PROBATE PRACTICE Reporter™

IN THIS ISSUE

November 2022
Volume 34, Number 11

Reciprocal Trust Doctrine and Joint SLATS: Future IRS Happy Hunting Ground?

By L. Paul Hood, Jr.

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Introduction: At present, the transfer tax applicable exclusion amount is at a historic high. However, considering the automatic significant reductions in the exclusion beginning in 2026, and other legislative proposals, many clients desire to take advantage of the historically high exclusion amounts. However, this requires irrevocable gifts, and many clients are justifiably concerned about irrevocably giving away too much wealth that they may need later in life. Therefore, they're interested in gifting strategies that allow them some access to the donated wealth "just in case."

Enter the Spousal Lifetime Access Trust (SLAT): The SLAT essentially is a lifetime credit shelter trust in which the other spouse, descendants, and others, including charitable organizations, are permissible beneficiaries. The SLAT potentially reduces or eliminates the fear of running out of other money. This is because the donor spouse, by virtue of the marital relationship, at least during the marriage, effectively retains some theoretical indirect access to the gifted property inside the SLAT and the income therefrom. As a result, SLATs have become ubiquitous in estate planning. But SLATs done by both spouses can be fraught with peril in some circumstances.

Introduction to Joint SLATs: Both spouses often desire the indirect use access that a SLAT potentially gives. Often, each donor spouse wants to set up a SLAT for his or her beneficiary spouse and other beneficiaries. Most of the time, the spouses each want to establish a SLAT for the other spouse at the same time by the same lawyer, who represents the couple jointly, and pursuant to the same integrated plan, which I'll refer to herein as "joint SLATs."

Because the significant adverse estate tax risk of the reciprocal trust doctrine is greater where both spouses establish a SLAT for the other spouse, some cautious planners have one spouse create a SLAT where a spouse is a beneficiary with the couple's descendants and/or others and have the other spouse create a separate trust solely for the benefit of the spouses' descendants when neither spouse is a current beneficiary (but with a power given to a trust protector to add either or both spouses as beneficiaries in the future) as an alternative to joint SLATs.

Unfortunately, joint SLATs may be problematic due to the specter of the reciprocal trust doctrine. I believe that this practice exposes the estate plan if the IRS subsequently successfully prevails on the reciprocal trust doctrine. In this article, I explore the application of the reciprocal trust doctrine to joint SLATs and suggest a way that they may be done more safely in light of the risks of the post-death application of the reciprocal trust doctrine.

The Reciprocal Trust Doctrine: Just as unfortunately, many estate planning commentators and thought leaders haven't been clear enough about the significant risks of application of the reciprocal trust doctrine to joint SLATs. Practitioners should not be assured that the reciprocal trust doctrine will not apply if the joint SLATs that are formed at virtually the same time by the same lawyer who represents the spouses jointly pursuant to the same integrated estate plan but aren't identical trust instruments, but instead contain some significantly different terms that are added simply to make the instruments substantively different. Practitioners should endeavor to discuss any attendant risks with clients.

Most rely in part on a Tax Court Memorandum (as opposed to a reviewed decision) decision in *Estate of Herbert Levy v. Comm'r*, T.C. Memo. 1983-453 (1983). However, in my opinion, that conclusion overlooks the critical factor that caused the Tax Court judge in the *Estate of Levy* decision to decide as he did. That position also arguably flies in the face of the leading United States Supreme Court pronouncement on the reciprocal trust doctrine in *United States v. Estate of Grace*, 395 U.S. 316 (1969).

In *Estate of Grace*, the United States Supreme Court, in pertinent part, stated:

> We agree that "the taxability of a trust corpus . . . does not hinge on a settlor's motives, but

 Probate Practice Reporter (USPS 004231) (ISSN 1044-7423) is published monthly for $295.00 a year by Probate Practice Reporter, LLC, USC School of Law, 1525 Senate Street, Columbia, SC, 29208, (803) 777-7465. Periodicals Postage paid at Columbia, SC. Postmaster: Send address changes to *Probate Practice Reporter,* USC School of Law, 1525 Senate Street, Columbia, SC, 29208.

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> depends on the nature and operative effect of the trust transfer." Id., at 705. See also *Commissioner v. Estate of Church, supra.*
>
> We think these observations have particular weight when applied to the reciprocal trust situation. First, inquiries into subjective intent, especially in intrafamily transfers, are particularly perilous. The present case illustrates that it is, practically speaking, impossible to determine after the death of the parties what they had in mind in creating trusts over 30 years earlier. Second, there is a high probability that such a trust arrangement was indeed created for tax-avoidance purposes. And, even if there was no estate-tax-avoidance motive, the settlor in a very real and objective sense did retain an economic interest while purporting to give away his property. Finally, it 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.
>
> For these reasons, we hold 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 settlors. Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. 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 settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.
>
> Applying this test to the present case, we think it clear that the value of the Janet Grace trust fund must be included in decedent's estate for federal estate tax purposes. It is undisputed that the two trusts are interrelated. They are substantially identical in terms and were created at approximately the same time. Indeed, they were part of a single transaction designed and carried out by decedent. It is also clear that the transfers in trust left each party, to the extent of mutual value, in the same objective economic position as before. Indeed, it appears, as would be expected in transfers between husband and wife, that the effective position of each party vis-à-vis the property did not change at all. It is no answer that the transferred properties were different in character. For purposes of the estate tax, we think that economic value is the only workable criterion. Joseph Grace's estate remained undiminished to the extent of the value of his wife's trust and the value of his estate must accordingly be increased by the value of that trust. [emphasis added]

In *Estate of Levy*, a Tax Court Memorandum decision — i.e., a decision that was not reviewed by the entire Tax Court — Judge Shields stated:

> Thus, to determine whether the Herbert Levy Trust and Ilse Levy Trust are interrelated, we will consider their terms, corpus, trustees, and beneficiaries, as well as their date of creation and their relation, if any, to a prearranged plan.
>
> Respondent insists that the trusts are interrelated because: (1) they were created on the same date pursuant to joint consultations with the same attorneys; (2) they each contained twelve and one-half shares of Wel-Fit; (3) Ilse Levy and Herbert Levy were each the trustee of the other's trust; and (4) the residuary beneficiary of both trusts was

> Lawrence Levy, the son of Herbert and Ilse Levy.
>
> Petitioner does not dispute these facts. He argues, however, that the trusts are not interrelated because their terms are <u>not identical</u>. In particular, he points out that the Herbert Levy Trust gave Ilse Levy a special power of appointment which permitted her to appoint the income and corpus of the trust created by Herbert Levy to anyone except herself, her estate, her creditors, and the creditors of her estate. The Ilse Levy trust did not confer a similar power of appointment upon Herbert Levy. <u>Thus, petitioner asserts that the Herbert Levy Trust and the Ilse Levy Trust had very different legal consequences and were not interrelated for purposes of applying the reciprocal trust doctrine. We agree.</u> [emphasis added.]

With all due respect to Judge Shields, he essentially read the clear United States Supreme Court authority out of the law through what can fairly be characterized as a confused and tortured interpretation of the "interrelated" prong of the United States Supreme Court's reciprocal trust analysis.

To reiterate, the Supreme Court's holding and test in *Estate of Grace* was:

> Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be <u>interrelated</u>, and that the arrangement, <u>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.</u> [emphasis added.]

In my opinion, the *Estate of Levy* decision is easily explained and distinguished, and it shouldn't be relied upon going forward as a blanket inoculation against application of the reciprocal trust doctrine, which would happen in both spouses' estates. As Judge Shields himself acknowledged, the subject trusts were created on the *same date* pursuant to joint consultation with the *same lawyers* and *funded with related property*. Thus, to add more assurance to the plan, it is preferable that separate counsel represent each spouse independently.

But Judge Shields erroneously added the slight difference between the trust instruments to the "interrelated" analysis instead of considering it as part of the second "same economic position as life beneficiaries" prong, saying: "Petitioner does not dispute these facts. He argues, however, that the trusts are not interrelated because their terms are not identical."

The Supreme Court's "interrelated" prong that it set down in Estate of Grace never required ***perfectly identical*** instruments. In fact, the subject instruments in *Estate of Grace* weren't identical, which the Supreme Court expressly pointed out, noting: "They are <u>substantially identical</u> in terms, and were <u>created at approximately the same time</u>. Indeed, they were <u>part of a single transaction designed and carried out by decedent</u>." [emphasis added]

By so doing, Judge Shields determined that the trusts weren't interrelated, obviating the need for him to even consider the second "same economic position as they would have been in had they created trusts naming themselves as life beneficiaries" prong.

Judge Shields went on to consider whether

> During her life, and prior to the death of Herbert Levy, Ilse Levy could appoint the income and the corpus of the Herbert Levy Trust when and as she pleased except to herself, her creditors or her estate. In contrast, Herbert Levy had no power of appointment over the income or the corpus of the Ilse Levy Trust. He was merely its trustee. As a result, decedent and his wife had markedly different interests in, and control over, the trusts created by each other. The reciprocal trust doctrine

> does not purport to reach transfers in trust which create different interests and which change "the effective position of each party vis a vis the [transferred] property * * *." *United States v. Estate of Grace*, supra at 325.

In my opinion, Judge Shields was faulty in his analysis and could've easily decided the case as he did on the merits simply by pointing out that Mrs. Levy's *lifetime* special power of appointment, which Mr. Levy didn't get, made the interests of each spouse *not identical* because she had the present ability to exercise her lifetime special power of appointment in favor of someone other than her husband, which would've defeated his beneficial interests.

The existence of Mrs. Levy's lifetime special power of appointment made the spouse's life beneficiary interests not identical under the *Estate of Grace* test. Had Judge Shields decided the case on that line, I assert that his result and rationale would've been in accordance with the Supreme Court test in *Estate of Grace*. In my opinion, Judge Shields reached the ultimate correct result in *Estate of Levy* but on faulty rationale because Judge Shields conflated and confused the two separate prongs of the Supreme Court's test from *Estate of Grace*.

Unfortunately, in my opinion, some cite *Estate of Levy* for the proposition that the mere insertion of instrument differences provides legal protection against application of the reciprocal trust doctrine. In my opinion, this is an inaccurate interpretation and contrary to the analysis of the United States Supreme Court in the holding in *Estate of Grace*, which was:

> Rather, we hold that application of the reciprocal trust doctrine requires only that the trusts be <u>interrelated</u>, 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 <u>naming themselves as life beneficiaries</u>. [emphasis added]

Does the Insertion of Distinguishing Differences in Trust Instruments Make Any Difference?: In their April 2012 article in *Trusts & Estates*, Marty Shenkman and Bruce Steiner posited several differences that could be inserted into the SLAT instruments of the spouses to hopefully ensure that joint SLATs won't be caught by the snares of the reciprocal trust doctrine under the *Estate of Levy* rationale, including:

- Drafting the trusts pursuant to different plans.
- Refraining from putting a husband and wife in the same economic position following the establishment of the two trusts.
- Using different distribution standards in each trust.
- Using different trustees or co-trustees.
- Giving one spouse a non-cumulative "5 and 5" power, but not the other.
- Giving one spouse a power of appointment and not the other spouse.
- Giving one beneficiary spouse the broadest possible special power of appointment and the other beneficiary spouse a special power of appointment exercisable only in favor of a narrower class of permissible appointees, such as issue or issue and their spouses.
- Giving one spouse a special power of appointment exercisable both during lifetime and by will and the other spouse a testamentary special power of appointment only.
- In the case of insurance trusts, including a marital deduction savings clause in one trust, but not the other.
- Create different vesting provisions for each trust.
- Instead of mandating distributions, give the beneficiaries control, or a different degree of control, at different ages.
- Vary the beneficiaries.

- Create the trusts at different times.
- Contribute different assets to each trust, either as to the nature or the value of the assets.

At the outset, if these differences are being suggested to be added to create the appearance of significant differences, it is potentially problematic because the Service could assert that this *exalts form over substance*, especially if the joint SLATs are drafted by the same lawyers and/or pursuant to the same integrated plan. The key is that the differences in each SLAT instrument must have significant economic effect that must be recognized and honored during administration.

While reasonable minds certainly can differ, it's at least arguable that some of these suggested built-in "differences" don't actually materially alter the economic interests of the grantor spouses as *lifetime beneficiaries* (as required by the Supreme Court's test in *Estate of Grace*) of the SLAT that the other spouse created for the beneficiary spouse if the SLATs were uncrossed in a classic application of the reciprocal trust doctrine. In the author's opinion, all suggested differences that don't affect the respective spousal interests as *lifetime beneficiaries* are ineffective as shields against application of the reciprocal trust doctrine.

A Safer Way to Create "Joint" SLATs: In my opinion, a safer way that both spouses can form SLATs is to be separately represented by unrelated lawyers in different firms without any communication or coordination between the lawyers.

Conclusion: The SLAT can be an effective way to ensure locking in the current high level of applicable exclusion amount while retaining indirect access to the assets via a spouse. I suspect that, in some inappropriate circumstances, the SLAT has been used for clients who really can't afford to irrevocably part with access to the capital contributed to the SLAT. Back in the early 1990s, I predicted that the IRS would be able to successfully challenge many family limited partnership arrangements on IRC section 2036 grounds, which came to pass. I now predict that the IRS will enjoy similar success with challenging joint improperly-done SLATs on the reciprocal trust doctrine using the *Estate of Grace* decision.

Paul Hood is a prolific author and frequent speaker about estate planning and tax issues. Paul may be reached at paul@paulhoodservices.com.

Probate Report

- **Emails Can Be Trust Amendment**

In *In Re Omega Trust*, 281 A.3d 1281 (N.H. 2022), the settlor executed a trust document in 2005 and amended it twice in 2015. The trust language required that the settlor sign any amendment and provide notice to the trustee. In poor health in July 2016, the settlor sought the assistance of the trust protector, who helped the settlor craft an email to his attorney informing him that he was making changes to the trust. The settlor also informed the trustee that he was contacting his attorney to amend the trust. The next month, the settlor emailed his attorney informing him of his desire to amend his estate planning documents, including the trust. The email contained specific changes, including the addition of beneficiaries. The attorney emailed back with some questions about the changes and followed up with an email summarizing the changes to the estate plan and asking for confirmation. The attorney represented that his firm was working on the revised documents,