Spousal Lifetime Access Trust

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1. SPOUSAL LIFETIME ACCESS TRUST (SLAT) DISCUSSION.

A Spousal Lifetime Access Trust is a popular estate planning device today. Common acronyms are SLAT or SAT (for spousal access trust). The trust (for this example, assume created under Arizona law, which in many instances is representative of other states) contains provisions similar to the following description. One spouse creates a trust for the benefit of the other (the "beneficiary spouse"). That spouse has a right to income or perhaps a right to distributions for her health, education, maintenance and support ("HEMS right") and may have an annual noncumulative ("use it or lose it") 5% right of withdrawal, as well as a special power of appointment. The beneficiary spouse can be the trustee. None of the property contributed to the trust was that of the beneficiary spouse, or that spouse would be contributing to the trust for herself, and to that extent that allocable share would be reachable by her creditors. None of those rights will alone cause the trust to be includable in the federal gross estate of the beneficiary spouse. Code Section 2041(a)(2), (b)(1) and (b)(2). Furthermore, the rights are not reachable by the creditors of the spouse. Arizona's statutes are representative of the other Uniform Trust Code states: ARS Sections 14-10504(E), 14-10505(B)2. Some states permit the Settlor of a trust to be reimbursed for his income taxes attributable to the trust, and that right is not reachable by his creditors. Ex: Arizona: ARS Section 14-10505(A)2(a); Ohio: ORC Section 5805.02(B)(3)(c). In such states, if an independent trustee has discretion to make the reimbursement then such right does not cause the trust to be includable in his gross estate under Code Section 2036(a). Rev. Rul. 2004-64.

Property interests to the extent the spouse beneficiary was an owner, which would include community property, that is to be funded to the trust is not suitable because of the self-settled trust rule that permit creditors to reach trust assets (discussed in detail below). However, the spouse in most states can easily transmute or recharacterize property into the property solely that of the donor spouse. The spouses could just declare that jointly owned property (or community property) is the separate property of the to-be-donor. The problem with the gifting of that property to the trust is that there is a serious risk that the IRS would successfully assert that the step transaction doctrine would apply to treat the gift of the one half community property interest to the one spouse and the separate gift of the newly characterized separate property to the trust is collapse into a transfer of one half of the property by each of the spouses to the trust. Such would cause one half of the balance of the trust at the death of the beneficiary spouse to be included in the gross estate under Code Section 2036. For the same reason, that one half of the trust may be reachable by the creditors of the beneficiary. ARS Section 14-10505(A)(2). Therefore, twice the amount of the jointly owned property should be divided into the separate ownership of each spouse, and the donor gifts only his interest to eliminate the self-settled trust issue.

Once the gift has been made, it is a plain vanilla irrevocable trust, fully effective for gift, estate, and generation-skipping transfer ("GST") tax purposes.

The SLAT is generally a grantor trust for income tax purposes, income taxable to the donor spouse. The common technique to assure grantor trust status is for the donor to have the nonfiduciary power to substitute property of equivalent value. Code Section 675(4)(C). Holding such power will not threaten estate tax inclusion of the trust in the donor's estate. Rev. Rul. 2008-22; Rev. Rul. 2011-28. Because the spouse is a discretionary income beneficiary, the trust is unavoidably a grantor trust. Code Section 677(a)(1).

Reacquisition of SLAT Interest - Creditor Issue.

Ideally, the donor would like to be able to benefit from the trust at some point. The one sticking point is that under the general rule at common law and under the Uniform Trust Code ("UTC") and most states, the donor remains the settlor and would be unable to protect from his creditors any interest he reacquires in the trust. Model UTC Section 505(a)(2); ARS Section 14-10505(A)(2). There are still possible ways to get around this. One method available at common law is to allow someone the right to withdraw all the assets for some period. This general power of appointment should purge the trust from being treated as settled by the donor spouse and permit asset protection for the interest reacquired by the donor spouse as if he were only a beneficiary and not a settlor. Some states offer more protection.

(Certain State Exceptions.) The relevant law may provide important exceptions. ARS Section 14-10505(E) 1, 2, and 3 permit the donor to become a beneficiary of the trust after the death of the donee spouse, and not be treated as its settlor. Without that section, the creditors of the donor could intercept any distributions that are to be made to him. ARS Section 14-10505(E)(3) provides that the donor spouse is not the settlor if the trust was "for the [beneficiary] spouse," and the donor become a beneficiary after her death. Arizona and Texas <u>do not require</u> that the property have been included in the spouse's gross estate for estate tax purposes: ARS Sec. 14-10505(E)(1), (2), and (3); Tex. Trust Code Sec. 112.035(g)(1) and (2). However, Ohio's and Michigan's statutes do: ORC Sec. 5805.05(B)(3)(b); MCL Sec. 700.7506(4).

There are still many traps for the unwary, even assuming compliance with state statutes that protect donor spouse who become a beneficiary. If the reacquired rights of the donor are limited to the rights of the spouse described in the first paragraph of this section "Spousal Access Trust," then the creditors of the donors are no better off than the creditors of the beneficiary spouse. If the rights given back to the donor are such that, if held by a nonsettlor beneficiary, are reachable by creditor, then those rights can be taken.

In most states the settlor's creditor could reach the trust to the extent of the settlor's resulting interest. In such states, the trust would be includable in the settlor's gross estate under Code Section 2036(a)(1). Since the settlor's creditors can reach the assets of the trust to the extent of his interest until his death, he is deemed to retain the right to enjoyment of his property. See *Estate of German v. U.S.*[1]

Reacquisition of SLAT Interest - Estate Tax Issue.

Arizona is one of a handful of states that expressly permit a settlor to reacquire trust interests and not be deemed a settlor. In those states that are not so accommodating, the reacquisition of an interest in the trust automatically will cause the interest to be includable in the gross estate of the settlor, because it is reachable by his creditors. Therefore, to avoid loss of creditor protection, the spouse who created the trust for the other cannot become a beneficiary at any time thereafter. If the creditor of a beneficiary, whether or not the original settlor, can generally reach trust assets, then the trust will be includable in the estate of that beneficiary to the extent of those assets reachable.

Either or both Code Sections 2036 and 2038 can apply to cause some or all of the trust to be includable in the settlor's estate, even in Arizona.

Section 2036 - Transfers with retained life estate.

(a) General rule.

The value of the gross estate shall include the value of all property of which the decedent has at any time made a transfer(except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained—

(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 enjoy the property or the income there from.

Section 2038 – Revocable Transfers.

(a) In general. The value of the gross estate shall include the value of all property—

(1) over which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), 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 by the decedent, to alter, amend, revoke, or terminate.

Code Section 2036 applies only if the settlor *retains* an interest in the trust. If the Settlor was not entitled to reacquire the interest upon creation of the trust, then Code Section 2036 does not apply. The trust may be includable in the estate if there was found to be an understanding that, through exercise of a power of appointment or otherwise, the settlor would ultimately receive back an interest. In any event, the trust agreement should not provide that the settlor automatically have a returning interest if federal estate tax is a potential issue.

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[1] 757 F.2d 1522 (Cl. Ct. 1985).

Section 2038 will cause that portion of the trust to be included in the gross estate of the settlor if, at the time of the death of the settlor, the settlor had the power, alone or in conjunction with another, to change the beneficial interests of that portion. In other words, the settlor cannot acquire a special power of appointment in the trust to avoid application of Section 2038.

Trust assets will not be included in the Donor Spouse's gross estate under Section 2036(a)(2) or Section 2038 if the Donor Spouse is serving as Trustee if the only "right" or "power" reserved with respect to the property is subject to a definite external standard subject to court supervision. <u>See</u> *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

Other discussion - Sections 2036 and 2038.

<u>Retained Power vs. Power Held At Death For Whatever Reason.</u> Under Section 2036(a)(2), only powers "retained" by the decedent cause inclusion. Under Section 2038, it is sufficient that the decedent holds the power at death, regardless of "at what time or from what source the decedent acquired his power." Treas. Reg. § 20.2038-1(a). For example, if a decedent did not retain the power to control distributions, but acquired the power only through appointment as trustee by another person, Section 2038 would apply, but Section 2036 would not.

<u>Exception for Powers Held By Third Party Trustee.</u> Powers held by a third party rather than by the grantor will not cause estate inclusion. The IRS's "de facto" control argument has not been well received by the courts. However, the grantor must be careful not to have an express agreement or understanding regarding the trustee's decisions. Also, the reciprocal trust doctrine might apply to uncross powers held by trustees of "interrelated trusts."

<u>Ascertainable Standard Exception.</u> If the distribution powers held by the grantor are limited by a determinable external standard, enforceable in a court of equity, the grantor arguably does not have any power to alter the distributions from the terms of the trust, because the standard sufficiently limits the grantor's discretion. However, there is no explicit ascertainable standard exception in the statutory provisions or regulations to Sections 2036 and 2038. (Regulations under various other sections give guidance on what standards would constitute an ascertainable standard or a definite external standard. Treas. Reg. §§ 20.2041-1(c)(2), 25.2511-1(g)(2), and 1.674(b)-1(b)(5)(i).)

The seminal case establishing the ascertainable standard exception for a donor controlled power over disposition is *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947). In that case, the grantor retained the power as trustee to make distributions to enable the beneficiary to keep himself and his family in comfort "in accordance with the station in life to which he belongs." The court held that power would not cause inclusion under the predecessor to Section 2038. Since that time, many courts have ruled on whether particular standards are sufficient to avoid inclusion under Section 2036 and 2038. Standards relating to "health education, support and maintenance" are invariably held to avoid estate inclusion, by analogy to the standards exception in Section 2041. E.g., *Estate of Weir v. Comm'r* , 17 T.C. 409 (1951), acq. 1952-1 C.B. 4 ("the education, maintenance and support"' and "in the manner appropriate to her station in life").

Summary of Planning for Ascertainable Standard Exception. To be conservative in the planning process, if the trust instrument reserves for the grantor any dispositive powers, the instrument should apply a strict "health, education, support and maintenance" standard. Using any other words is taking a risk that the IRS might question whether Sections 2036 or 2038 should apply. E.g., Rev. Rul. 73-143, 1973-1 C.B. 407 (power to make payments early "in case of need for education purposes or because of illness or for any other good reason" is not an ascertainable standard). Even though the courts have generally recognized other reasonable standards as being ascertainable, why place yourself in the position of having to argue with the IRS and possibly face an adverse court decision?

Effect of Adding That Trustee Makes Decision "In His Sole Discretion". Various cases have held that adding that a trustee may decide in his sole or uncontrolled discretion whether the stated standards have been satisfied does not change the result. E.g., *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947) ("in their absolute discretion"); *State Street Trust Co. v. U.S*., 160 F. Supp 877 (D. Mass 1958) (power to invade capital for the "comfortable maintenance and/or support" of each beneficiary, in the trustee's '"sole and uncontrolled discretion"), aff'd, 263 F.2d (1st Cir. 1959); *Estate of Budd v. Comm'r*, 49 T.C. 468 (1968) ("suitable support, education and maintenance of any such beneficiary, the Trustee may, in his uncontrolled discretion, apply …"). In Estate of Budd, the IRS argued that adding the modifier "in his uncontrolled discretion" rendered the standard as not being ascertainable. The Tax Court disagreed, under the reasoning that even though "a court of equity ordinarily will not substitute its discretion for that of the trustee, nevertheless, even where the power is granted in terms of the 'sole' or 'uncontrolled' discretion of the trustee, it will review his action to determine whether in light of the standards fixed by the trust instrument, such discretion has been honestly exercised." Cf. Treas. Reg. § 25.2511-1(g)(2)("the fact that the governing instrument is phrased in discretionary terms is not itself an indication that no such standard exists"). However, some commentators have pointed out that adding such a modifier, where the grantor has retained a power over distributions, is dangerous and generally should be avoided. See Kasner, Why One Should Never Rely on A Private Letter Ruling, TAX NOTES, 742 (August 5, 1996) (commenting on Letter Ruling 9625031 in which the IRS held that trusts were not included under Section 2036 and 2038 where the trustees—including the grantor—had the right to pay the beneficiary "in their discretions" for his health, support, maintenance, and education). Indeed, the IRS did raise the argument, albeit unsuccessfully, in Estate of Budd.

The QTIP regulations. The QTIP regulations make clear that any interest retained by the donor-spouse in qualified terminable interest property will not cause the property subject to the retained interest to be includible in the gross estate of the donor-spouse—whether the donor-spouse dies before the donee-spouse or after the donee-spouse has died and the property has passed into a "bypass trust" for the benefit of the original donor-spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11.

Inclusion in Donor's Estate. The main issue is whether the trust assets are included in the donor's gross estate, (1) if the donor predeceases the spouse, or (2) if the spouse predeceases and in fact appoints the trust property to a trust for the benefit of the donor.

Section 2036(a)(1) includes in a decedent's gross estate 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 the decedent has retained for the decedent's life or for any period which does not in fact end before the decedent's death the possession or enjoyment of, or the right to the income from the property. Has the donor retained an interest in the trust, if the spouse must later exercise the power to leave the assets back to the donor? Regulation § 20.2036-1(a) provides that an interest or a right is treated as being retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.

The regulations address such a contingency with respect to Sections 2038 and 2036(a)(2), dealing with powers that the donor could regain upon the occurrence of contingencies, but does not address the effect of such a contingency under Section 2036(a)(1), which is the relevant section. Reg. §§ 20.2038-1(a)(3) & 20.2036-1(b)(3).

In one 1991 ruling, the donee-wife of an inter vivos QTIP would, on the same day the trust was funded, execute a codicil to her appointing the assets to a trust for the donor-husband. That ruling concluded that the trust assets would not be in the donor's estate, whether he died before donee-wife, or whether she died first after appointing the assets to a trust for his benefit. The ruling reasoned that the original donor-husband is not considered the transferor of the Subtrust for his benefit, so Sections 2036 or 2038 are inapplicable. *Ltr. Rul. 9140069*. However, the QTIP trust situation is distinguishable from other transfer situations. The QTIP regulations make clear that any interest retained by the donor-spouse in qualified terminable interest property will not cause the property subject to the retained interest to be includible in the gross estate of the donor-spouse—whether the donor-spouse dies before the donee-spouse or after the donee-spouse has died and the property has passed into a "bypass trust" for the benefit of the original donor-spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11.

Some states such as Texas, Ohio, and Arizona provide that a settlor is not considered a beneficiary of a trust solely because the settlor's interest in the trust was created by the exercise of a power of appointment by a third party. See Ariz. Rev. Stat. §14-10505(E-F); Ohio Rev. Code §5805.06(B)(3)(a); Tex. Prop.

Code §112.035(d)(2). In DAPT states which have broader protections for the settlor, if the QTIP trust or SLAT creates a trust for the settlor under the donee spouse's exercise of a power of appointment the donor spouse creditors should not be able to reach assets in a successor trust for the donor spouse.

No §2036 Issue – Exercise of non-general power of appointment is not a transfer under 2036. Donor Spouse did not "retain" any power.

No §2038 Issue – Exercise of non-general power of appointment is not a transfer under 2038. Donor Spouse did not make a "transfer" which is subject to his power to alter, amend, revoke, or terminate (Distribution powers limited to HEMS).

Inclusion in Spouse's Estate. Whether the trust is included in the spouse's estate depends on whether, under traditional planning principles, the spouse has a power over the trust that is taxable under Section 2041. Two letter rulings in 1991 addressed situations in which the donee-spouse had a power of appointment to appoint the trust property back to the donor. In Letter Ruling 9140068, the transfer was to an inter vivos QTIP trust, and the trust assets were includible in the donee spouse's estate under Section 2044. In Letter Ruling 9141027, the transfer was to a trust that was not included in the spouse's estate. Letter Ruling 9128005 involved an outright transfer from Donor Spouse to Donee Spouse, where the Donee Spouse, on the same day as the gift, executed a codicil leaving the property back to a trust for the Donor Spouse if she predeceased him. The property was obviously included in the Donee Spouse's gross estate.

Implied Agreements – Section 2036.

In another 1991 ruling, where the original transfer was made to a trust that was not included in the spouse's estate for estate tax purposes, the IRS concluded that the trust assets would be included in the gross estate of the donor because the spouse intended to exercise the power of appointment to leave the assets to a trust for the donor's benefit. Ltr. Rul. 9141027. In that ruling, the donor-husband proposed transferring assets to an irrevocable trust for his wife's benefit, and the donee-wife proposed exercising her testamentary power of appointment (by a will executed on the same day the original transfer is made to the trust) to appoint the property, under a standard marital deduction formula approach, to a bypass trust for the benefit of the original donor-husband. The IRS concluded, based on these facts, that an implied agreement existed that the transferred property would later be transferred for the donor's use and benefit.

"A [the original donor] and B [the original donee] agreed that if A transfers property to the Spousal Trust for the benefit of B, B will execute a Codicil to her will that will appoint Spousal Trust principal to a trust under which A may be a beneficiary. This implied agreement between A and B results in A retaining benefits of property that he plans to transfer. It is not necessary that A has definite right to the property. In view of the facts presented, the possibility that A may reacquire an interest in previously transferred property after B dies constitutes a retained interest in the transferred property. Therefore, the value of the Spousal Trust will be includible in A’s gross estate under section 20.2036-1(a) of the regulations.” (emphasis added).

Under the facts of the ruling, finding an implied agreement to appoint the property back to the donor seems clear, based on the representation that the donee spouse planned to exercise the power of appointment by signing a revised will on the very day that the gift was made to the trust. The italicized words in the ruling suggest that the mere existence of the power caused the estate inclusion problem for the original donor, and not the actual exercise of the power of appointment.

Various other possible restrictions would help bolster the argument that the spouse’s power of appointment would not cause an estate inclusion problem for the donor. The actual exercise of the power, or even more conservatively, the manner in which the power of appointment could be exercised in favor of the donor-spouse, could be limited in the following possible ways. The appointment for the donor could be limited to payments for the health, support and maintenance of the donor. (Observe, however, that there are no cases suggesting an ascertainable standard exception for Section 2036(a)(1) like there are for Sections 2036(a)(2) and 2038.) Additionally, the permissible trust could require that distributions could be made to the grantor only after other income and assets of the donor had been exhausted, so that A’s creditors could not reach the property.

However, A will retain an interest in the transferred property because at the time of the transfer there will be an implied agreement between A and B that the transferred property will later be transferred for A's use and benefit. A's initial creation of the Spousal Trust and the transfer of property to the trust will be interrelated with B's testamentary exercise of her power of appointment under the trust. A proposes to transfer property to a trust under which his spouse has a power to appoint trust principal to another trust. B then proposes to execute a Codicil to her will that appoints the Spousal Trust principal to the Revocable Trust. Any property that B appoints to the Revocable Trust will be distributed to the Sub-Trust of the Family Trust. While A cannot be a trustee or appoint the trustee of the Sub-trust, A may be a beneficiary of the Sub-trust. As a beneficiary of the Sub-Trust, A will benefit from previously transferred property.

A and B have agreed that if A transfers property to the Spousal Trust for the benefit of B, B will execute a Codicil to her will that will appoint Spousal Trust principal to a trust under which A may be a beneficiary. This implied agreement between A and B results in A retaining benefits of property that he plans to transfer. It is not necessary that A has a definite right to the property. In view of the facts presented, the possibility that A may reacquire an interest in previously transferred property after B dies constitutes a retained interest in the transferred property. Therefore, the value of the Spousal Trust will be includible in A's gross estate under Section 20.2036-1(a) of the regulations.

Implied Agreements Donor Spouse and Donee Spouse – Gift of House: The court stated that it would not imply an agreement where the record shows that the Donor Spouse expressed a desire that the Donee Spouse have the property in such a way that her situation would be equivalent to that of a former Donee Spouse to whom after his second marriage he had transferred exclusive ownership and use of a home which he and she formerly had owned jointly and where it also appeared that over the years it was the custom and practice of the Donor Spouse to make substantial outright gifts of property to his second Donee Spouse. Other courts take the same view. *Binkley, Gordon Est v. U.S.,* (1966, CA3) 17 AFTR 2d 1392, 358 F2d 639, 66-1 USTC ¶12389. *Stephenson, Elizabeth, exrx v. U.S.,* (1965, DC VA) 15 AFTR 2d 1408, 238 F Supp 660, 65-1 USTC ¶12314; *Burr, George Est*, (1945) PH TCM ¶45364, 4 CCH TCM 1054.

Implied Agreements Parent and Child – FLP: The Tax Court said that the existence of an implied agreement was established by the following facts:

The decedent—in violation of the partnership agreements—deposited the income from the FLPs into the account used by her as a personal checking account, where it was commingled with income from other sources. According to the Tax Court, deposits of income from transferred property into a personal account were highly indicative of “possession or enjoyment”. (2) The decedent's children acknowledged that the formation of the FLPs was merely a way to enable the decedent to assign interests in the partnership assets to members of her family, and that the assets and income would be managed by the decedent exactly as they had been managed in the past. According to the Tax Court, where a decedent's relationship to transferred assets remains the same after the transfer as it was before the transfer, Code Sec. 2036(a)(1) requires that the assets be included in the decedent's gross estate. *Schauerhamer, Dorothy Est,* (1997) TC Memo 1997-242 , RIA TC Memo ¶97242 , 73 CCH TCM 2855.

Implied Agreements between Parents and Children – Gift of House: The Tax Court found that a prime indication of an implied agreement was the fact that the parent had exclusive possession of the house after the transfer. Here, a father gave his sons a quit-claim deed to his home. The deed was recorded and given to one of the sons. The father continued to live alone in the house; all his sons had their own homes. He paid no rent but did pay all bills received in connection with the property. When he entered a nursing home, the property was left vacant until after he died. Linderme, Emil Sr. Est, (1969) 52 TC 305

The Tax Court found an implied agreement, arising contemporaneously with the gift, to let the donor continue to live in the house, where a father (donor) had deeded his house to his two daughters and filed a gift tax return reporting the transfer. Although the gift was made four years before the donor died, he continued in almost exclusive possession of the residence until his death. The donees continued to live in their own homes and never lived in or tried to sell or rent the gifted property. The donor paid no rent to the donees, and he continued to pay the real estate taxes on the property. The value of the residence was included in the donor-decedent's estate. Rapelje, Adrian Est, (1979) 73 TC 82

A mother gave her house to her daughter by a deed which was recorded, and filed a gift tax return. The mother continued to occupy the house and pay real estate taxes and repairs. The daughter continued to live in her own residence. The Fourth Circuit said that, while the issue of implied agreement must turn on all the circumstances of each transaction, the continued exclusive possession by the donor, and the withholding of possession from the donee, were highly significant factors. *Guynn, Jane, exrx v. U.S.,* (1971, CA4) 27 AFTR 2d 71-1653, 437 F2d 1148, 71-1 USTC ¶12742, revg & remg (1970, DC VA) 25 AFTR 2d 70-1528, 309 F Supp 233, 70-1 USTC ¶12661.

Best Mode of Donor Spouse SLAT Interest Reacquisition.

If state law is conducive, the trust instrument may permit the beneficiary spouse to appoint the trust in whole or in part in trust for the benefit of the donor settlor, and, in many states, may permit him to be the trustee safely if he is the sole beneficiary during his lifetime. Whether or not the beneficiary spouse has the power to appoint the trust outright to the donor, if she appoints it back but desires that the trust not be in the gross estate of the donor spouse, she should grant the donor no more than a HEMS right, a 5% right of withdrawal, or an income right, or any combination of them. If she desires to avoid the inclusion of the trust in the gross estate of the donor spouse, she should not give the donor a power of appointment, special or general. Even if she did, the donor may be able to make a qualified disclaimer of the undesirable powers. Code Section 2518. If it is not certain that the donor spouse will have a taxable estate, it may be advisable to give the beneficiary spouse the power to give the donor spouse a power of appointment that could cause the Delaware Tax Trap to apply to step up basis in trust assets. This is to assure inclusion in his estate to cause step up in basis of trust assets upon his death if it is likely that he will have an estate significantly less than the anticipated exemption, and if there is property in the trust with a value significantly greater that the basis the trust has in the property. Code Section 1014(b)(9). The beneficiary spouse will exercise the power without granting the donor a power of appointment if he is likely to have a taxable estate. She can cherry pick the assets to be includable. Alternatively, she could appoint a trust protector who could grant the power to the donor at any time.

Reciprocal Trust Issue.

The SLAT trust works perfectly well, as described above. But to make things near perfect, it would be great if each spouse could be the beneficiary of the trust he or she settled. It seems too good to be true. Two hurdles have to be jumped that did not exist with only one SLAT trust in order to accomplish this desired result. One is the issue of whether creditor can reach trust assets under the common law as a result of the mutual actions. The other is whether, for federal estate tax purposes, a spouse will be deemed to be the transferor of the trust of which he or she is the beneficiary, and therefore no estate tax benefit results.

Common Law Reciprocal Trust Doctrine.

Restatement (Third) of Trusts, Section 58 reports that at common law, assets of a trust created by the settlor for his benefit are subject to the claims of his creditors to the extent the trustee is empowered to make distributions to him. If the beneficiary of a trust provided the consideration to induce a person to settle a trust for his benefit, then he will be treated as the settlor of the trust. The following appears in Comment f:

> **Illustrations:**
> ///
> 9. S. transfers $500,000 to T in trust to pay the income to S's brother B for life, remainder to B's issue. At about the same time, pursuant to their prearrangement, B creates a similar trust, also of $500,000, for S and her family. Each trust contains a spendthrift clause. Nevertheless, as settlor of the trust ostensibly created for her by B, she can transfer her interest, and her creditors can reach that interest. (On the tax aspects of this type of "reciprocal trust" arrangement, see Reporter's Notes.) The restraint on alienation is valid, however, with respect to the remainder interests.

Restatement (Second) of Trusts, Section 156, Comment f had previously endorsed the rule:[2]

> f. *Under what circumstances beneficiary is settlor*. In order that a trust shall come within the terms of this Section, it is not necessary that the beneficiary shall have himself conveyed the property held in trust. It is sufficient that he paid the purchase price for a conveyance upon a trust, of which he is the beneficiary or one of the beneficiaries.
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> **Illustration:**

[2] The Second Restatement may be the only relevant Restatement in Arizona for this legal issue. ARS Section 14-10106 provides: Common law of trusts; principles of equity

a. The common law of trusts and principles of equity supplement this chapter, except to the extent modified by this chapter or another statute of this state.

b. The court shall look to the restatement (second) of trusts for interpretation of the common law and not to subsequent restatements of trusts to determine:

1. The rights and powers of creditors of beneficiaries.

2. The duties of trustees to distribute to those to whom a beneficiary owes any duties.

3. Whether public policy may affect enforceability and effectiveness of the terms of the trust.

4. And effectuate the settlor's intent.

2. In consideration of the payment of $10,000 by A to B, B transfers Blackacre to C in trust to pay the rents and profits to A during his life, and to convey Blackacre to D on A's death. At A's request B inserts a provision in the trust deed to the effect that A's interest should not be transferable by him or subject to the claims of his creditors. A can transfer his interest; his creditors can reach his interest.

There is one reported case applying the common law espoused in the restatements. *Security Trust v Sharp,* 77 A.2d 543 (Del. Ct. Ch. 1950). Interestingly, in that case the parties wanted the reciprocal trusts to be uncrossed. By treating the beneficiary as the settlor of her trust, the spendthrift trust provision was invalid. That permitted the beneficiary to assign his interest. The court observed that "it is not unlikely that the same approach would be taken by the courts when such trusts are attacked by creditors."

If this common law reciprocal trust doctrine ("CLRTD") applies, then each spouse is deemed to have settled the trust funded by the other. In such case, creditors of a spouse could reach the trust assets to the extent of the interest of the spouse. ARS Section 14-10505(A)1.

Unique Rule in Arizona and Texas. Arizona's ARS Section 14-10505(E)4, in its own style, prevents application of the CLRTD**:**

> E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:
> ///
> 4. An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse.

Texas copied Arizona's statute. Tex. Trust Code Section 112.035(g)(3)(A).

So, for Arizona and Texas law purposes, creditors should not be able to avail themselves of the CLRTD.

Estate Tax Reciprocal Trust Doctrine

The federal estate tax is not so easily handled.

a. Definition. The estate tax reciprocal trust doctrine was created in response to trusts drafted with the intention of avoiding the terms of the predecessor to Code Section 2036 (Internal Revenue Code of 1939, Section 811(c)(1)(B)), which provides that certain transferred property in which a decedent retained a life interest was to be included in his gross estate. The reciprocal trust doctrine is applied when two grantors create similar trusts at approximately the same time and there are similar beneficial interests or powers granted by the grantors to one another. The terms of the trust agreements must be sufficiently different to withstand the assertion that Section 2036 applies. The result of application of the doctrine is inclusion of such property in the grantor spouses' respective estates.

b. Case Law and Rulings.

   i. *U.S. v. Grace*, 395 U.S. 316; 23 A.F.T.R.2d 69 (1969). In Grace, the decedent, Joseph Grace, created a trust of which he was a co-trustee and which provided his wife, Janet, with an income interest for life, principal in the discretion of the trustees, and a testamentary power to appoint the trust principal among Joseph and their children. Two weeks later, Janet created a trust for Joseph, naming herself as a trustee and mirroring the terms of the trust that Joseph previously created. The U.S. Supreme Court formulated a two-part test with the following required elements: First, the trusts must be interrelated; and second, the transaction must leave the grantors of the trusts in the same economic position as they would have been in if they had created the trusts naming themselves as life beneficiaries. After applying the test, the court uncrossed the Grace transfers and included in Joseph's gross estate the property that was held in Janet's trust. It is important to note that the there is no need to prove that that trusts were created in consideration of the creation of the other. "Quid pro quo" is not a fact relevant to application of the estate tax reciprocal trust doctrine.

   ii. *Estate of Levy*, T.C. Memo. 1983-453 (1983). In Levy, the decedent and his wife had created trusts for each other on the same day. The trusts were identical, except that the decedent's wife was given a special power of appointment while the decedent was not. The court found that because a power of appointment was created in one trust, but not in the other, the decedent and his wife had substantially different interests in the trusts and, consequently, the trusts were not interrelated for purposes of the reciprocal trust doctrine.

iii. *Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir. 1940), cert. denied, 310 U.S. 637 (1940). In Lehman, two brothers each created two trusts transferring their one-half share of stocks and bonds to the trusts, giving the other brother income for life, with the remainder to the brother's issue. Each brother had the right to withdraw $75,000 from the other brother's trust. Neither brother executed the right of withdrawal. One brother died and the court held that $150,000 of the other brother's trusts was includable in decedent's estate. The decision was affirmed. If decedent transferred $150,000 to himself for his lifetime in trust, no one would dispute that such amount was includable in his estate. The present case is the same. Each brother transferred the same property in trust to the other brother. The court held that the trusts were "reciprocated" or "crossed," such that the amount subject to withdrawal by decedent from his brother's trust was includable in decedent's estate. The decisive point was that the decedent, by transfer of his share to the brother or for the brother's use or according to the brother's direction, caused the brother to make a transfer of property in trust under which the decedent had the right to withdraw $150,000 from principal, e.g. "quid pro quo."

iv. Estate of Bischoff, 69 TC 32 (1977). Reciprocal Trust Doctrine is applied to uncrossing trusts in which two settlors (spouses) created a trust for their descendants, giving the other a power to alter the beneficial interests. The court found Grace applicable since 2036 applies to retained powers over trust assets under Codes Section 2036(a)(2) to the same extent it applies to retained rights to trust assets under Code Section 2036(a)(1). Code Section 2038(a)(1) also is applicable.

v. PLR 200748016. IRS held that the Reciprocal Trust Doctrine does not apply to uncross trust when siblings are beneficiaries and trustees of trusts settled by their parents. Grace and Bischoff involved settlors with rights and powers in other trusts. Here, the power holders who could benefit one another did not establish or fund the trusts.

c. <u>An example of trust arrangements created that are intended to avoid the Reciprocal Trust Doctrine</u>:

This is an example of trusts that are intended to avoid application of Code Section 2036. The below enumeration describes differences between the Husband's Trust and the Wife's Trust:

1. In the Wife's Trust, Husband has a special power of appointment from the Trust to any of the Wife's descendants and charitable organizations, and to appoint in trust for Wife. In the Husband's Trust, the Wife does not have a special power of appointment in the Trust.

2. In the Wife's Trust, the Trustee may distribute amounts for the benefit of the Husband and the Settlors' descendants; whereas in the Husband's Trust, the Trustee may only distribute amounts to the Wife during her lifetime.

3. Trust Protector in Husband's Trust can appoint in trust for Husband at Wife's death. Trust Protector may also have other powers to modify trust.

4. If there are no descendants, then the trust property is distributed to different beneficiaries in the Husband's Trust than in the Wife's Trust. 2 children, A and B from Wife Trust, and two children C and D from Husband's Trust.

5. One is income distribution and 5% power, and the other is HEMS standard.

d. <u>Suggested variances to avoid the Reciprocal Trust Doctrine</u>:

- i. Different beneficiaries;
- ii. Different trust terms, such as:
  1. Discretionary powers of trustee limited to ascertainable standard (hems power);
  2. Special Power of Appointment for one grantor only;
- iii. Created at different times;
- iv. Different corpus, or property funding the trusts, and different in amounts;
- v. There should be no relation or reference to a prearranged plan; and
- vi. Different Trustees.

e. Alternatively, simulate domestic assets protection trust terms:

i. require the trustee to be other than the spouses

ii. distribution provision are purely discretionary

iii. follow fact pattern of PLR 200944002 (self-settled Alaska trust ruled not includable in settlor's gross estate)