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Presented by
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Spousal Trusts: Opportunities and Pitfalls

presented to NAEPC

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Brown & Streza LLP is a law firm providing exceptional, integrated legal services in the areas of tax, estate, business, and charitable planning, mergers and acquisitions, business succession planning, trust and estate administration, and real estate. We serve families, businesses, entrepreneurs, investors, philanthropists, and charitable organizations. We provide caring service, deep expertise, innovative solutions, and a stable, professional, and well-respected staff while embracing and communicating that *life is more than wealthSM*.

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- Religious Institutions
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TAX, TRUSTS, & ESTATES

- Foundational Estate Planning
- Ultra-High-Net-Worth Planning
- Trust & Estate Administration
- Federal & State Income Tax
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Matt Brown is a partner with the Orange County, California law firm of Brown & Streza LLP. Matt heads the firm's Tax, Trusts, & Estates Group and its Ultra-High-Net-Worth subgroup. He represents business owners and philanthropists in personal planning, business succession planning, and charitable planning. Matt is a Fellow of the American College of Trust and Estate Counsel (ACTEC) and a former adjunct professor of law at University of California, Irvine School of Law.

Matt is a Certified Specialist in Estate Planning, Trust & Probate Law by the California State Bar Board of Legal Specialization and has been included in the Top 50: Orange County Super Lawyers list every year since 2016.

Matt has been quoted twice in the Wall Street Journal, twice in the Orange County Register, and in various other publications. Matt is also a frequent speaker and a published author on advanced estate planning, business succession, tax and philanthropy topics.

Matt earned his undergraduate degree in Agricultural and Managerial Economics from the University of California at Davis and his Juris Doctor degree, cum laude, from Southern Methodist University Dedman School of Law, where he was a member of the Southern Methodist University Law Review.

Matt lives in Ladera Ranch, California with his wife, Julie, and their four children: Michael, Ryan, Kevin, and Cassidy. The entire family attends Crossline Community Church in Laguna Hills, California.

Record Estate & Gift Tax Exemption

The Numbers

- \$12,060,000 per person or \$24,120,000 per couple
- Inflation-adjusted annually
- \$360,000 increase (\$720,000 per couple) from \$11,700,000 exemption in 2021
- Likely to increase by over \$500,000 (\$1,000,000 per couple) in 2023
- 2026 sunset (\$5,000,000 inflation-adjusted from 2010 base year through 2026 and beyond)
 - IRC § 2010(c)(3)(B)

Record Estate & Gift Tax Exemption

Use It or Lose It

- Exemption Bubble: Top-Half/Bottom-Half
- Pre-2026 Legislative Risk?

Record Estate & Gift Tax Exemption

Solutions for the “Statutorily Poor”

- We trust our children!
 - Note discussion of string statutes below

Record Estate & Gift Tax Exemption

Solutions for the “Statutorily Poor”

- Acceptance – Let it Go
- Valuation Discounts – Exemption Bubble Cushion
- Grantor Trusts – “Tax Burn”
 - Grantor trust with tax reimbursement clause
 - Turn off grantor trust status if it gets too expensive
 - Who holds the power?
- Spousal Trusts
 - Grantor
 - Nongrantor
- Life Insurance adds stability/flexibility



The most powerful estate tax planning tool is the passage of time. Over a long (e.g., 20 years+) remaining lifetime, there may be more value represented by future estate growth than present estate value, particularly with tax burn caused by grantor trust status.

Reciprocal Trust Doctrine

Conceptual Background: Too Easy

Reciprocal Trust?

	Yes	No
Same Date?	X	
Nearly Identical?	X	
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Lifetime Beneficiaries?	X	
Reciprocal Remainder Beneficiaries?	X	

Irrevocable Trust

Trustee: Husband
 Lifetime Beneficiary: Husband
 Remainder Beneficiaries: Descendants
 Distinct provisions: None

Irrevocable Trust

Trustee: Wife
 Lifetime Beneficiary: Wife
 Remainder Beneficiaries: Descendants
 Distinct provisions: None

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Reciprocal Trust Doctrine

Conceptual Background: More Pain Points

Reciprocal Trust?

	Yes	No
Same Date?	X	
Nearly Identical?	X	
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Lifetime Beneficiaries?	X	
Reciprocal Remainder Beneficiaries?	X	
Same Amount?	X	

Irrevocable Trust

Trustee: Husband
 Lifetime Beneficiary: Children
 Remainder Beneficiaries: Husband, if survives Wife, otherwise descendants
 Inter Vivos Power of Appointment: None
 Testamentary Power of Appointment: Appoint among descendants and charity
 Distribution Limitations: No income or principal for three years; principal only for HEMS thereafter
 Settlor Power to Remove Trustee?: Yes
 5/5 Withdrawal Power?: No

Irrevocable Trust

Trustee: Wife & Child Co-Trustees
 Lifetime Beneficiary: Wife
 Remainder Beneficiaries: Children
 Inter Vivos Power of Appointment: Appoint among descendants of H&W ancestors
 Testamentary Power of Appointment: None
 Distribution Limitations: Income/Principal for HEMS if interested trustee or fully discretionary if noninterested trustee
 Settlor Power to Remove Trustee?: No
 5/5 Withdrawal Power?: Yes

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Tax Risk – Financial Risk Continuum

Balancing Risk for Close Calls

Personal Financial Risk*



- Neither Spouse is Beneficiary
- One Spouse Only Beneficiary if Survives Other Spouse
 - Only One Spouse is Beneficiary
 - Only One Spouse has PoA
 - Reciprocal Trustees**
 - Reciprocal PoAs of Different Scope
- Reciprocal Spousal Beneficiaries but Different Distribution Standards
 - Same Gift Value
 - Same Gift Type
- Trusts Executed Same Day
 - Identical Trusts

Estate Tax Risk



* Personal Financial Risk: Lack of access to, or control of, transferred assets

** May only be a risk if Bischoff applied

Tax Risk – Financial Risk Continuum

Balancing Risk for Close Calls

- The value of the Exemption Bubble is not just the extra amount today. It is the growth on the extra amount.
- What if it is too much for children?
 - Power to appoint to charity or other family members

Reciprocal Trust Doctrine

Conceptual Background

- Interrelatedness
- Mutual economic value/benefit

Reciprocal Trust Doctrine

It's Not (Really) a Gift Tax Issue

- Annual exclusion gifts
- The String Statutes
 - Retained Benefit: 2036(a)(1)
 - Retained Power: 2036(a)(2) & 2038
- Is this tax avoidance or just an effort to utilize a statutorily-created exemption amount?
 - Congress intended gifting to be painful
 - String statutes protect the estate tax system – makes estate tax planning more difficult if senior generation needs access to interim estate growth

Reciprocal Trust Doctrine

Case Law: Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940)

- On December 6, 1930, two brothers each created two trusts FBO other brother
- Each trust was trusted by the settlor plus the brother plus a third brother
- Each trust provided for income to settlor's brother, allowed settlor's brother to withdraw \$75,000, and left the remainder to settlor's descendants
- Held: Trusts uncrossed under quid pro quo theory – consideration furnished for creation of a trust makes the party paying consideration the settlor

	Yes	No
Same Date?	X	
Nearly Identical?	X	
Same Trustee?	X	
Reciprocal Trustees?	X	
Reciprocal Lifetime Beneficiaries?	X	
Reciprocal Remainder Beneficiaries?	X	
Same Amount?	X	

Reciprocal Trust Doctrine

Case Law: United States v. Estate of Grace, 395 U.S. 316 (1969)

- December 15, 1931, Joseph creates trust FBO Janet
- December 30, 1931, Janet creates trust FBO Joseph with nearly identical terms
- Each trust named the settlor-spouse, a nephew, and a third party as co-trustee
- Held: Circuit split re: quid pro quo resolved, and no quid pro quo required
 - Interrelatedness: Trusts are interrelated; and (nonexclusive list includes):
 - Substantially identical terms;
 - Creation at the same time; or
 - Part of a single design
 - Mutual Economic Value/Benefit: Arrangement, to the extent of mutual value, leaves settlors in approximately the same economic position as if the trusts named themselves as life beneficiaries

Reciprocal Trust Doctrine

Case Law: United States v. Estate of Grace, 395 U.S. 316 (1969)

- Narrow interpretation: Application limited to situations where settlors exchange economic benefits (Green)
- Broad interpretation:
 - Dissent: Inclusion should have been based on trusteeship. Object of a reciprocal trust is to rid oneself of "all taxable power over the corpus by exchanging taxable powers with the other settlor." Id. at 325
 - Adopted in Bischoff
- Court of Claims: Could not find reciprocity under either of the former competing standards (subjective quid pro quo or objective reciprocity)
 - Grace rejected the subjective element, effectively presuming a tax-avoidance motivation in intrafamily transactions

Reciprocal Trust Doctrine

Case Law: United States v. Estate of Grace, 395 U.S. 316 (1969)

	Yes	No
Same Date?	X	
Nearly Identical?	X	
Same Trustee?		X
Reciprocal Trustees?		X
Reciprocal Spousal Beneficiaries?	X	
Reciprocal Non-Spousal Beneficiaries?	X	
Same Amount?	X	
Same Assets?	X	
Retained Power (Interrelatedness) Case?	X	
Retained Benefit (Economic Value) Case?	X	

Reciprocal Trust Doctrine

Case Law: Bischoff v. Commissioner, 69 T.C. 32 (1977)

- Broad interpretation of Grace (see Green for narrow interpretation)
- 12/31/1957: Bruno (husband) created four trusts for the benefit of grandchildren and name wife as trustee
- 01/01/1958: Bertha (wife) created four trusts for the benefit of same grandchildren and named husband as trustee
- Each trust funded with identical interests (0.75% interest in Frank Brunckhorst Co.)
- Each trust named the other spouse as trustee and the settlor-spouse as successor trustee
- Held: Reciprocal trust due to interrelatedness (reciprocal trustees) even though no exchange of economic value
 - Note implied standard that reciprocal trustee is only an issue when similar assets are contributed

Reciprocal Trust Doctrine

Case Law: Bischoff v. Commissioner, 69 T.C. 32 (1977)

	Yes	No
Same Date?	X	
Nearly Identical?	X	
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Spousal Beneficiaries?		X
Reciprocal Non-Spousal Beneficiaries?	X	
Same Amount?	X	
Same Assets?	X	
Retained Power (Interrelatedness) Case?	X	
Retained Benefit (Economic Value) Case?		X

Reciprocal Trust Doctrine

Case Law: Estate of Levy v. Commissioner, T.C. Memo. 1983-453

- May 1, 1972 Herbert (husband) created trust FBO Lawrence (son)
- May 1, 1972 Ilse (wife) created trust FBO Lawrence (son)
- Identical assets (12.5% interest in Wel-Fit)
- Herbert & Ilse were reciprocal trustees
- Nearly identical terms, except for broad lifetime power of appointment held by Ilse
- IRS stipulated that the existence of an inter vivos limited power of appointment, if valid, was sufficient to break reciprocity
 - IRS argued (i) validity under New Jersey law and (ii) subjective likelihood of exercising the power
- Held: Wife's limited power of appointment sufficient to break interrelatedness; likelihood of exercise irrelevant but also a significant power given ability to combine with other interests in stock to exercise substantial control over Wel-Fit

Reciprocal Trust Doctrine

Case Law: Estate of Levy v. Commissioner, T.C. Memo. 1983-453

	Yes	No
Same Date?	X	
Nearly Identical?		X
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Spousal Beneficiaries?		X
Reciprocal Non-Spousal Beneficiaries?	X	
Same Amount?	X	
Same Assets?	X	
Retained Power (Interrelatedness) Case?	X*	
Retained Benefit (Economic Value) Case?		X**

* Court may not have fully addressed due to stipulations. Consider result in Bischoff.

** Consider whether heavy reliance on Levy is appropriate given this distinction

Reciprocal Trust Doctrine

Case Law: Estate of Green v. U.S., 68 F.3d 151 (6th Cir. 1995)

- Narrow interpretation of Grace – very hostile to Bischoff, which was a broad interpretation of Grace
- December 20, 1966: Jack (husband) created a trust FBO Jennifer (granddaughter) and named Norma (wife) as trustee
- December 20, 1966: Norma (wife) created an identical trust for the benefit of Greer (grandson) and named Jack (husband) as trustee
- Trusts substantially identical
- Held: No retained economic benefit, so no reciprocal trust doctrine. Given lack of economic benefit, interrelated nature of trusts was irrelevant.
 - “[T]he government seeks to rewrite Grace by a strained and attenuated interpretation of language that needs no interpretation.”

Reciprocal Trust Doctrine

Case Law: Estate of Green v. U.S., 68 F.3d 151 (6th Cir. 1995)

	Yes	No
Same Date?	X	
Nearly Identical?	X	
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Spousal Beneficiaries?		X
Reciprocal Non-Spousal Beneficiaries?		X*
Same Amount?	X	
Same Assets?	X	
Retained Power (Interrelatedness) Case?		X**
Retained Benefit (Economic Value) Case?	X	

* One trust FBO each grandchild

** Not addressed due to lack of retained economic benefit

Reciprocal Trust Doctrine

Case Law

How do we reconcile cases?

- Bischoff applies reciprocal trust doctrine broadly
 - Full tax court opinion
- Green applies reciprocal trust doctrine narrowly
 - Appellate opinion

Reciprocal Trust Doctrine

PLRs: PLR 9643013

- Only cites Grace & Levy, not Bischoff
 - Significant since there were reciprocal trustees
- Husband settles trust for children and names third party as distribution trustee and wife as managing trustee
- Wife settles similar trust for children and husband
- Held: Not reciprocal under Estate of Grace
 - No mention of Bischoff, Levy, or Green
 - Limited facts, and limited application of law to the facts, so not terribly helpful

Reciprocal Trust Doctrine

PLRs: PLR 9643013

	Yes	No
Same Date? Not Addressed		
Nearly Identical?	X	
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Spousal Beneficiaries?		X
Reciprocal Non-Spousal Beneficiaries?	X	
Same Amount? Not Addressed		
Same Assets? Not Addressed		
Retained Power (Interrelatedness) PLR?		X
Retained Benefit (Economic Value) PLR?	X	

Reciprocal Trust Doctrine

PLRs: PLR 200426008

- Reciprocal ILITs (with Crummey withdrawal powers)
- Differences (5)
 - If son predeceases Wife (unlikely), three things happen:
 - 5x5 power
 - Lifetime limited power of appointment to appoint to Husband's child, descendants, or their spouses
 - Testamentary limited power of appointment to appoint to Husband's child, descendants, their spouses, and charity
 - Marital trust savings clause in both, but two differences:
 - Husband-settled trust gives Wife 5x5 power and testamentary limited power of appointment
 - Wife-settled trust precludes Husband from being a beneficiary for three years after Wife's death or never if his income is too high
 - Doesn't even qualify for marital deduction, so hardly material

Reciprocal Trust Doctrine

PLRs: PLR 200426008

	Yes	No
Same Date? Not Addressed		
Nearly Identical?		X
Same Trustee?		X
Reciprocal Trustees?	X	
Reciprocal Spousal Beneficiaries?	X	
Reciprocal Non-Spousal Beneficiaries?	X	
Same Amount? Not Addressed		
Same Assets?		X
Retained Power (Interrelatedness) PLR?		X
Retained Benefit (Economic Value) PLR?	X	

Reciprocal Trust Doctrine

Nope!

Smaldino v. Commissioner, T.C. Memo. 2021-127

- Not step transaction or reciprocal trust

Reciprocal Trust Doctrine Drafting Tips

	Consider Avoiding	Consider Instead
Timing	Trusts created/funded on same date	Create/fund trusts at different times; create/fund trusts pursuant to different plans or in different tax years
Trustees	Reciprocal/identical trustees	Appoint different, non-reciprocal trustees with different powers (beneficiary power to remove/replace trustee in one trust but not the other; internal decanting in one trust but not the other)
Funding	Funding with equal value/same assets	Fund with different values/different types of assets; partial sale to one trust

Reciprocal Trust Doctrine Drafting Tips

	Consider Avoiding	Consider Instead
Powers of Appointment	Granting each spouse PoA exercisable among same permissible appointees	Granting one spouse a PoA; granting each spouse a PoA with different permissible appointees (e.g., charity in one trust but not the other; broader class of family members in one trust but not the other; granting PoA at different timeframes (lifetime only in one and lifetime or upon death in another); granting special power of appointment to one or more third parties)
Distribution Standards	Identical distribution standards	Different distribution standards (prohibit income distributions from one trust but not the other, perhaps for a limited time; mandatory income distributions from one trust but not the other; purely discretionary distribution standard in one trust and HEMS in the other)
Withdrawal Standards	Identical withdrawal standards	5/5 withdrawal power in one trust and no withdrawal power in the other

Reciprocal Trust Doctrine

Drafting Tips

	Consider Avoiding	Consider Instead
Current Beneficiaries	Identical current beneficial interests	Only one spouse is a current beneficiary of a trust settled by the other spouse during the settlor-spouse's lifetime; spouse plus children beneficiaries of one trust and spouse-only beneficiary of another trust; one or more trusts only for the benefit of children with no spousal beneficiary; one spouse only become beneficiary upon death of other spouse or divorce from other spouse
Remainder Beneficiaries	Identical remainder beneficiaries	Descendants as beneficiaries of one trust and descendants plus charity as beneficiaries of the other; protective QTIP marital trust FBO spouse if there is estate inclusion

Reciprocal Trust Doctrine

Other Considerations

- Use life insurance to reduce client desire for reciprocity
 - Be sure one or both spouses are insurable before making transfers!
 - Consider private split dollar to potentially allow access to cash value while removing death benefit from estate
- Use among siblings? Unmarried couples?
- Don't overdo it
 - Keep enough assets for lifestyle needs
- Divorce – floating spouse
- Don't take trust distributions unnecessarily
 - Break the habit
 - It is common to continue taking distributions from entities gifted to trusts out of habit
- Respect Formalities
 - Trust distributions should remain beneficiary-spouse's separate property
 - Make cash distributions to beneficiary-spouse's separate property bank account

Reciprocal Trust Doctrine

Potential Fixes

- Trust Modification
 - Nonjudicial Modification (trustor/beneficiary consent)
 - Judicial Modification (scrivener's error)
 - Appellate case brief: 2019WL 144377; default judgment via appeal to Supreme Court of Kansas
 - Commissioner v. Estate of Bosch, 387 U.S. 456 (1967)
 - Only distinctions: Principal withdrawal by H (5/5 power) and lifetime LPOA – mistake of law argument (meaning attorney didn't forget, just didn't know?)
 - Just because you don't get to highest court doesn't mean modification wasn't valid
 - Decant
- Swap Assets (may address reciprocal/same trustee issues per apparent rationale in Bischoff)
- 2035 (3-Year Rule) considerations

Reciprocal Trust Doctrine

Other Considerations

- California Property Tax
- Power of Appointment in favor of settlor-spouse
 - Self-settled trust inclusion risk in California and perhaps other states
 - Consider alternate trust domicile
- Cannot gift-split for gift to spouse
- Spousal gifts not required to be reported on 709, even if 709 is otherwise required to be filed

Nongrantor Trust FBO Spouse

- Trust FBO spouse is normally a grantor trust under IRC § 677(a)(2)
 - Trump with adverse party consent
- State income tax planning (ING-alternative)
- 642(c) deduction for charitable gifts
- Income shifting to lower-taxed beneficiaries (i.e., children as concurrent beneficiaries)
- QSBS Multiplier
- Pre-Transaction Planning

Partially Nongrantor QTIP

- Structural Considerations
 - Mandatory Income to Spouse
 - Grantor trust under IRC Section 677(a)(1) because income is distributed to grantors spouse
 - Discretionary Principal to Spouse
 - Principal distribution to spouse requires consent of adverse party, which allows trust to be nongrantor under IRC Section 677(a)
 - QTIP election must be made on timely-filed IRS Form 709. Unlike 706, no 9100 relief for late QTIP election.

Conclusion

Questions?

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Thank you for attending!