

Beware of the “reciprocal trust” doctrine

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If you and your spouse have similar irrevocable trusts that benefit each other, it's important to know that the trusts might be subject to the “reciprocal trust” doctrine. In a nutshell, the doctrine prohibits tax avoidance through trusts that are interrelated and place both spouses in the same economic position as if they'd each created trusts naming themselves as life beneficiaries.

Avoid this scenario

Let's suppose that you and your spouse's estates will trigger a substantial tax bill when you die. You transfer your assets to an irrevocable trust that provides your spouse with an income interest for life, access to principal at the trustee's discretion and a testamentary, special power of appointment to distribute the trust assets among your children.

Ordinarily, assets transferred to an irrevocable trust are removed from your taxable estate (though there may be gift tax implications). But let's say that two weeks later, your spouse establishes a trust with a comparable amount of assets and identical provisions, naming you as life beneficiary. This arrangement would violate the reciprocal trust doctrine, so for tax purposes the transfers would be undone by the IRS and the value of the assets you transferred would be included in your respective estates.

In this example, the intent to avoid estate tax is clear: Each spouse removes assets from his or her taxable estate but remains in essentially the same economic position by virtue of being named life beneficiary of the other spouse's estate.

Create two substantially different trusts

There are many ways to design trusts to avoid the reciprocal trust doctrine, but essentially the goal is to vary factors related to each trust, such as the trust assets, terms, trustees, beneficiaries or creation dates, so that the two trusts aren't deemed “substantially similar” by the IRS. Please contact us to learn more.

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