

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1282

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From: Steve Leimberg's Estate Planning Newsletter
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Estate of Levy – A Frequently Miscited Case? The Doctrine of Reciprocal Trusts – Part III

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This LISI is part of a continuing series known as the **Modular Approach to Estate Planning**.¹

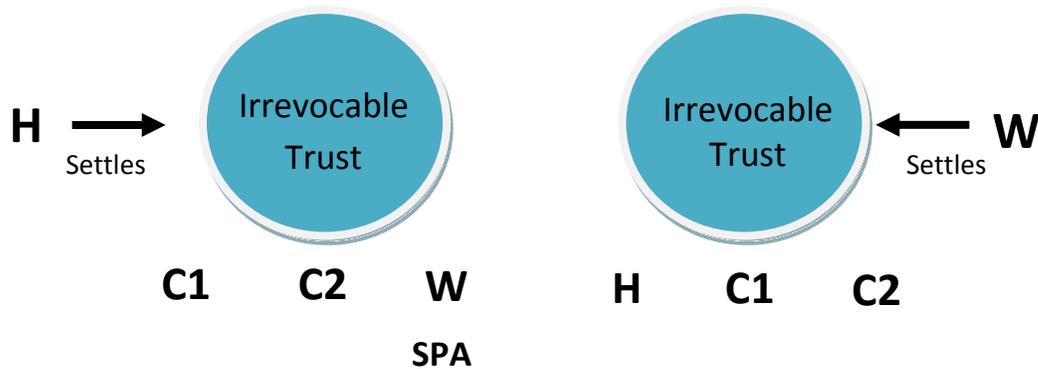
EXECUTIVE SUMMARY:

My first **LISI** on this topic, [Estate Planning Newsletter # 1271](#), delineated the two prong test under the U.S. Supreme Court decision in *Grace*.ⁱⁱ

My second **LISI** on reciprocal trusts, [Estate Planning Newsletter # 1276](#), discussed the first prong of *Grace* and how any life interest requirement may have well been eliminated under the doctrine of reciprocal trustees and reciprocal gifts and a life interest or economic interest may no longer be a requirement under the reciprocal trust doctrine. This third installment will discuss the *Estate of Levy*ⁱⁱⁱ, which may be one of the most miscited cases in estate planning literature.

FACTS:

Some planners have stated that the doctrine of reciprocal trusts could be broken merely by including a special power of appointment in one of the trusts, but not the other. In other words, husband would create a trust for the benefit of his wife and children, and wife would create a trust for the benefit of husband and her children. *One* of the trusts would contain a special power of appointment, but not the *other*.^{iv} Please refer to the diagram below.



Planners that advocate that the above structure will break the reciprocal trust doctrine are focusing on the *second* prong of *Grace* – whether or not the trusts are interrelated. As discussed in the first LISI, *Grace* stipulated *two* requirements to determine whether the trusts were interrelated:

1. the trusts were created at the same time (i.e. pursuant to the same estate plan); and
2. the trusts had substantially identical terms.

COMMENT:

If a mere insertion of an SPA into one trust broke the interrelated connection, it would be no more than child’s play to circumvent the doctrine of reciprocal trusts.

However, based on the following analysis, I would disagree that a mere special power of appointment in one trust would break the doctrine of reciprocal trusts.

Conversely, if the two trusts are drafted with fundamentally *different* provisions, the substantially identical factor of the interrelated test should be broken. Assuming other factors such as different trustees are appointed, not husband and wife, and separate assets are contributed to the trusts, I am hopeful that the interrelated prong should be broken.

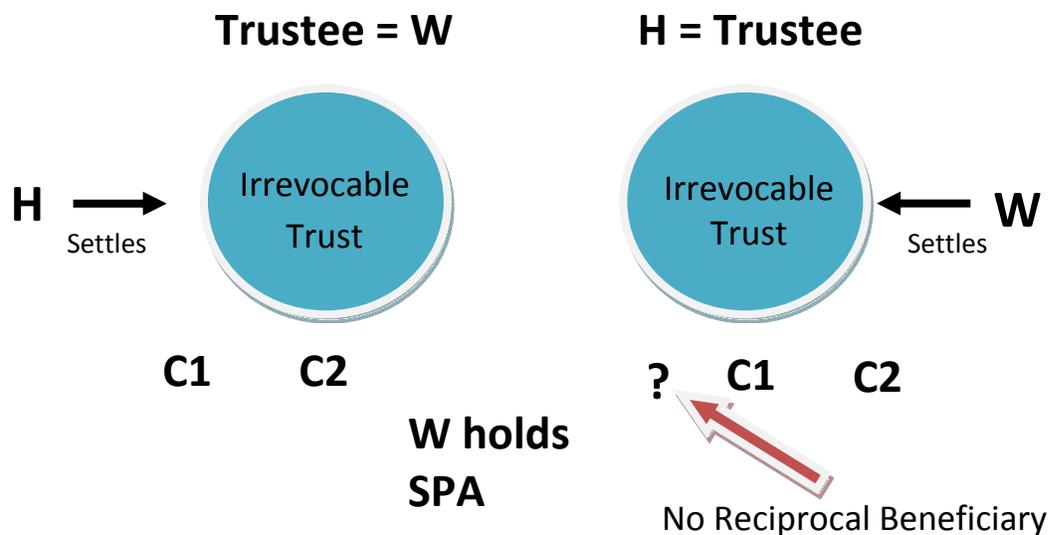
I. Estate of Levy is Not a Reciprocal Beneficiary Case

Some of the facts of the case are as follows:

- (1) Pursuant to the same plan, husband and wife each create a trust for the benefit of their son;
- (2) The husband is appointed the trustee of the trust settled by the wife, and the wife is appointed as trustee of the trust settled by the husband (i.e., there is no question there are reciprocal trustees);

- (3) The husband was not a beneficiary of the spouse settled by trust created by the wife, and the wife was not a beneficiary of the trust settled by the husband.
- (4) The trust settled by the husband granted his wife an inter vivos SPA where she could appoint the trust property to anyone other than herself, her creditors or the creditors of her estate. In other words she could appoint the property to him.
- (5) The trust settled by the wife did *not* grant the husband *any* power of appointment.
- (6) Other than the SPA, the terms of the trusts were identical.

A diagram depicting the structure is below



When comparing the above diagram to the first diagram in this LISI, one should note that the two diagrams have fundamentally different assumptions:

The first diagram assumes that there are reciprocal beneficiaries and that an SPA held by *either* the husband or wife, but not both, hopefully breaks the interrelated prong of the *Grace* test.

With the second diagram, neither the husband nor the wife is a beneficiary of either trust. However, due to the SPA solely in the husband's trust for the benefit of the wife, she has ability to bring these assets back into the family unit. Therefore, the logical conclusion would be that the first prong of *Grace* had been broken, and husband and wife were *not* in the same economic position.

THE TAX COURT'S ANALYSIS

Reading all of the conclusions of the *Levy* case, it appears that the Tax Court came to the same result, but by a different logic process. Rather, than analyzing each prong of *Grace* separately, the Tax Court seemed to combine all the issues in both prongs to determine whether the trusts were interrelated. The Tax Court stated when determining whether the trusts were interrelated,

“we consider their terms, corpus, trustees, and beneficiaries, as well as their date of creation and their relation, if any, to a prearranged plan.”

Without reviewing each of these six factors, the Tax Court made the following conclusion;

“During her life, and prior to the death of Herbert Levy, Isle Levy could appoint the income and the corpus of the Herbert Levy Trust when and as she please except to herself, her creditors or her estate. In contrast, Herbert Levy had no power of appointment over the income or corpus of the Isle 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 part vis a vis the [transferred] property . . .’ citing U.S. v. Grace.” [Italic emphasis added]

While the Tax Court began by discussing the interrelated prong, its conclusion seems to have addressed the same economic position prong. Unfortunately, the case analysis and holding is not a model of clarity.

WHEN A CASE SEEMS CONFUSING, WHY NOT CALL BOTH COUNSEL FOR CLARIFICATION?

When I reviewed *Levy*, there seemed several areas of confusion:

First, why didn't the Tax Court discuss all of the factors it listed as interrelated?

Second, why did the Tax Court combine both prongs of *Grace* into one test?

Third, how could a mere SPA possibly break the doctrine of reciprocal trusts?

Logically, I therefore located the counsel who represented the Service in the case, as well as the counsel that represented the taxpayer.

After speaking with both counsel, *neither* of them thought that a mere SPA in one trust would break the doctrine of reciprocal trusts. They both felt that the SPA was very specific to the business interest that had been contributed to both of the trusts. Further, they clarified and added to some of the following facts and opinions:

- (1) The facts of the case as well as the outcome were stipulated.
- (2) In the stipulated facts, the Service agreed the reciprocal trust doctrine would not apply if the special power of appointment were valid. This is why most of the discussion regarding the case was on whether the SPA was valid under New Jersey law, and the case did not discuss all of the other factors of interrelated trusts.
- (3) Since the outcome of the case depended on whether the SPA was valid, the Service argued that the SPA (a) was not valid under New Jersey law; and (b) subjectively the power would not be exercised.
- (4) Through the combined voting power of the SPA and her own shares, the wife could effectively block any major reorganizations of the family business under New Jersey law.
 - (a) There were 100 shares of stock outstanding.
 - (b) Husband and Wife each owned 35 shares individually.
 - (c) Each trust owned 12.5 shares.
 - (d) Wife could gift to a third person her 35 shares + 12.5 under her POA. The receiving person would have the power to block any corporate reorganizations by holding a greater than 1/3 vote, since New Jersey Law requires a 2/3 vote for a corporate reorganization.

After husband and wife each transferred 12.5 share to each trust, because of the SPA, wife had significantly greater control in her ability to block a corporate reorganization as noted above. In addition to more control, she had a significantly different economic interest in the trust. She had the ability to appoint the trust assets to her husband (i.e. back to the family unit) or any other person other than herself. Her husband did not have any similar reciprocal beneficiary equivalent power. In essence, while the Tax Court combined both prongs of *Grace* under the term “interrelated,” it appears that it actually decided the case under the “same economic position” prong of *Grace*.

WHY DIDN'T THE SERVICE PURSUE THE RECIPROCAL TRUSTEE ISSUE?

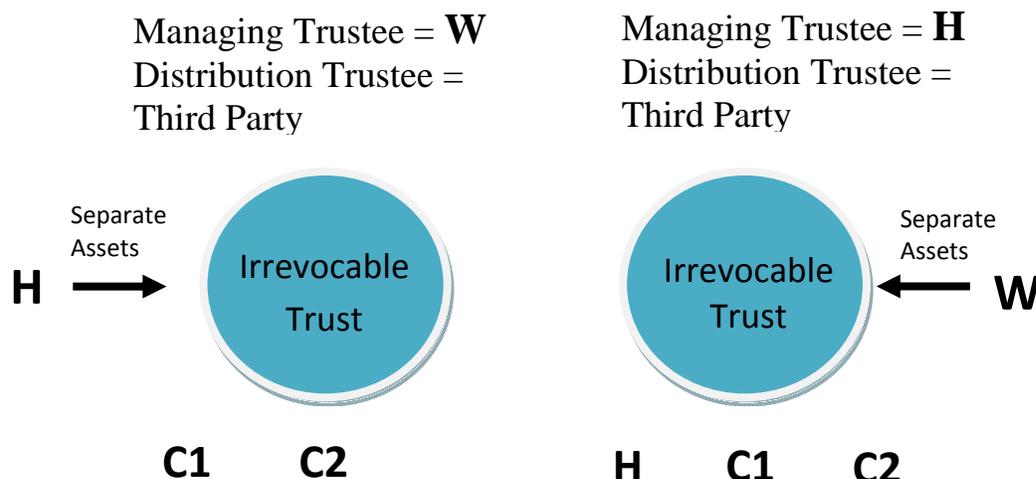
Both spouses contributed the same property and shares in the corporation. The trustees were crossed with husband serving as a trustee on the trust settled by the wife, and wife serving as trustee on the trust settled by the husband. Why didn't the Service pursue the reciprocal trustee doctrine discussed in our last [LISI \(Estate Planning Newsletter # 1276\)](#)? Counsel for the Service informed me that the reciprocal trustee issue under *Bischoff* was not presented to the Tax Court, because the facts and outcome were stipulated, something he noted that he would never do again. The only issue for the Tax Court to decide was whether the SPA was valid under New Jersey law. If it was, the parties had agreed that the doctrine of reciprocal trusts would not apply. Counsel for the Service also stated that the Service thought the case was an aberration.

WHAT POSSIBLE CONCLUSION DOES THE ESTATE OF LEVY SUPPORT?

Assuming that reciprocal trustees are not present, which they were in *Levy*, the *Estate of Levy* provides support that if a spousal access trust^v is created only by one spouse, but not the other, the first prong of the *Grace* test has been broken, and the doctrine of reciprocal trusts does *not* apply.

II. PLR 9643013 ALSO NOT A RECIPROCAL BENEFICIARY FACT PATTERN

Levy was decided in 1983 and since then there have not been any other reciprocal trust cases. Rather, there have been only two PLRs directly on point. In PLR 9643013, husband settles a trust and names a third person as the distribution trustee and his wife as the managing trustee. Wife reciprocates and settles a trust naming the husband as a managing trustee and a third person as a distribution trustee. Husband does not name the wife as a beneficiary of the trust that he settles. However, wife names the husband as a beneficiary of the trust that she settled. Both trusts have SPAs, however neither SPA may be exercised in favor of the other spouse. Settlers also contributed separate assets. A diagram of the structure is detailed below



Unfortunately, the PLR substantially lacks any analysis of the reciprocal trustee issues. It also does not discuss the reciprocal beneficiary issue in detail. Rather, after citing verbatim IRC Sections 2036, 2037, and 2038, it concludes,

“In view of the differences between the trusts created by A and B, we conclude that the M and N trusts are not reciprocal within the meaning of U.S. v. Estate of Grace.”

Therefore, since no analysis was provided in PLR 9643013, I have provided the following discussion.

NO RECIPROCAL TRUSTEE ISSUE

Some planners may well conclude that the Service did not consider the reciprocal trustee issue, and only looked at the reciprocal beneficiary issue. On the other hand, other planners note that the reciprocal trustee doctrine probably does not apply, because the powers of the trustee were divided between the managing and distribution trustee, who was the clients' CPA. It is true that the managing trustees were both husband and wife and could make all of the investment decisions regarding the trust. However, all of the distribution powers of a trustee were vested in a third person. As to the distribution of assets, *neither* husband nor wife was left in the same economic position. Furthermore, there is a second reason why the doctrine of reciprocal trustees should not apply: both husband and wife each contributed their separate assets to the trust. Therefore, after the trusts, neither husband nor wife was left in the same economic position regarding the management of the same assets.

RECIPROCAL BENEFICIARY ANALYSIS

Since the SPAs did not allow either spouse to appoint the property to the other spouse, neither husband nor wife could force the distribution of assets on behalf of the other. Further, only the husband was a beneficiary of one of these trusts. In this respect, the trustee of the trust settled by the wife could distribute such assets for the benefit of the husband, but the reverse was not true. Therefore, the facts under PLR 9643013 support the conclusion that the first prong of the *Grace* test had been broken, the parties had *not* been left in the same economic position. Once either prong of the *Grace* test is broken, the reciprocal beneficiary doctrine does not apply.

THE INTERRELATED PRONG

Conversely, there were some issues with the interrelated prong. As discussed in my first [LISI, Estate Planning Newsletter # 1271](#), courts have primarily used the following four factors to determine whether two trusts were interrelated, with the presence of the first two being deadly.

1. The trusts were formed as part of the same estate plan;
2. The trusts were substantially identical;
3. The trustees had the same trustee; and
4. The settlers contributed the same assets.

I will discuss the first, third, and fourth factors first.

There is no question that the trusts were part of the same estate plan as there is also no question that both trusts used the same trustee, the clients' CPA. However, husband and wife

each contributed their own separate assets to the trust that he or she settled. Therefore, the fourth element in favor of finding the trusts were interrelated was missing.

As noted in *Grace*, when the first and second factor are combined, the interrelated prong is met. Therefore, whether the trusts are interrelated may depend solely on whether the second factor is met.^{vi} If one was to take a broad reading of the PLR, he or she may note that the PLR listed quite extensively many of the provisions of the two trusts, and for the most part they were identical. The only significant differences were (1) the wife was not a beneficiary of the trust settled by the husband; (2) the wife held an SPA on the trust created by the husband, but an independent person held the SPA on the trust created by the wife.

As noted above, the SPA could be exercised in favor of the husband's and wife's descendants or their spouses, but neither SPA could be exercised to appoint the property to either the husband or wife. Those who take a broad reading of the PLR might point to the SPAs, refer to *Levy*, and conclude that a mere SPA breaks the interrelated prong of the *Grace* test, and consequently breaks the doctrine of reciprocal trusts.

I disagree with this conclusion, and would take a narrower reading of the PLR as there were two drafting differences between the trusts: First, the wife was not a beneficiary of the trust settled by the husband. Therefore, even if one was to attempt to argue that a mere SPA could break the doctrine of reciprocal trusts, an SPA was not the only drafting difference. Second, as discussed above, husband and wife were not left in the same economic position. There were neither reciprocal trustees nor reciprocal beneficiaries in the PLR. Therefore, I would take the position that this PLR stands for the proposition that

“As long as there are not any reciprocal trustee or reciprocal beneficiary issues, a spousal access trust may be created only by one spouse, but not the other.”

CONCLUSION:

Levy may well be one of the most frequently miscited cases. For the most part, the case discussed whether the settlers were left in the same *economic* position, *not* whether the trusts were interrelated. Further, there were no reciprocal beneficiaries in *Levy*. Rather, the SPA held by only the wife could only bring assets back to the family unit from one of the trusts. In this respect, *Levy* more likely stands for the proposition that:

“If only one spouse may benefit from one of the trusts settled by husband and wife, husband and wife are not left in the same economic position.”^{vii}

A similar conclusion may be reached under PLR 9643013, where the husband was the only person who benefited from a spousal access trust.

The estate planner must ask, “Is half a loaf better than no loaf at all.” Husband and wife have access to only one trust in the above two fact patterns, but not both. In my next **LISI**, we will

look at a golden PLR where we have a true reciprocal beneficiary case, the estate planning attorney drafted around the substantially identical trust terms, and the Service blessed it.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

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CITES:

- i The modular approach to estate planning is trademarked by Mark Merric.
- ii *U.S. v. Grace*, 395 U.S. 316 (1969).
- iii T.C. Memo 1983-453.
- iv Part of this confusion may be attributable to reading the West head note and not reading the case. The head note states: “Decedent and wife created trusts which had similar terms but under the decedent’s trust, wife had a special power of appointment over the trust corpus. Held the trusts are not interrelated and therefore not reciprocal within the meaning of *United States v. Grace*.” However, if one reads the case, one discovers not only was there an SPA in one trust, but there were no reciprocal beneficiaries.
- v The insurance industry frequently uses the term “spousal access trust” to refer to an inter vivos trust that names the spouse of the settlor as a beneficiary.
- vi As discussed in the first installment of this article, some courts have included having the same trustee and contributing the same assets as factors finding in favor of reciprocal trusts. However, due to the limited number of cases regarding these factors, the author is unable to distill what weight should be granted to these factors when finding in favor of reciprocal trusts.
- vii This statement assumes that the doctrine of reciprocal trustees does not apply.