Planning Pitfalls with SLATs[1]

I. INTRODUCTION

With the memory of the Great Recession still fresh in the nation's collective memory and its wealth in flux, many individuals in a position to take advantage of the fact that the gift and estate tax exemption has temporarily shot up to $11.0 million under the 2017 Tax Act are, adjusted for inflation, currently $11.4M going to $11.5 M in 2020, nevertheless, hesitant to relinquish significant assets, fearful that another economic downturn could reveal that they had given away more than they could reasonably afford to live without. Accordingly, rather than establishing trusts for the exclusive benefits of their descendants, many clients wishing to use their exemption but seeking security are establishing Spousal Lifetime Access Trusts ("SLATs"). On their face, SLATs seem a neat solution to achieve a client's dual goals of utilizing the increased lifetime gift tax exemption while retaining access (albeit indirectly through one's spouse) to the assets contributed to the trust. However, there are a myriad of tax and non-tax complexities that clients and their advisors must consider before engaging in SLAT planning. Perhaps the most important of these issues is the reciprocal trust doctrine, but also important are whether the trust will be structured as a grantor or non-grantor trust (through an "ING" structure), whether allowing the settlor spouse to be a discretionary beneficiary or appointee in the event of the beneficiary spouse's death would cause the trust to be includible in the donor's estate under Sections 2036 or 2038 or treated as a self-settled trust and addressing claw-back issues for state level estate taxes. The complexities of SLAT planning are magnified and distorted by the "unexpected" divorce – former spouses remaining income tax owners of assets over which they have no control, substantial wealth held in irrevocable trusts potentially outside of the reach of the family law courts and beneficiaries/permissible appointees who are now mortal enemies. Join us as we chart a path through the tax and non-tax pitfalls of SLAT planning.

A. *Topics*

In this presentation, we will discuss:

1. The origins of the reciprocal trust doctrine.

2. The use of SLATs to make completed gifts without fully relinquishing access to trust assets.

3. The increased focus on and importance of the reciprocal trust doctrine in the context of dual SLATs and the current state of the law.

4. Practical drafting tips for avoiding the application of the reciprocal trust doctrine based on a variety of differentiating factors.

5. A Case Study

B. *Objectives*

This presentation is intended to enable practitioners to:

1. Identify scenarios in which the reciprocal trust doctrine may apply.

[1] The planning opportunity discussion of SLATs under the 2017 Tax act stems from an article by co-authors Domingo P. Such, III, Deborah V. Dunn and Mitchell A. Meneau of Perkins Coie LLP published in Bloomberg Tax, the Tax Management Estates, Gifts, and Trusts Journal 1/11/2018.

2. Identify the factors that courts may consider to determine whether the reciprocal trust doctrine is applicable.

3. Understand the basic design and utility of a SLAT.

4. Understand how the application of the reciprocal trust doctrine may be avoided when creating trusts of which spouses are beneficiaries.

5. Identify and navigate pitfalls with spousal trusts.

II. EVOLUTION OF THE RECIPROCAL TRUST DOCTRINE

A. *Lehman* - The Origin of the Reciprocal Trust Doctrine

The first version of the reciprocal trust doctrine was enunciated by the Second Circuit in *Lehman v. Commissioner*,[2] in which each of two brothers, using his one-half share of an investment account, created a trust under which the other would receive all income and was entitled to withdraw $150,000, with the remainder payable to the descendants of the other. Invoking the substance over form doctrine and reasoning that each brother had effectively paid the other to create a trust for his benefit, the court declared,

> The fact that the trusts were reciprocated or "crossed" is a trifle, quite lacking in practical or legal significance…. While section 302(d) [(the substance of which is currently embodied in Internal Revenue Code ("IRC") § 2038(a)(2))] speaks of a decedent having made a transfer of property with enjoyment subject to change by exercise of power to alter, amend or revoke in the decedent, it clearly covers a case where the decedent by paying a quid pro quo has caused another to make a transfer of property with enjoyment subject to change by exercise of such power by the decedent…. "A person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another."[3]

Accordingly, each of the trusts was "uncrossed," or recast as having been settled by its lifetime beneficiary (*i.e.*, the brother of its purported grantor), and the amount subject to withdrawal was found to have been includable in the decedent brother's gross estate.

In light of the *Lehman* opinion, until 1969 courts evaluated the taxability of potentially reciprocal trusts in terms of whether the grantors of the respective trusts had created them as a quid pro quo. Not surprisingly, this standard proved difficult to apply and resulted in wholly inconsistent opinions among the appellate courts, even in circumstances in which identical trusts were created on the same day, with some suggesting that a quid pro quo may be inferred from those facts alone[4] and others demanding evidence of an agreement, reasoning that in the spousal context, the settlors could be presumed to have been motivated by a desire to provide for their descendants, irrespective of whether the other chose to do the same.[5]

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[2] 109 F.2d 99 (2nd Cir.1940).
[3] *Id*. at 100-101 (citations omitted).
[4] *See, e.g., Hanauer's Estate v. C.I.R.*, 149 F.2d 857 (2d Cir. 1945); *Orvis v. Higgins*, 180 F.2d 537 (2d Cir. 1950).
[5] *See, e.g., McLain v. Jarecki*, 232 F.2d 211 (7th Cir. 1956); *Tobin v. C.I.R.*, 183 F.2d 919 (5th Cir. 1950).

B. *Grace* and the Current State of the Reciprocal Trust Doctrine

This unpredictability continued until the Supreme Court, in *Estate of Grace*,[6] examined a scenario in which a decedent transferred securities and real estate interests to a trust of which the trustees were his wife, his nephew, and a third party. The trust directed the trustees to pay to the decedent's wife all of the income of the trust, as well as "any part of the principal which a majority of the trustees might deem advisable," and granted to the decedent's wife a testamentary power to appoint the remaining trust property among the decedent and their children.[7] Fifteen days later, the decedent's wife created a trust that was "virtually identical" to husband's trust, funding it with "the family estate and corporate securities, all of which had been transferred to her by decedent in preceding years."[8] In addressing the split that had developed among the appellate courts and the difficulty of ascertaining the existence of a quid pro quo in a family context, Justice Thurgood Marshall, writing for the majority, declared,

> [A]pplication of the reciprocal trust doctrine is not dependent upon a finding that each trust was created as a quid pro quo for the other…. 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 settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries***.[9]

Accordingly, the Supreme Court found that the value of the transferred property was to be included in the decedent's estate under the precursor to IRC § 2036(a).

Under the above formulation of the reciprocal trust doctrine, then, the first and most important element in evaluating whether the doctrine applies is whether the trusts in question are "interrelated." This has largely become a matter of identifying whether or not the trusts in question and the circumstances surrounding their creation are substantially (or exactly) identical. The second element requires that, to the extent of mutual value, the settlors be left in the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries. This requirement should, in theory, be deeply intertwined with the first, as the similarity of the trust terms would heavily impact whether the grantors' economic positions have changed. Nevertheless, it has been interpreted instead to limit the value subject to tax to the lowest net asset value among interrelated trusts.[10] Indeed, as further discussed below, the Internal Revenue Service (the "IRS") has taken the position, and some courts have agreed, that the application of the reciprocal trust doctrine does not depend on the grantors' possessing any economic interests in the trusts, whether as life beneficiaries or otherwise.

C. *Levy,* and the Narrow Interpretation of the Reciprocal Trust Doctrine

The principle set forth in *Grace* remains the standard for evaluating the existence of reciprocal trusts, although its interpretation has arguably been more favorable to taxpayers than would be expected, as courts have struggled to find the existence of reciprocal trusts where the grantors' interests are not identical. In *Estate of Levy*,[11] for example, the decedent and his wife each created a trust naming the other

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[6] *U.S. v. Estate of Grace*, 395 U.S. 316 (1969).
[7] *Id*. at 319.
[8] *Id*. at 319.
[9] *Id*. at 324 (emphasis added).
[10] *See, e.g.*, *Krause v. C.I.R.*, 57 T.C. 890 (1972), *aff'd* , 497 F.2d 1109 (6th Cir. 1974), in which the Tax Court determined that trusts holding 300 and 700 shares of stock, respectively, were to be uncrossed to the extent of the value of 300 shares.
[11] *Estate of Levy v. C.I.R.*, 46 T.C.M. (CCH) 910 (T.C. 1983).

as trustee. The trusts were created on the same day, were funded with the same number of shares of their family corporation, and were identical in all respects, except that the trust created by the decedent granted to his wife the power to appoint the income and principal of the trust, during her lifetime or at her death, to anyone except herself, her estate, her creditors, and the creditors of her estate. The wife's trust, on the other hand, granted no power of appointment to the decedent husband. In examining whether the trusts were interrelated, the Tax Court cited several factors that, in prior cases, had tended to demonstrate that the trusts in question were reciprocal:

1. Creation of the trusts at the same time;

2. Identical terms;

3. Primary beneficiaries who were "natural objects of the grantor's bounty;"

4. Identical assets;

5. Evidence of a prearranged plan; and

6. Identical trustees.

Despite that every other relevant fact appeared to favor the application of the reciprocal trust doctrine, the Tax Court determined that the wife's power of appointment "had objective value which cannot be ignored" and that the trusts were not related. Key to this finding was that the shares that the wife owned directly, when combined with the shares over which she possessed a power of appointment, constituted enough voting power to block certain corporate actions under state law. Seizing on the Supreme Court's disregard for the subjective intent of the grantors, the Tax Court went on to state, "The subjective likelihood of [the wife's] exercising her power of appointment, whether due to her age, her love for her husband, or some other motive, is completely irrelevant." Notably, the opinion also indicates that the IRS agreed that the power of appointment, if valid, was sufficient to avoid the application of the reciprocal trust doctrine.

In Private Letter Ruling 9643013,[12] a husband and wife each proposed to create trusts under which the settlor's spouse and an unrelated accountant would be the trustees, with the latter possessing all fiduciary powers with respect to distributions. The proposed trusts differed in the following respects:

- Husband would be a current beneficiary of the trust created by Wife, eligible to receive distributions in the sole discretion of the independent trustee, and would have *Crummey* withdrawal rights. Wife would not be a beneficiary of the trust Husband created.

- Wife would possess a power to appoint the property of the trust created by Husband among Husband's descendants and their spouses, while the independent trustee would have a power of appointment over the trust Wife created, exercisable in favor of the same persons.

The ruling, perhaps not surprisingly, provides that the trusts are not reciprocal "in view of the differences between [them]," but it offers no criteria with which to evaluate the circumstances under which non-identical trusts would be considered to be reciprocal.

In Private Letter Ruling 200426008,[13] the IRS evaluated whether trusts with the following terms, created by a husband and wife, would be subject to the reciprocal trust doctrine:

[12] July 19, 1996.

- Each of Husband and Wife is appointed as trustee of the trust created by the other.

- With respect to the trust created by Wife, the couple's son would be entitled to distributions for health, support, maintenance and education. Except for a contingent QTIP trust created in the event that Husband survived Wife and their son (from which Husband would receive mandatory income payments), Husband would become eligible to receive distributions three years after Wife's death, but only if his net worth and income from personal services dropped below certain thresholds, and only to the extent that their son's needs were satisfied.

- With respect to the trust created by Husband:

  - Wife would be a current beneficiary, along with the couple's son, and, to the extent that their son's needs were satisfied, she would be eligible to receive distributions for health, support, maintenance and education.

  - Wife would have a "5 or 5" withdrawal power and power to appoint trust property among Husband's descendants and their spouses (and possibly charity) under various circumstances if their son predeceased her.

After citing *Levy* and detailing each of the differences among the proposed trusts, the ruling concludes that the proposed trusts would not be reciprocal, again without providing any analysis with which to understand how the conclusion was reached.

D. *Bischoff*, and the Broadening of the Reciprocal Trust Doctrine

Notwithstanding that the reciprocal trust doctrine has been interpreted narrowly in the context of the interrelatedness element, the Tax Court, in *Estate of Bischoff*,[14] did broaden the potential application of the doctrine considerably by disregarding the economic position element. In that case, the decedent and his wife each created four identical trusts for the benefit of their grandchildren and appointed the other of them as trustee of each. Unlike in all of the other post-*Grace* reciprocal trust fact patterns, the grantors retained no economic interests (whether directly or indirectly), although each of them, as the trustee of the trusts created by the other, possessed the power to accumulate or distribute income and principal in his or her sole discretion. Notwithstanding the Supreme Court's statement in *Grace* that in order to apply the reciprocal trust doctrine, interrelated trusts must leave their settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries, the IRS argued, and the Tax Court agreed, that the assets of the trusts created by the decedent should be included in his estate because (a) the trusts were interrelated and (b) if the decedent had created the trusts of which he was the trustee, the assets of those trusts would be included in his estate under IRC § 2038(a)(1) by virtue of his ability to affect the timing of the enjoyment of the assets. In so ruling, the Tax Court reasoned that the Supreme Court's reference in *Grace* to the "same economic position as life beneficiaries" reflected the fact that the IRS was seeking inclusion in the decedent's gross estate in that case under the precursor to IRC § 2036, not that a retained economic interest was required for the application of the reciprocal trust doctrine.

The Federal Circuit then endorsed the *Bischoff* holding in ruling that where spouses made simultaneous transfers of stock to one another under the Florida Uniform Gifts to Minors Act, each would be treated as possessing custodial powers over the stock that he or she transferred and that as a result of the husband's death while acting as custodian, the stock he held was included in his gross estate under IRC §§ 2036(a)

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[13] June 25, 2004.
[14] *Estate of Bischoff v. C.I.R.*, 69 T.C. 32 (1977).

and 2038(a)(1).[15] While the court made clear that each spouse had possessed an indirect economic interest in the stock he or she held as custodian by virtue of his or her ability to use custodial assets to satisfy his or her support obligations, it indicated that such a finding was not required to apply the reciprocal trust doctrine as enunciated in *Grace*.[16]

More recently, the Sixth Circuit rejected this interpretation of *Grace*, holding that the reciprocal trust doctrine is inapplicable in the absence of a indirectly retained economic benefit.[17] Nevertheless, the IRS thereafter continued to assert the doctrine's applicability to fact patterns in which no economic interests were retained, either directly or indirectly (*see* Private Letter Rulings 9735025[18] and 9804012[19]), so taxpayers outside of the Sixth Circuit should be wary of crossing powers that would trigger the application of IRC § 2038(a)(1) if directly retained by the grantor of a trust.

The IRS took the logic of *Bischoff* even further in Private Letter Ruling 9235025,[20] in which the father of the decedent named the decedent and the decedent's brother as co-trustees of two trusts, one for the benefit of the decedent and one for the benefit of the decedent's brother. The terms of each trust provided that the co-trustees may, in their "absolute discretion," distribute the principal of the trust to the life beneficiary for the his "support, maintenance, comfort, emergencies and serious illness." Although this standard of distribution was determined not to be an ascertainable standard under Treas. Reg. § 20.2041-(c)(2), New York EPTL § 10-10.1 precluded each beneficiary-trustee from participating in any distributions to himself. Nevertheless, the IRS, citing *Grace*, ruled that each beneficiary-trustee possessed a general power of appointment and that, as a result, the assets of the trust created for the benefit of the decedent would be included in his estate under IRC § 2041(a)(2) (which, importantly, does not require the *retention* of a power), stating,

> [B]ecause of the reciprocal nature of the control [the decedent's brother] and the decedent could exercise over each other's trust, it can be objectively inferred that the decedent and [the decedent's brother] would exercise their respective distributive powers on a reciprocal basis. That is, because of the reciprocal nature of the parties' distributive powers, [the decedent's brother] and the decedent could ensure that each received whatever he desired from his trust (within the bounds of the "comfort" limitation).

Though the ruling does not expressly mention the reciprocal trust doctrine, in repeatedly discussing the reciprocal nature of the siblings' powers and citing *Grace*, the IRS effectively adopted the position that the reciprocal trust doctrine may be applied where the holders of reciprocal powers or interests are unquestionably not the settlors of the trusts in question While the appropriateness of applying the reciprocal trust doctrine to the facts at hand is doubtful in light of the fact that doing so requires an evaluation of the subjective intent of the siblings, which is manifestly contrary to the express logic underlying *Grace*, this position has yet to be tested in court.

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[15] *See Exch. Bank & Tr. Co. of Fla. v. U.S.*, 694 F.2d 1261 (1982).
[16] Note that while *Exchange Bank* did not involve transfers in trust, courts have shown a clear willingness to apply the reciprocal trust doctrine outside of the context of trusts. *See also Schuler v. C.I.R.*, 282 F3d 575 (8th Cir. 2002).
[17] *See Estate of Green v. U.S.*, 68 F.3d 151 (1995).
[18] August 29, 1997.
[19] January 23, 1998.
[20] August 28, 1992.

III. OTHER APPLICATIONS OF THE RECIPROCAL TRUST DOCTRINE

While the reciprocal trust doctrine arose in the estate tax context, it is also relevant in the income and gift tax contexts, as illustrated in the few cases in which courts have had the opportunity to consider the applicability of *Grace* to periods prior to the death of the settlors.

A. Application of the Reciprocal Trust Doctrine in the Income Tax Context

In *Krause*,[21] a husband and wife each created three trusts of which the other was, along with their children (in the case of the trusts created by the husband) and grandchildren (in the case of the trusts created by the wife), a current beneficiary. The trusts were created on the same day, had identical trustees (a corporate trustee and an unrelated individual co-trustee) and contained identical provisions. Based on these similarities and the fact that the "primary beneficiaries were the natural objects of the grantor's bounty,"[22] the court determined that the trusts were interrelated and that they must be uncrossed to the extent of the mutual value of the trusts. Accordingly, each settlor was recast as having created a trust under which the nonadverse trustees were permitted to accumulate income for future distribution to him or her, and each settlor was therefore found to be taxable under IRC § 677 on the income produced by the lower number of shares of stock contributed to the wife's trust.[23]

Similarly, in Private Letter Ruling 8813039,[24] each spouse created a trust for the benefit of the other, the terms of which required that the trustees pay all income to the spouse-beneficiary, as well as "so much or all of the principal of each trust… as the trustee (other than the income beneficiary) in her sole discretion shall deem necessary or desirable." Accordingly, the IRS ruled that following the resignation of the grantors' daughter as trustee and the acceptance of trusteeship by a nonadverse grandchild, each spouse would be taxable on the income of the trust created by the other under IRC § 676(a), which provides that the grantor "shall be treated as the owner of any portion of a trust…where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both."

B. Application of the Reciprocal Trust Doctrine in the Gift Tax Context

The reciprocal trust doctrine has also been applied in the gift tax context. The grantors of the trusts discussed in Private Letter Ruling 8813039,[25] for instance, applied for the ruling in connection with a claim for refund of the gift taxes paid on their respective contributions, presumably on the basis that because each retained an interest in the trust of which he or she was, after application of the reciprocal trust doctrine, deemed to be the grantor, he or she had not made a completed gift. In other cases, the IRS has used the reciprocal trust doctrine to recast gifts and deny annual exclusions claimed by the purported grantor. For instance, in *Sather*,[26] three siblings, each of whom had three children, made gifts to nine irrevocable trusts, one for each of the nine children, and claimed an annual exclusion for each. Based on the fact that the gifts were all made on the same day with an identical number of shares of a family business after the siblings had together sought advice on how to transfer the business to the next generation, the Eight Circuit determined, without expressly considering the terms of the trusts in question at all, that each sibling had actually made $90,000 of gifts in equal shares among his own children and was entitled to claim only three annual exclusions. Notably, while the court indicated that each sibling

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[21] *Krause v. C.I.R.*, 57 T.C. 890 (1972), *aff'd* , 497 F.2d 1109 (6th Cir. 1974).
[22] *Id*. at 900.
[23] While the current version of IRC § 677 also applies if income may be held or accumulated for future distribution to the grantor's spouse without the consent of an adverse party and would apply without the need to uncross the trusts, *Krause* examined the statute before it was amended to mention the grantor's spouse.
[24] April 1, 1988.
[25] *Id*.
[26] *Sather v. C.I.R.*, 251 F.3d 1168 (8th Cir. 2001).

had received an indirect benefit by virtue of the others' gifts to his children, it reiterated the holding of *Bischoff*, that grantors need not have any continuing economic interest in the trusts in question to trigger application of the reciprocal trust doctrine. A similar result was reached in *Schuler*, where the court determined that a series of transfers of two different family businesses among the families of two brothers "amount[ed] to transfers of each brother's stock to his own children."[27] And in Revenue Ruling 85-24,[28] the IRS ruled that gifts by three business partners to trusts for benefit of the children of the others were not eligible for annual exclusions.

IV. SPOUSAL TRUSTS AND THE CONTINUING IMPORTANCE OF THE RECIPROCAL TRUST DOCTRINE[29]

While the reciprocal trust doctrine was first put forth in *Lehman* nearly 80 years ago, and while it has not been addressed in any depth in case law or authoritative guidance in over a decade, it has taken on a renewed importance in recent years. As the nation's wealth plunged from late 2007 through 2009 and 2010, so too did our willingness to part with that wealth, and the estate planning community witnessed an extreme incongruity with respect to gift giving. In one sense, beginning in 2011, taxpayers were more incentivized than ever to transfer wealth to the next generation, as the lifetime gift tax exemption shot up from $1 million to $5 million. The incentive became even greater in 2012 when the exemption was set to return to $1 million from $5.12 million after year-end. Although the increased exemption was eventually made permanent (after a momentary lapse on January 1, 2013), clients were faced with the prospect of permanently losing the ability to give away $4 million of property or more if they failed to do so in 2011 or 2012. Nevertheless, many who were in a position to make additional gifts were reluctant to do so, either because their wealth remained depleted following the Great Recession (which, if only temporary, presented an even greater incentive to make a gift before values recovered) or because they envisioned the possibility of being forced to beg their children for money in the event of a similar downturn.

A. SPOUSAL LIFETIME ACCESS TRUSTS

Enter the spousal lifetime access trust, or "SLAT." While there are a potentially endless number of variations on this estate planning technique, the basic premise is that an irrevocable trust is created under which the grantor's spouse is a current beneficiary and some other person or persons (often the grantor's descendants) are also beneficiaries. By including his or her spouse as a beneficiary, the grantor is able to take advantage of his or her increased lifetime gift tax exemption to (if all goes well) transfer the trust assets and all appreciation thereon out of his or her estate without fully relinquishing either the assets or the appreciation.[30] The grantor's spouse will often be entitled to receive distributions from the trust for his or her health, education and support, or for his or her best interests, and given that the wellbeing of both parties to a marriage is inherently intertwined, the grantor maintains a safety valve through which he or she may (indirectly, through his or her spouse) reacquire the trust assets if the need should arise. If the spouse is appointed as trustee of the trust, distributions can even be made without the need to involve an outside party in the couple's finances.[31] If the grantor and his or her spouse never have a need to reacquire the trust assets, the SLAT is no less efficient from a transfer tax perspective than an irrevocable

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[27] *Schuler v. C.I.R.*, 282 F3d 575 at 579 (8th Cir. 2002).
[28] 1985-1 C.B. 329 (1985).
[29] Id. FN 2; Adams, Kurlander & Such, *Annual Exclusion Giving: Nonmarital Spousal Gift Trusts*, Trusts & Est., April 1999.
[30] This, of course, assumes that the grantor's spouse remains his or her spouse and/or is inclined to follow the grantor's wishes.
[31] Note, however, that in order to avoid the trust assets being included in the spouse's estate under IRC § 2041, he or she, if serving as sole trustee, may be granted the discretion to make distributions to himself or herself only to the extent that such distributions are subject to an ascertainable standard.

trust that excludes the grantor's spouse as a beneficiary. If the couple does require a distribution of trust assets, the strategy creates an inefficiency only to the extent that they subsequently own assets that become subject to transfer tax (*i.e.,* the lifetime exemption was "wasted"). If the couple ultimately is not subject to either gift or estate tax on such distributed assets, nothing is lost. Moreover, SLATs can be used in GST tax planning in the same manner as a non-spousal trust, though the potential transfer tax inefficiency is made even greater if a distribution must be made to the grantor's spouse.

Consequently, the SLAT is an attractive estate planning strategy for those who are wary of relinquishing assets, as it achieves the dual goals of utilizing the increased lifetime gift tax exemption (and, if so desired, the GST tax exemption) for the benefit of descendants or others while retaining access (albeit indirectly through one's spouse) to the assets contributed to the trust. Given the current $5.49 million lifetime gift tax exemption, if both spouses create a SLAT, the opportunity exists to transfer nearly $11 million in this fashion. However, this scenario, in which each spouse creates a trust for the benefit of the other, raises obvious concerns regarding the reciprocal trust doctrine, as a number of non-tax motives exist to structure the trusts as similarly as possible. For example, a married couple may strive for the ideal of equity as a component of a harmonious marriage or alternatively, may adopt adversarial roles, each spouse working to ensure that he or she is not disadvantaged relative to the other in the event of divorce. At a more practical level, identical trusts facilitate more expedient and cost-effective drafting and are easier to understand. Finally, estate planners may wish to avoid the potential for being accused of favoring one spouse's interests over those of the other spouse. However, as discussed above, if the trusts are deemed to be interrelated and the reciprocal trust doctrine is applied to them because they are too similar, the transfer tax benefits will be lost.[32]

B. AVOIDING APPLICATION OF THE RECIPROCAL TRUST DOCTRINE

1. Drafting Nonreciprocal SLATs. In light of the foregoing, how may SLATs be structured to avoid application of the reciprocal trust doctrine? While one cannot say with certainty that any of the techniques below would alone preclude the application of the reciprocal trust doctrine, utilizing each as one of a number of differentiating factors will increase the likelihood of the trusts passing muster.

- **Beneficiaries:** If one trust is for the benefit of the grantor's spouse and descendants, while the other trust is for the benefit of the grantor's descendants only, it is less likely that they would be determined to be interrelated or that it would be determined that the spouse's economic positions had not changed. While the latter trust would not actually be a SLAT, and while such an arrangement might at first appear to be contrary to the logic discussed above, as one of the spouses would not have access to trust property, this apparent inconsistency can be overcome with additional planning, as further discussed below. In the absence of additional planning, the inequity between the spouses can be limited to a large extent by including in the SLAT a provision that the spouse-beneficiary ceases to be a beneficiary in the event of divorce. Although this may lead to a scenario in which neither party is able to access any of the assets, the grantor of the SLAT may be no worse off if his or her ex-spouse is unable to access trust assets. Alternatively, the non-spousal beneficiaries may vary between trusts, though *Krause* suggests that this should not be relied upon as the only difference between the trusts.

- **Powers of Appointment:** *Levy* suggested that granting a power of appointment to one spouse and not the other may be enough to escape the reciprocal trust doctrine, although the fact that the amount of stock held by the trust in that case was enough to block certain corporate actions certainly

[32] The negative impact of this may be mitigated by distributing the assets to the spouse-beneficiaries and creating new trusts to which the reciprocal trust doctrine does not apply. However, the fact that the transfers resulted in incomplete gifts may not be discovered until years later, after the assets have appreciated in value substantially.

influenced the court's decision. As an alternative to completely omitting a power of appointment from one of the trusts, the powers may be varied in terms of whether they are inter vivos and/or testamentary and in terms of the breadth of permissible appointees. For instance, one power may be exercisable during the spouse-beneficiary's lifetime or upon his or her death and only in favor of descendants, while the other spouse-beneficiary's power may be exercisable only at death in favor of descendants and charity, or in favor of anyone other than the spouse-beneficiary, his or her estate, or the creditors of either.

- **Distribution Standards:** Clearly, if the standards for distribution to the spouse-beneficiaries differ, an argument can be made that their economic positions must have changed and that the trusts cannot be reciprocal. For instance, one spouse may be eligible to receive income only for his or her health and support, while the other may receive distributions of income and principal for his or her best interests (perhaps subject to annual limit) in the sole discretion of an unrelated trustee.[33] Distribution standards may also be vary among the other beneficiaries of the trusts.

- **Withdrawal Rights:** The flipside of the fact that differing distribution standards will cause the grantors' economic positions to differ is that, notwithstanding all of the other potential differences among the trusts, to the extent that both spouses have an absolute right to withdraw similar assets of a given value, their economic positions will be identical. Accordingly, a withdrawal right should be granted to only one spouse-beneficiary, or one spouse's withdrawal rights should be made subject to a contingency.

- **Trustees:** *Bischoff* suggests that it would be advantageous to avoid making each spouse-beneficiary the sole trustee of the trust created by the other. Rather, one or both spouse beneficiaries may serve with a co-trustee (including perhaps an institutional trustee) or may be omitted from trusteeship altogether. Further, provisions may differ in terms of when trusteeship may change. For instance, one trust agreement may provide that descendant beneficiaries may become trustees at a particular age while the other allows them to become trustees only after the spouse-beneficiary ceases to act.

- **Timing:** Funding trusts at different times should strengthen the argument that they are not interrelated, although it is unclear how large a gap in time would be deemed meaningful. Where the trusts are completely identical, fifteen days proved to be too little time,[34] and while it may be argued that two parties funding trusts at different times must each do so of his or her own volition (because the first transferor cannot know that the second will follow suit, and the second transferor's interest in the trust created earlier is unaffected by whether he or she then creates a trust), the reciprocal trust doctrine as articulated in *Grace* purports to disregard the subjective intentions of the settlors. Moreover, it may not be practical or worthwhile to separate the funding of trusts if the grantors' wealth is concentrated in a single asset that requires an appraisal or on which restrictions on the timing of transfers are imposed, and 2012 presented a scenario in which clients could not be sure that a tax benefit would continue to be available if their transactions were not consummated by year-end. Nevertheless, given the myriad possible events that may occur in even a short period of time (*e.g.*, death or divorce), the passage of time should not be ignored, and creating the trusts in different tax years may at least avoid highlighting the potential for application of the reciprocal trust doctrine.

- **Assets:** All other things being equal, to the extent that spouses are able to contribute different assets to the SLATs, their economic interests will have literally changed, though it is unclear what differences may be regarded as being material enough to avoid application of the reciprocal trust

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[33] While mandatory distributions are also a possibility, they are not as efficient in terms of removing assets from the couple's gross estate or protecting assets from creditors.
[34] *See Grace*.

doctrine. In *Schuler*, for instance, the court did not even consider what differences may exist between the two family companies that were subject to transfer. Nonetheless, different assets have different economic profiles and may be subject to non-economic constraints (such as in the case of a family entity), both of which require consideration by the trustee and may lead to differing distribution decisions between the trusts, and as a result, this should factor into any determination of whether trusts are interrelated.

2. Case Study

There are a myriad of tax and non-tax complexities that clients and their advisors must consider before engaging in SLAT planning. Perhaps the most important of these issues is the reciprocal trust doctrine, but also important are whether the trust will be structured as a grantor or non-grantor trust (through an "ING" structure), whether allowing the settlor spouse to be a discretionary beneficiary or appointee in the event of the beneficiary spouse's death would cause the trust to be includible in the donor's estate under Sections 2036 or 2038 or treated as a self-settled trust and addressing claw-back issues for state level estate taxes. The complexities of SLAT planning are magnified and distorted by the "unexpected" divorce – former spouses remaining income tax owners of assets over which they have no control, substantial wealth held in irrevocable trusts potentially outside of the reach of the family law courts and beneficiaries/permissible appointees who are now mortal enemies.

V. CONCLUSION

While the reciprocal trust doctrine has been invoked by courts for almost 80 years, there exist a number of questions to be answered with respect to its precise application. Nevertheless, the Great Recession has prompted a planning environment in which now more than ever, client spouses wish to retain the ability to unwind gifts by designating each other as beneficiaries of trusts intended to, if all goes well with their remaining assets, effect intergenerational wealth transfers. Consequently, it is essential that estate planners be aware of the reciprocal trust doctrine and the wide variety of means through which dual SLATs may be differentiated. Once differentiated, the real fun begins with the tax attributes being at issue when there is a divorce. The path through the tax and non-tax pitfalls of SLAT planning presents a myriad of traps for the unwary.