

# TRUST CONNECTION

BRINGING TOGETHER TAX PROFESSIONALS, QUALIFIED ADVISORS AND WESCOTT TRUST SERVICES FOR THE BENEFIT OF OUR MUTUAL CLIENTS.

A PERIODIC COMMUNICATION FOCUSING ON TRUST INFORMATION

**D**o you have a client who hates the idea of estate taxes? A client who constantly asks how to avoid estate taxes, but not really give the money away? The Spousal Lifetime Access Trust (SLAT) could be an answer.

A SLAT is an irrevocable trust created by a married person for the benefit of his or her spouse. In order to avoid inclusion of the assets of the SLAT in the gross estate of the spouse/beneficiary under IRC Section 2036, only separate property of the grantor may be used to fund the SLAT. In a community property state, the community should be bifurcated into equal shares of separate property, and the grantor should transfer his or her share of the separate property to the SLAT.

A typical SLAT grants the spouse a life interest. The spouse can be the trustee if the distribution standard is limited to an ascertainable standard either under the document or state law, and the spouse cannot satisfy the legal obligations of the trustee or the grantor. If an agreeable third party is available to serve as trustee, the distribution standard can be more liberal. In either case, the spouse beneficiary may be granted the power to withdraw the greater of \$5,000 or five percent of the trust principal.

Most practitioners avoid having the grantor serve as trustee to avoid inclusion of the assets of the SLAT in the gross estate of the grantor under IRC Section 2036. The grantor's spouse could serve as trustee if his or her distributive powers are limited by an ascertainable standard.

**Example:** A husband establishes a SLAT for his wife, with the remainder passing to the children and grandchildren, in trust and makes a gift of \$5 million. Alternatively, the SLAT can be for the benefit of multiple beneficiaries during the wife's life to provide greater flexibility if the funds are not needed by the parents. In either case, the SLAT must prohibit any distributions in discharge of the husband's legal obligation to support any beneficiary.

The husband allocates his \$5 million gift tax exemption and, if desired and the trust is drafted to be excluded from the children's estates, his \$5 million generation-skipping transfer tax exemption to the transfer.

This works particularly well for couples that may have a pension or other income stream payable to only one of them that disappears when one of them dies, or an interest in a trust (such as one established by a parent) that passes directly to children rather than to the spouse, or a business interest that will bypass the wife.



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## Let's Do Two

You've explained the process to your client and the next logical response is, "Great, let's do two!"

Can the couple establish a second trust identical to the first but for the other spouse? The short answer is no, because of the reciprocal trust doctrine.

## Reciprocal Trust Doctrine

The reciprocal trust doctrine is set out in *Lehman v. Comm'r*, 109 F.2d 99 (2nd Cir 1940). In *Lehman*, the decedent transferred stocks and bonds into trust for his brother. His brother transferred substantially identical stocks and bonds into trust for the decedent.

Each trust provided that the trustee was to pay the income to the other brother for life, with remainder to that brother's issue. The Internal Revenue Service "uncrossed" the trusts, finding that each trust was the quid pro quo for the other, and treated the decedent as the settlor of the trust created by his brother, thereby including the trust in the decedent's gross estate under the predecessor to IRC §2036(a)(1) (retained life estates).

*Lehman* was amplified in *U.S. v. Estate of Grace*, 395 U.S. 316 (1969). In *Grace*, the decedent transferred substantial assets to his wife during a 23-year period. The decedent then established an irrevocable trust for his wife, with remainder to their issue. Two weeks later, at the husband's request, his wife established a substantially identical trust for his benefit, with remainder to issue.

In finding that the wife's trust was includible in the husband's estate, the Supreme Court held that:

"Application of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo for the other. Such a 'consideration' requirement necessarily involves a difficult inquiry into the subjective intent of the Settlers. Nor do we think it necessary to prove the existence of a tax-avoidance motive. ... Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the Settlers in approximately the same economic position as they would have been in had they created the trusts naming themselves as life beneficiaries."

The IRS has succeeded in applying the reciprocal trust doctrine even in situations in which the settlors did not retain beneficial interests in the trusts they created.

In *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977), each settlor (grandparent) created four discretionary trusts—one for each grandchild—and named the other grandparent as trustee. The Tax Court uncrossed the trusts on the basis that the trustee's discretionary powers over income left the settlors "in approximately the same economic position." As a result of uncrossing the trusts, each settlor was deemed to have retained the power to designate the persons to whom income was distributable, and the trusts were includible in their respective gross estates under IRC §2036(a)(2).

The Sixth Circuit refused to follow *Bischoff* in *Estate of Green v. U.S.*, 68 F.3d 151 (6th Cir. 1995), where the IRS sought to apply the reciprocal trust doctrine for purposes of applying IRC 2036(a)(2).

*For blended families or those without a family member or friend who can serve as trustee, Wescott Trust Services can serve as the trustee of a SLAT. Please contact Scott Poulin (305.960.2357 or spoulin@wescott.com), for more information.*

In *Green*, the decedent and his wife each created separate trusts for their two grandchildren. For one grandchild, the decedent was the settlor and his wife was the trustee. For the other grandchild, the decedent was the trustee and his wife was the settlor.

Even though the settlor and his wife did not possess beneficial interests in the two trusts, the IRS sought to uncross the trusts based on reciprocal fiduciary powers. If each settlor was the trustee of the trust he or she had created, the trustee's discretionary powers over

distributions of income and principal would have resulted in inclusion of the trust's corpus in the gross estate of the settlor under IRC §2036(a)(2).

The Sixth Circuit rejected the *Bischoff* analysis on the grounds that the "same economic position" test in *Grace* required the settlor to retain a beneficial interest and that mere control of beneficial interests as trustee was not sufficient.

## Application to SLATs

The reciprocal trust is likely to be imposed if both spouses create identical SLATs.

## Avoiding the Doctrine

In PLR 9643013, a husband and wife created irrevocable trusts in which the husband's trust named the wife as

trustee and the children as beneficiaries, and the wife's trust named the husband as trustee and the husband and children as beneficiaries. Each trust vested distributive discretion in an independent trustee. In this factual situation, the IRS held that the reciprocal trust doctrine did not apply. Unlike in *Green*, the parties did not keep administrative control and with an independent trustee it would appear that they were not in "approximately the same economic position".

There is little further guidance, but commentators and practitioners have suggested that some of the following may be sufficient to avoid the doctrine:

- Different trustees
- Different beneficiaries (spouse and children in one trust and only children in another)
- Withdrawal powers in one trust
- Sprinkling powers in one trust
- Different remainder men

## ABOUT US

### ABOUT WESCOTT FINANCIAL ADVISORY GROUP

Founded in 1987, Wescott Financial Advisory Group LLC is an SEC-registered, fee-only investment advisory and wealth management firm. Wescott's clients are high net worth individuals, families, trusts, foundations, pension plans and institutions. The firm's investment philosophy is a uniquely disciplined, tax sensitive and opportunistic "open architecture, multi-manager (passive and active management)" approach that has been maintained for over 20 years. This approach allows Wescott to control risk while creating portfolios with a combination of complementary styles, diversifications and enhanced returns. Wescott is rated one of the top investment management firms in the United States. The firm is ranked in the top 50 nationally by Barron's, was named a top firm in South Florida by the South Florida Business Journal, and the Philadelphia Business Journal ranks Wescott in the top 20 of all money management firms in the Philadelphia region. With offices in Philadelphia, Miami, Boca Raton and San Francisco, Wescott's mission is: "Achieving Client Goals".

### ABOUT NATIONAL ADVISORS TRUST

National Advisors Trust is chartered by the Office of Thrift Supervision (OTS), is authorized to administer trusts in all 50 states, and is a member of the Federal Deposit Insurance Corporation (FDIC). In business since 2001, National Advisors Trust administers over \$7 billion in assets. By law, client assets are segregated from the capital assets of National Advisors Trust and are not subject to potential creditor claims against the trust company. As an independent trust company, created by the client's trusted advisor, the trust company's primary responsibility is to ensure the safekeeping of investment assets. Wescott Trust Services is a division of National Advisors Trust in which Wescott Financial Advisory Group is a shareholder.

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