(a), which provided that the subsection did not apply "to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673." I.R.C. § 677(a) (1954). The Tax Court reasoned that the last sentence did not apply in this case since Treasury Regulation § 1.677(a)-1(f) (current version at Treas. Reg. § 1.677(a)-1(f) (1996)) provided that if income is "to be accumulated for 10 years and then . . . may be distributed to the grantor, the grantor is treated as the owner of the trust from its inception." *Krause*, 57 T.C. at 902 (quoting Treas. Reg. § 1.677(a)-1(f)).

165. See *Krause v. Commissioner*, 497 F.2d 1109, 1112 (6th Cir. 1974).

166. *Id.* at 1112 (citation omitted).

167. See John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 110-13 (1993). The estate tax was enacted in 1916, but it was not until 1924 that the first gift tax was enacted. See *id.* For a complete legislative history of the gift tax, see *id.* at 110-13.

168. See *id.* at 111.

169. See *id.* at 110-11.

introduced by the Tax Reform Act of 1976,¹⁷⁰ there are still advantages to gift rather than estate tax treatment in certain cases for assets transferred to trusts. Basically, gift tax treatment allows a donor to make a gift of property with significant appreciation potential instead of retaining the property in his estate in order to remove the post-transfer appreciation from the donor's transfer tax base.¹⁷¹ For example, if the grantor expects that the assets in the trust (e.g., securities) will appreciate significantly, it may be advisable to pay the gift tax on the date-of-transfer value, rather than the estate tax on the date-of-death value.¹⁷²

In addition, even with the uniform rates, the "effective" gift tax rate is lower than the estate tax rate.¹⁷³ The disparity in effective rates exists because the gift tax is applied on the net gift (net of the tax), whereas the estate tax is applied on the estate pre-tax.¹⁷⁴ This distinction is conventionally expressed as the gift tax base being "tax-exclusive" and the estate tax base being "tax-inclusive."¹⁷⁵ Thus, taxpayers may prefer gift tax treatment to benefit from this disparity. The possibility of utilizing the lower "effective" gift tax rate is of course thwarted if "uncrossing" the trusts would cause inclusion in the estate under the retained interest or powers sections of the estate tax provisions. However, by far the most important continuing feature of the gift tax rules for purposes of reciprocal trusts is the annual

170. Pub. L. No. 94-455, 90 Stat. 1520. Prior to the revision of the Tax Reform Act of 1976, the gift and estate taxes were separate taxes with different rate structures.

171. See Dodge, *supra* note 26, at A-79.

172. Determining whether a completed gift (and the corresponding payment of gift taxes) is preferable to inclusion of the assets in the grantor's estate requires a financial analysis comparing the alternatives. For a discussion setting forth the formulas for making this determination, see *id.* at A-79 to A-83.

173. See Theodore S. Sims, *Timing Under a Unified Wealth Transfer Tax*, 51 U. CHI. L. REV. 34, 35 (1984).

174. See *id.* at 39-40. In his article on the need for comprehensive estate and gift tax reform, David Brockway provides the following example of the benefit of the divergence in "effective" tax rates:

[U]sing the 39.6 percent rate . . . to illustrate the point, the inclusion of an additional \$100 in the taxable estate would give rise to an estate tax of \$39.60, leaving \$60.40 after tax to be transferred to the intended beneficiary. If, however, the \$60.40 net transfer was made as an inter vivos gift, the gift tax would only be \$23.90 (39.60 percent of \$60.40).

David H. Brockway, *Comprehensive Estate and Gift Tax Reform*, 67 TAX NOTES 1089, 1096 (1995).

175. See Sims, *supra* note 173, at 40. In order to obtain the benefit of the lower effective gift tax rate, however, the donor would have to survive three years from the date of the transfer and thereby avoid § 2035(c). See I.R.C. § 2503(c) (1994). For a thorough discussion of § 2035, see Cremer, *supra* note 27.

exclusion. As some practitioners have noted, "[a]fter unification of the estate and gift taxes, reciprocal trusts still serve the purpose of permitting the transfer of appreciable assets out of the estate under the shelter of annual gift tax exclusion."¹⁷⁶

Generally, the gift tax acts as a backstop to the estate tax.¹⁷⁷ A gift tax is imposed on lifetime transfers of property shifted out of the grantor's gross estate.¹⁷⁸ Section 2501(a) of the Code is the operative provision, and it imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.¹⁷⁹ Section 2511(a) provides that the § 2501 gift tax shall apply "whether the transfer is in trust, or otherwise," and "whether the gift is direct or indirect."¹⁸⁰ There is, however, an annual exclusion that affords taxpayers relief from the gift tax system for certain gifts. Section 2503(b) provides that the first \$10,000 of gifts of present interests made to any person by the donor during the calendar year shall not be included in the total amount of gifts made during such year.¹⁸¹

The legislative history of the annual exclusion reveals that it was designed, in part, to make the gift tax politically acceptable.¹⁸² When first establishing the annual exclusion, Congress explained that it would serve to exclude customary and occasional gifts, such as wedding and holiday presents.¹⁸³ This limited purpose explains why the exclusion is not without limitations.¹⁸⁴ It applies to present interests, not future interests.¹⁸⁵ Moreover, it is limited on a per-donee basis.¹⁸⁶

176. Jacques T. Schlenger et al., *Reciprocal Trusts May Not Be Used to Create Present Interests for Gift Tax Purposes*, 12 EST. PLAN. 239, 239 (1985).

177. See STEPHENS ET AL., *supra* note 28, ¶ 9.01, at 9-2.

178. See Dodge, *supra* note 26, at A-2. Generally, the estate and gift taxes (transfer taxes) are taxes on donative transfers of property. See *id.* The tax is applied on cumulative lifetime gifts (not including annual exclusions) and the taxable estate at the death of the donor. See *id.* The cumulative transfer is taxed at the progressive tax rates set forth in § 2001. See I.R.C. § 2001. There is a credit of \$192,800 against this transfer tax which has the effect of exempting the first \$600,000 of cumulative transfers from the tax base. See Dodge, *supra* note 26, at A-2.

179. See I.R.C. § 2501. Section 2501(a) provides that "a tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or non-resident." *Id.* § 2501(a).

180. *Id.* § 2511(a). Section 2511(a) also provides that the gift tax will apply whether the property is real or personal, tangible or intangible. See *id.*

181. See *id.* § 2503(b).

182. See Steinkamp, *supra* note 167, at 106.

183. See H.R. REP. NO. 72-708 (1932), *reprinted in* 1939-1 C.B. (pt. 2), at 457, 478; S. REP. NO. 72-665 (1932), *reprinted in* 1939-1 C.B. (pt. 2), at 496-525; Steinkamp, *supra* note 167, at 117.

184. See Steinkamp, *supra* note 167, at 106.

185. See I.R.C. § 2503(b).

The first case dealing with crossed gifts involving the annual exclusion was *Furst v. Commissioner*,¹⁸⁷ decided prior to *Grace*. Three sets of married donors were involved in *Furst*: two brothers and a cousin, and their wives.¹⁸⁸ Over two days, each set of married donors transferred the same number of shares of a certain corporation's stock to members of their immediate family and to individuals in each of the other two family groups.¹⁸⁹ None of the donors paid a gift tax on the transfers, claiming that the transfers fell within the applicable per-donee annual exclusion amount.¹⁹⁰ The Service issued notices of tax deficiency to the taxpayers, claiming that the gifts the donors made "to members of their immediate families, and cross transfers to others, amounted to gifts of all stock transferred by each to members of their immediate families," and therefore limited the exclusion amount to the per-donee limit in the immediate family.¹⁹¹

The Tax Court agreed with the Service that the "realities of the transfer" controlled the gift tax liability of the donors.¹⁹² It concluded that "each petitioner was the real donor of the stock which the members of his or her immediate family ultimately received and the number of exclusions is ruled by the number of recipients in each petitioner's family."¹⁹³ Finding no cases involving crossed gifts, however, the court in *Furst* borrowed from the reciprocal trust doctrine, as developed in *Lehman*,¹⁹⁴ to tax the substance of the crossed gifts: "While we do not find any cases involving cross-gifts, there is ample authority for [uncrossing the gifts] in the reasoning and conclusion reached in the reciprocal or cross-trusts cases."¹⁹⁵

The *Furst* court did not seem troubled by, nor did it address directly, the quid pro quo requirement of *Lehman*. Indeed, the donors denied that there had been any prior arrangement or agreement among the parties, and conceded only that there "might have been some talk" among the transferors before the transfers were made.¹⁹⁶ The uncrossing, it appears, was based almost entirely on the

186. *See id.*

187. 21 T.C.M. (CCH) 1169 (1962).

188. *See id.* at 1170.

189. *See id.*

190. *See id.* at 1171. The per-donee annual exclusion amount with the split spousal election at the time was \$6000. *See id.* at 1170 n.2.

191. *Id.* at 1172.

192. *Id.*

193. *Id.*

194. For discussion of *Lehman*, see *supra* notes 41-42 and accompanying text.

195. *Furst*, 21 T.C.M. at 1172.

196. *Id.*

"simultaneous" nature of the "transfers of identical property" and the attempt at circumventing a "taxing statute that reaches gifts 'direct' or 'indirect.'" ¹⁹⁷ If so, *Furst* represents a broad reading of the reciprocal trust doctrine, similar to the reading later adopted in *Bischoff*—i.e., that it serves to identify the transferor. ¹⁹⁸

The first major case to address crossed gifts after *Grace* was *Schultz v. United States*. ¹⁹⁹ In *Schultz*, a taxpayer gave equal amounts of stock to each of his three children and to each of his brother's three children. ²⁰⁰ On the same day, the taxpayer's brother gave the same amounts of stock to each of the taxpayer's three children. ²⁰¹ The taxpayer claimed an annual exclusion for the gifts to his children, nieces, and nephews. ²⁰² The lower court held that the actual intent of the taxpayer was immaterial and that the only issue was the nature and operative effect of the transfers themselves; thus, it directed a verdict for the Service. ²⁰³ The court of appeals did not reach the issue of whether the rule of *Grace* applies with equal force to indirect gifts. ²⁰⁴ Instead, the court affirmed the directed verdict because a reasonable jury could have concluded only that the taxpayer intended to benefit his children—rather than his brother's children—by the gifts in question. ²⁰⁵

Faced with this less than conclusive resolution from the courts as to whether the reciprocal trust doctrine after *Grace* applied in the gift area, the Service published Revenue Ruling 85-24, ²⁰⁶ attempting by administrative fiat to end the use of crossed gifts to expand the annual exclusion. The ruling, in which the donees obtained lapsing withdrawal powers in certain interests in trusts, addressed the issue of whether crossed annual gifts in trusts would be uncrossed. ²⁰⁷ Specifically, three business partners had simultaneously established three trusts funded with \$20,000 each. ²⁰⁸ Every partner named his

197. *Id.*

198. In his excellent article on the gift tax, Professor Steinkamp observes that *Furst* anticipated the holding in *Bischoff* that the reciprocal trust doctrine's function is merely to identify the true transferor. See Steinkamp, *supra* note 167, at 135.

199. 493 F.2d 1225 (4th Cir. 1974).

200. See *id.* at 1225.

201. See *id.*

202. See *id.*

203. See *id.* at 1225-26.

204. See *id.* at 1226.

205. See *id.*

206. Rev. Rul. 85-24, 1985-1 C.B. 329.

207. See *id.*

208. See *id.*

own children as beneficiaries of \$10,000 and the other two partners as beneficiaries of \$5,000 each.²⁰⁹ The terms of each trust provided that trust income would be accumulated for the benefit of the children and distributed when they reached age forty.²¹⁰ Each trust provided, however, that the children could withdraw up to \$10,000 from the trust for a sixty-day period following establishment of the trust.²¹¹ The trusts also provided that each business partner beneficiary had the power to withdraw up to \$5,000 from the trust during the sixty-day period after creation of the trust.²¹² Similar withdrawal powers would apply to any future additions to the trusts.²¹³ Each grantor/partner filed a gift tax return showing the transfer of \$20,000 in trust as gifts of \$5,000 to one partner, \$5,000 to the other partner, and \$10,000 to his child.²¹⁴ The partners claimed gift tax annual exclusions for the full amount of the trust transfers (i.e., \$20,000).²¹⁵

The Service acknowledged that "[w]hen a trust instrument gives a beneficiary the power to demand immediate possession of corpus, the beneficiary has received a present interest," thus falling within the requirement of the annual exclusion that the gift be a present interest and not a future interest.²¹⁶ The Service reasoned, however, that the powers of withdrawal held by the partners were not genuine because each partner's ability to withdraw \$5,000 from another's trust would likely trigger similar withdrawals by the other partners from the other trusts.²¹⁷ Thus, the Service reasoned that the withdrawal powers would never be exercised.²¹⁸ Citing *Grace*, the Service determined that "[w]hen two donors establish similar trusts under circumstances such that the beneficial interests are matching, the transfers may be treated as reciprocal whether or not the transfers were actually in consideration for each other."²¹⁹ Accordingly, the Service ruled that each partner would be allowed a \$10,000 exclusion for the amount transferred to his own children but that no other ex-

209. *See id.*

210. *See id.*

211. *See id.*

212. *See id.*

213. *See id.*

214. *See id.*

215. *See id.*

216. *Id.* The Service conceded in the ruling that *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), stood for this proposition. *See* Rev. Rul. 85-24, 1985-1 C.B. 329.

217. *See* Rev. Rul. 85-24, 1985-1 C.B. 329.

218. *See id.*

219. *Id.*

clusions would be allowable for the transfers.²²⁰

V. NEED FOR RECIPROCAL TRUST DOCTRINE

Judge Learned Hand, writing for the Second Circuit in *Helvering v. Gregory*,²²¹ acknowledged that “[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”²²² Creative taxpayers can and do arrange their transactions so as to minimize the applicable tax consequences, and there is little disagreement that such stratagems within the system are acceptable. However, somewhere in the continuum, otherwise acceptable machinations rise to a level of manipulation that cannot be tolerated without jeopardizing the integrity of the taxing scheme. In such circumstances, courts face a dilemma: Should they reach beyond the words of the tax statute in question and impose a “substance” requirement on the transaction, or must they wait for a legislative “solution”?²²³ The argument is persuasive that the courts’ role in the proper administration of the tax laws would be severely circumscribed if the laws could not be applied to the substance of the transaction.²²⁴ This principle certainly applies to the use of the corollary reciprocal trust doctrine for ne-

220. See *id.* Two years later, the Service issued a private letter ruling utilizing the analysis of Revenue Ruling 85-24 to address a situation in which two brothers and their wives made almost identical gifts to the members of each other’s families. See Tech. Adv. Mem. 87-17-003 (Jan. 8, 1987). The issue was whether the gifts by each donor to his or her nieces and nephews would be “treated as made instead to the donor’s own children, thereby causing the total gifts for each donor to exceed the available annual gift tax exclusions.” *Id.* The Service cited *Bischoff* for the proposition that “the reciprocal trust doctrine is intended to identify the transferor of property.” *Id.* (citing *Bischoff v. Commissioner*, 69 T.C. 32 (1977)). The Service reasoned that the indirect nature of the “transfers is very similar to the way the taxpayer made gifts in *Schultz*.” *Id.* (citing *Schultz v. United States*, 493 F.2d 1225 (4th Cir. 1974)). Accordingly, the Service concluded that the transfers made by each couple to the children of the other should be treated as gifts to their own children and that the aggregate value of such gifts made to each donee exceeded the annual gift tax exclusion allowable. See *id.*

221. 69 F.2d 809 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

222. *Id.* at 810.

223. In the tax area, there also is often the subsidiary question of whether the government’s pronouncements regarding the statute (typically in the form of Treasury Department regulations) should be given weight if they, in effect, add to the legislative scheme. There are no Treasury Regulations applicable to crossed-trust arrangements. For a discussion of the proper weight courts should accord general and legislative regulations, see Caroline Elizabeth Costle, Note, *Judicial Deference to Interpretive Regulations in the Face of Inconclusive Legislative History: The Example of Nalle v. Commissioner*, 47 TAX LAW. 259 (1993).

224. See Baillif, *supra* note 7, at 294-97; Brown, *supra* note 3, at 226.

gating crossed trusts or gifts. But questions remain with respect to the reciprocal trust doctrine.

In applying the reciprocal trust doctrine, the courts need to decide whether to uncross interrelated transfers where the uncrossing would result in tax liability, as suggested in *Bischoff*,²²⁵ or only where the taxpayers maintained a substantial economic benefit, as suggested by the *Green* court.²²⁶ A related question is whether application of the doctrine should depend on the type of tax in question (i.e., gift, estate, or income tax).

In answering these questions, it is helpful to recall the birth of the substance-over-form doctrine itself. *Gregory v. Helvering*²²⁷ is widely regarded as the genesis of that doctrine.²²⁸ In that case, the taxpayer wanted to benefit from a provision in the Code that allowed for tax-free corporate reorganizations in order ultimately to obtain capital gains, rather than dividend, treatment on the sale of the underlying assets of her closely held corporation.²²⁹ The taxpayer wanted to obtain the proceeds from a sale of the underlying assets of a corporation whose stock she owned.²³⁰ If the corporation had sold the assets and then distributed the proceeds to her, she would have been taxed on the distribution at the high dividend rates.²³¹ If the corporation instead sold the assets to another corporation that in turn liquidated, the gain on the sale of the assets would be capital gains and the liquidation would be tax-free.²³² The taxpayer formed a new corporation, which purchased the assets of her first corporation and liquidated it. The taxpayer claimed that the liquidation fell under a specific provision of the Code allowing for tax-free reorganizations.²³³ Although the liquidation of the second corporation fell within the literal terms of the reorganization statute, the Court recharacterized the transfer as a taxable dividend.²³⁴ The Court determined that the substance of the transaction did not fall within the intended legislative scheme for tax-free reorganizations, which

225. See *Bischoff v. Commissioner*, 69 T.C. 32, 45-46 (1977).

226. See *Estate of Green v. Commissioner*, 68 F.3d 151, 153 (6th Cir. 1995).

227. 293 U.S. 465 (1935).

228. See *Brown*, *supra* note 3, at 170.

229. See *Gregory*, 293 U.S. at 467.

230. See *id.*

231. See *id.*

232. See *id.*

233. See *id.*

234. See *id.* at 469-70.

are a matter of legislative forbearance.²³⁵

In *Gregory*, the taxpayer was foiled from utilizing a provision of the Code absolving a transfer from taxation when the substance of that transfer did not fit the spirit of the provision.²³⁶ Similarly, crossed-gift situations present the case of a taxpayer attempting to benefit from transfers that do not fit the per-donee annual exclusion.²³⁷ In the crossed-gift situation, the taxpayer is in effect making more than the allowed per-donee gifts to the true intended donee.

There is a subtle, yet important, difference between (1) using crossed transfers (whether direct or in trust) to enlarge the \$10,000 annual gift tax exclusion, and (2) using crossed transfers to avoid the estate tax or the grantor trust rules of the income tax. In the gift tax situations, unlike the other two, if the crossed trusts are not "uncrossed," the taxpayer benefits from a statutory relief provision in a situation where Congress clearly did not intend that benefit to apply. By contrast, in the estate tax and income tax situations, by crossing the powers or interests in the trusts, the taxpayers escape the literal words of the Code. In those cases, if the crossed trusts are not "uncrossed," the taxpayer is not "obtaining" a statutory tax benefit beyond the legislative scheme. Rather, "uncrossing" the trusts in the estate or income tax situations results in tax liability that would not be imposed absent the "uncrossing."

The gift tax annual exclusion scenario presents the easiest case for application of the reciprocal trust doctrine because the court's role in such a case fits well within typical substance-over-form analysis and arguably amounts to little more than proper statutory interpretation. As the Second Circuit noted in *Estate of Levine v. Commissioner*,²³⁸ "we cannot be unmindful of the rule of construction that Congress permits exclusions only as a matter of grace, and the exclusions sections are to be strictly construed against the taxpayer."²³⁹

235. See *id.*

236. See *id.* at 467-69.

237. See I.R.C. § 2503(b) (1994).

238. 526 F.2d 717 (2d Cir. 1975).

239. *Id.* at 721. Similarly, Justice Souter, in his concurring opinion in *United States v. Burke*, 504 U.S. 229 (1992), noted the rule of statutory interpretation that "exclusions from income must be narrowly construed." See *id.* at 248 (Souter, J., concurring). This reasoning notwithstanding, in *Cristofani v. Commissioner*, 97 T.C. 74 (1991), the Tax Court rejected the Service's invocation of substance-over-form to deny annual gift tax exclusions for gifts to holders of contingent trust interests with limited withdrawal powers. See *id.* at 84-85. Responding to *Cristofani*, the Service recently announced that it "will continue to litigate cases whose facts indicate that the substance of the transfers was merely to obtain

By contrast, in the grantor trust scenarios, applying the reciprocal trust doctrine would result in taxation not required under the literal terms of the statute. Moreover, the grantor trust legislative scheme is quite complex and therefore perhaps should not be tampered with by the courts. The latter argument, however, was addressed and dismissed in *Krause*.²⁴⁰ In that case, the Sixth Circuit did not accept the taxpayers' argument that the intricate nature of the grantor trust rules signified a legislative monopoly of the area precluding the use of the reciprocal trust doctrine.²⁴¹ In addition, similar judicially created anti-abuse doctrines clearly apply in the grantor trust area.²⁴² For example, even if the terms of a trust avoid the technical provisions of the grantor trust rules, a grantor will be taxed on income anticipatorily assigned to a trust under the "assignment of income" doctrine.²⁴³ Arguably, the reciprocal trust doctrine requires less judicial interference in the legislative scheme than the assignment of income doctrine. Viewed in its true light, the reciprocal trust doctrine is solely a means to identify the true transferor.²⁴⁴ In this limited role, the doctrine clearly has a place even in the intricate scheme of the grantor trust rules.

The estate tax cases, while perhaps not as compelling as the gift tax annual exclusion cases, also present the argument for application of the reciprocal trust doctrine. In the estate tax area, however, it is especially vital that the doctrine is understood in its proper light. The reciprocal trust doctrine should be viewed solely as a mechanism for determining the true "transferor," not as an invitation for courts to rewrite the legislative scheme based on vague notions of substance. In this light, the doctrine should be utilized to unravel any crossed "income interests" for estate tax purposes as well as any crossed "powers." The reciprocal trust doctrine taxes transfers that would in form circumvent the legislative intent.

The speed with which the reciprocal trust doctrine has been dismantled in recent court decisions cannot be explained by the doctrine's purported analytical flaws alone. Two external factors appear to have especially fueled the full frontal assault on the doctrine: first,

annual exclusions and that no bona fide gift of a present interest was intended." *Cristofani v. Commissioner*, 97 T.C. 74 (1991).

240. See *Krause v. Commissioner*, 497 F.2d 1109, 1110 (6th Cir. 1974).

241. See *id.*; *supra* notes 143-66.

242. See *Zaritsky*, *supra* note 136, at A-1, A-4.

243. See *id.* Similarly, sale-leaseback arrangements are carefully scrutinized to see if rent payments to the trusts should be deductible regardless of any technical compliance or non-compliance with the terms of the Code provisions. See *id.* at A-5 to A-6.

244. See *id.* at A-8.

a reluctance by courts to "undo" trusts on the somewhat vague assertion of "substance" out of deference to the notion that trusts themselves are by their very nature creatures of "form" and that a judicial doctrine which tends to disregard "form" chips away at the very foundations of this area of the law;²⁴⁵ and second, a recent current of "judicial passivity" in the tax area as Congress has assumed an increasingly preeminent role in federal tax matters.²⁴⁶ Finally, it is possible that several of the recent overly narrow interpretations of the reciprocal trust doctrine were rendered for the specific purpose of encouraging clearer legislative pronouncements in the area.

Whatever the full explanation, the recent emasculation of the reciprocal trust doctrine is ill-advised not only for its creation of overly generous tax loopholes, but also for the negative implications it may have in other areas. Determining the "true" settlor of a trust can affect, among other things, the proper application of the laws

245. For example, courts have refused to apply a substance-over-form analysis to prevent taxpayers from utilizing multiple trusts as separate taxpaying entities. The Tax Court in *Estelle Morris Trusts v. Commissioner*, 51 T.C. 20 (1968), determined that "by recognizing even one trust for tax purposes, [Congress] sanctions to some degree income splitting and the resulting lessening of taxes." *Id.* at 39. Thus, the court concluded, multiple trusts represent only a difference of degree, not a qualitatively distinct phenomenon. The Tax Court in *Morris Trusts* also noted that Congress had not enacted a provision making a tax avoidance motive determinative of tax liability in the trust area, as it had in other areas of tax law (such as §§ 269, 306, 482, 532, 1551). *See id.* Accordingly, the Tax Court reasoned that it would "limit those judicially developed doctrines ('tax avoidance,' 'business purpose,' and 'sham') to the situations which they were intended to cover." *Id.* at 43. The *Morris* court further stated that the "business purpose" test of *Gregory v. Helvering* was inapposite to the multiple accumulation trusts at issue in the case. *See id.*

Since 1986, the use of multiple trusts to reduce taxes has virtually been eliminated. Congress challenged income-shifting on two fronts. First, Congress curtailed "tax bracket shopping" both for income accumulated in the trust and income doled out to the beneficiaries. *See Omnibus Budget Reconciliation Act of 1993*, Pub. L. No. 103-66, § 13202, 107 Stat. 312, 416; H.R. REP. NO. 99-841 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4855. For accumulated income, Congress squeezed the tax brackets for trusts so that almost all trust income would be taxed at the highest marginal rate. *See Gary C. Randall & Susan L. Megaard, Defective Grantor Trusts Can Be Effective Education Funding Vehicles After RRA '93*, 81 J. TAX'N 150, 150-51 (1994). The 1993 Revenue Reconciliation Act ("RRA '93") provided that the highest individual marginal tax rate of 39.6% would govern trust income over \$7,500, as adjusted for inflation. *See Omnibus Budget Reconciliation Act of 1993*, § 13202, 107 Stat. at 416. Accordingly, the income tax savings occasioned by income-shifting to the trust in the hopes of earning the tax rate for trust accumulation of income are nominal. Similarly, the "kiddie tax" provisions of the 1986 Tax Reform Act ("TRA '86"), which tax unearned income over \$1000 of children under 14 at the parent's highest marginal rate, curtailed the use of trusts to obtain a lower rate on distributions to the trust beneficiaries. *See H.R. REP. 99-841 (1986).*

246. For a proposal that would all but eliminate the courts from the mix in at least one area of substance-over-form litigation, see Baillif, *supra* note 7, at *passim*.

regarding creditor access to trusts.²⁴⁷ For example, it is well-established that where a person creates a spendthrift trust for his own benefit, a so-called "self-settled" trust, a spendthrift provision restraining the reach of creditors to the trust assets is ineffective to block creditor access.²⁴⁸ In determining whether a trust is self-settled, potential creditors have for years successfully relied on tax cases for the proposition that "where one person creates a trust for another in consideration of the other's creating a similar trust for him, each is in substance creating a trust for himself."²⁴⁹ In short, the post-*Grace* disinclination by courts to uncross trusts may tend to jeopardize the ability of creditors to get their hands on assets of a settlor of a trust to which they are otherwise entitled. A viable reciprocal trust doctrine, on the other hand, would greatly assist creditors, who could argue that a judicially mandated uncrossing shows that a particular trust was in fact "self-settled," and the assets therefore should be accessible to creditors.²⁵⁰

In the taxing scheme and related areas, the intended purpose of the reciprocal trust doctrine is to identify the true grantor. In order to serve this purpose, the spirit of the *Grace* decision must be followed. The best recent articulation of that decision is found in the Tax Court's *Bischoff* holding that interrelated trusts should be uncrossed, giving rise to taxability. The courts can give teeth to the interrelatedness prong by requiring taxpayers who enter into transfers at similar times with similar terms to rebut a presumption that the transfers are interrelated. By placing a high burden on the tax-

247. See 2A AUSTIN WAKELAND SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* § 156.3, at 180-82 (4th ed. 1987).

248. See *id.* § 156, at 165 n.1.

249. *Id.* § 156.3, at 181.

250. The fall into disfavor of the reciprocal trust doctrine is, additionally, an ill harbinger for efforts to utilize the substance-over-form doctrine to iron out disparities between the treatment of domestic trusts and the treatment of transfers of assets by United States citizens to foreign trusts via so-called offshore asset protection trusts ("OAPTs"). Commentators have argued that OAPTs enjoy advantages unavailable to domestic trusts because courts allow the OAPTs' "form" to govern their accessibility to creditors. Domestic trusts have historically been scrutinized by American courts to determine if, in substance, the trust is self-settled and thus subject to creditor access. See Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 75-80 (1994). By contrast, foreign self-settled trusts are generally shielded from creditors, notwithstanding any implied agreements or side arrangements among the parties. See *id.* The recent "exalt[ation] of artifice over reality," see *supra* text accompanying note 2, in the discrediting of the reciprocal trust doctrine, reflecting yet another setback for the doctrine of substance-over-form, can be viewed with some apprehension as a setback also for the notion of leveling the playing field between domestic trusts and OAPTs by subjecting both to a careful substance analysis. *Id.*

payer to disprove interrelatedness, courts can minimize the likelihood that taxpayers will be able to circumvent that prong of the *Grace* test. With regard to the “mutual economic value” requirement, the *Bischoff* court’s “basis of taxation” analysis properly limits the judiciary’s role, while not tying its hands as does the *Green* court’s formulation.

