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Person To Contact:

, ID No.

Telephone Number:

In Re:

Refer Reply To:

CC:PSI:B04 – PLR-125317-03

Date: MARCH 10, 2004

Legend

Husband =

Wife =

Husband's Trust =

Wife's Trust =

Son1 =

\$a =

\$b =

Dear _____ :

This is in response to your letter dated April 9, 2003, and subsequent submissions, in which you request a ruling regarding the federal estate tax treatment of two trusts.

Facts

The facts submitted and representations made are as follows:

Husband and Wife each propose to execute an irrevocable trust agreement which will create Husband's Trust and Wife's Trust, respectively. Each trust will be the initial owner of a life insurance policy on the life of the respective settlor. Each settlor

will contribute cash to the trust that the settlor executed. Wife is named as the trustee of Husband's trust and Husband is named as the trustee of Husband's Trust.

The terms of the trusts are identical in the following respects:

Under Article I, specified beneficiaries have the right to withdraw specified portions of each transfer to the trust for a limited time.

Under Article III, for purposes of the trust agreement, the Settlor's spouse will be deemed to be deceased and the Settlor's spouse and heirs of the Settlor's spouse, other than the Settlor's issue, will be ineligible to be a beneficiary or trustee or to exercise any powers, if the Settlor and the Settlor's spouse are divorced, legally separated, or while a legal action for their divorce or separation is pending.

Article VII, Section 1. contains provisions that apply "[w]ith respect to the entire trust during the joint lifetimes of Settlor and Settlor's spouse, and for so long as Settlor's spouse is not deemed to be deceased pursuant to Article III." Under Article VII, Section 1., during the joint lives of the Settlor and the Settlor's spouse, the trustee must distribute to or for the benefit of the spouse and/or Son1 any amounts of income or principal as is necessary or advisable for their health, support, maintenance, and education. Son1's needs must be satisfied before any distribution may be made to the Settlor's spouse.

Under Article VII, Section 2., if the Settlor survives the spouse's actual or deemed death, during the Settlor's remaining life, the trustee must distribute to or for the benefit of Son1, or if Son1 is deceased, to the Settlor's issue, any amounts of income or principal as is necessary or advisable for their health, support, maintenance, and education.

Under Article VII, Section 3., if Son1 predeceases the Settlor but the spouse survives and is not deemed to be deceased under Article III, then to the extent that any trust property is included in the Settlor's gross estate for federal estate tax purposes, that property will be held as a separate Marital Trust as of the Settlor's death. During the remaining life of the Settlor's spouse, the Settlor's spouse will receive all of the net income of the Marital Trust at least quarter annually and any principal the trustee deems necessary or advisable to supplement that income to provide for the spouse's health, support, maintenance, and education.

Under Article VII, Section 4., if the Settlor's spouse survives the Settlor, with respect to trust assets not in a Marital Trust, the trustee must distribute to or for the benefit of the Settlor's spouse and/or Son1 any amounts of income or principal as is necessary or advisable for their health, support, maintenance, and education. Son1's needs must be satisfied before any distribution may be made to any other beneficiary.

Under Article VII, Section 5., if Son1 survives the Settlor and the actual or deemed death of the Settlor's spouse, the trust assets will be held for Son1 for his life.

In general, the trustee must pay to or for the benefit of Son1 any amount of income or principal as is necessary or advisable for Son1's health, support, maintenance, and education. Upon the death of the survivor of Son1, the Settlor, and the Settlor's spouse (including the deemed death of Settlor's spouse), the trust will be divided among and held for the Settlor's then living issue and deceased children with then living issue.

Under Article VIII, Section 4., a trustee cannot participate in any decision that would discharge the trustee's obligations as an individual, including a support obligation, or that would amend or terminate the trust, if doing so would cause inclusion of the trust assets in the trustee's gross estate.

The terms of the two trusts differ in several respects. Husband's Trust contains the following provisions that are not in Wife's Trust:

"With respect to the entire trust during the joint lifetimes of Settlor and Settlor's spouse, and for so long as Settlor's spouse is not deemed to be deceased pursuant to Article III," Husband's Trust provides as follows under Article VII, Section 1.:

b. After [Son1's] death, Settlor's spouse shall have the noncumulative personal right in any calendar year, within the period beginning December 1 and ending December 31 of each such calendar year, to withdraw from principal by written request amounts not exceeding five thousand dollars (\$5,000) in the aggregate and, in addition, if Settlor's spouse shall be living on the last day of such year to withdraw an amount, if any, by which five percent (5%) of the then market value of the principal exceeds the amounts previously withdrawn during such calendar year. The amounts which Settlor's spouse is entitled to withdraw under this Section 2.b. are in addition to any other amounts distributed from this trust.

c. Settlor's spouse may, during Settlor's spouse's lifetime, dictate how the trust principal shall be distributed subsequent to [Son1's] death. The exercise of this power shall be made by specific reference to it, in a written document delivered to the Trustee. This power may only be exercised in favor of (i) any one or more of those persons who are the issue of Settlor, (ii) any person who is a spouse of an issue of Settlor, and/or (iii) any trust which is created primarily for the benefit of one or more of those persons who are objects of this power. In no event shall this power be exercised in favor of Settlor's spouse, the creditors of Settlor's spouse, the estate of Settlor's spouse or the creditors of Settlor's spouse's estate.

Article VII, Section 1. of Husband's Trust provides that the trust assets will be held and administered under Article VII, Sections 2. or 3. and 4., to the extent that, upon the death of the first to die of Settlor or Settlor's spouse, Settlor's spouse does not exercise the power of appointment provided under Article VII, Section 1.c.

With respect to the Marital Trust, Husband's Trust provides, under Article VII, Section 3.:

c. The Trustee shall pay to Settlor's spouse such sums from the principal of the Marital Trust as Settlor's spouse may request in writing from time to time. The amount so paid in any calendar year shall in no event exceed five percent (5%) of the value of the Marital Trust on the first day of the calendar year during which payment is made. The amounts which Settlor's spouse is entitled to withdraw under this Section 3.c. are in addition to any amounts distributed from this trust under Sections 3.a. and 3.b. of this Article.

e. On the death of Settlor's spouse, . . . [t]he remaining principal of the Marital Trust. . . shall be paid as Settlor's spouse may appoint by Settlor's spouse's Will, specifically referring to this power of appointment. Any exercise of this power shall not take effect until after [Son1's] death. This power may only be exercised in favor of (i) any one or more of those persons who are the issue of Settlor, (ii) any one or more of those organizations, gifts to which qualify as deductible, charitable contributions under either Section 170 or Section 2055 of the Internal Revenue Code of 1986, as amended, and/or (iii) any trust which is created primarily for the benefit of any one or more of those persons or entities who are objects of this power. In no event shall this power be exercised in favor of Settlor's spouse, the creditors of Settlor's spouse, the estate of Settlor's spouse or the creditors of Settlor's spouse's estate.

To the extent Settlor's spouse does not exercise her power over the assets remaining in the Marital Trust at her death, those assets will be subject to the provisions of Article VII of that follow Article VII. Section 3.

With respect to any assets not placed in a Marital Trust if his spouse survives Husband, Husband's Trust provides under Article VII, Section 4.:

b. After [Son1's] death, Settlor's spouse shall have the noncumulative personal right in any calendar year, within the period beginning December 1 and ending December 31 of each such calendar year, to withdraw from principal by written request amounts not exceeding five thousand dollars (\$5,000) in the aggregate and, in addition, if Settlor's spouse shall be living on the last day of such year to withdraw an amount, if any, by which five percent (5%) of the then market value of the principal exceeds the amounts previously withdrawn during such calendar year. The amounts which Settlor's spouse is entitled to withdraw under this subsection are in addition to any other amounts distributed from this trust.

c. Settlor's spouse may, by Will or during Settlor's spouse's lifetime, dictate how the trust principal shall be distributed. The exercise of this power shall be made by specific reference to it in a written document delivered to the Trustee. . . . Any exercise of this power shall not take effect until after [Son1's] death. This power may only be exercised in favor of (i) any one or more of those persons who are the issue of Settlor, (ii) any one or more of those organizations, gifts to which qualify as deductible, charitable contributions under either Section 170 or Section 2055 of the Internal Revenue Code of 1986, as amended, and/or (iii) any trust which is created primarily for the benefit of one or more of those persons who are objects of this power. In no event shall this power be exercised in favor of Settlor's spouse, the creditors of Settlor's spouse, the estate of Settlor's spouse or the creditors of Settlor's spouse's estate.

Wife's Trust contains the following provisions that are not in Husband's Trust:

Under Article III, Section 3., Wife's trust provides:

Except with respect to the Marital Trust under Article VII, Section 3., Settlor's spouse shall be a Beneficiary under this Agreement only during such time or times ("Relevant Date") as:

- a. the net worth of Settlor's spouse is less than [\$a] (the "Net Worth Threshold");
- b. Settlor's spouse's income from personal services for the calendar year is less than [\$a] (the "Compensation Limit"); and
- c. the Relevant Date is at least three (3) years after the death of Settlor.

Furthermore, any distributions to Settlor's spouse under this Agreement at the Relevant Date(s) shall be limited to an amount equal to [\$b] ("Maximum Amount") reduced by Settlor's spouse's income from personal services during such calendar year.

Article III, Section 3. of Wife's Trust contains specific guidelines for determining if the net worth and income from personal services of Settlor's spouse meet the Net Worth Threshold and the Compensation Limit.

You have asked us to rule as follows:

1. Neither the Husband's Trust nor the Wife's Trust will be includible in the Husband's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.

2. Neither the Husband's Trust nor the Wife's Trust will be includible in the Wife's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.

Law and Analysis

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the decedent's interest therein at the time of his death.

Section 20.2033-1(a) of the Estate Tax Regulations provides, in general, that the gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death.

Section 2036(a) requires the inclusion in the gross estate of property to the extent of any interest of which the decedent has made a lifetime transfer under which he has retained for his life, or for any period not ascertainable without reference to his death or for any period that does not in fact end before his death the possession or enjoyment of, or the right to the income from, the property, or the right either alone or in conjunction with any other person, to designate the person or persons who shall possess or enjoy the property or the income therefrom.

Section 20.2036-1(b)(2) provides that the use, possession, right to income, or other enjoyment of the transferred property is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit. The term "legal obligation" includes a legal obligation to support a dependent during the decedent's lifetime.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein 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, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) either by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired the power) to alter, amend, revoke, or terminate, or where the decedent relinquished any such power during the three-year period ending on the date of the decedent's death. Section 20.2038-1 provides that § 2038 does not apply to a power held solely by a person other than the decedent.

In United States v. Estate of Grace, 395 U.S. 316, 324 (1969), the Supreme Court held that where donors create reciprocal trusts which do not change the economic

position of each donor with respect to the property while avoiding the literal terms of the predecessor to § 2036(a)(1), the trust will be includible in that donor's gross estate at death. In Grace, the donor created a trust providing for payment of income to his spouse for her life and payment of principal at the discretion of the trustees. The spouse was granted a testamentary special power to appoint the property to the donor and their children. Shortly thereafter, the spouse created a virtually identical trust naming the donor as life beneficiary. The Court held that the trusts were interrelated since they were substantially identical and were part of a single transaction designed by the donor. The transfers left each party in the same effective economic position as if they had created trusts naming themselves as life beneficiaries. The Court stated that, "application of the reciprocal trust doctrine is not dependent on a finding that each trust was created as a quid pro quo for the other." Estate of Grace, *supra* at 324. See also Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940).

In Estate of Levy v. Commissioner, 52 T.C.M (P-H) P 83,453 (1983), a donor and his spouse created irrevocable trusts on the same date. Each spouse was named as trustee of the trust created by the other spouse. Each spouse transferred to the trust that spouse created 12.5 shares of stock in a closely-held corporation that the spouses controlled. The donor's trust granted his spouse the power to appoint the income or the corpus of the donor's trust at any time during the spouses' joint lives to any person or persons other than the spouse, her creditors, her estate, or the creditors of her estate. The spouse's trust did not contain a similar provision but was substantially identical to the donor's trust in all other respects. The Tax Court stated that Grace created two tests for determining whether or not the reciprocal trust doctrine applies, "the first being whether or not the trusts are interrelated; and the second being whether or not the economic positions of the grantors have been altered by the creation of the trusts." Estate of Levy, *supra* at 1838-83. The Tax Court found that the spouse's special power was valid under state law. The court concluded that the trusts were not interrelated and, consequently, not reciprocal. After finding that the trusts in Levy were interrelated, the Tax Court did not reach the second test.

In the present case, Husband's Trust differs from Wife's Trust in several respects. Husband's Trust grants Wife the right to withdraw specified amounts of trust principal after Son1's death. Husband's Trust also grants Wife an inter vivos special power, effective at Son1's death, to appoint trust principal among any of Husband's issue and their spouses or any trust created primarily for the benefit of one or more of those persons. Further, to the extent Wife does not exercise her inter vivos special power, Husband's Trust grants Wife an inter vivos or testamentary special power, effective at Son1's death, to appoint trust principal among any of Husband's issue and any charities Wife designates or any trust created primarily for the benefit of one or more of those persons. Finally, if a Marital Trust is established, Husband's Trust grants Wife a testamentary special power to appoint the assets remaining in the Marital Trust

among any of Husband's issue and any charities Wife designates or any trust created primarily for the benefit of one or more of those persons.

Under Wife's Trust, with respect to any trust established under Wife's Trust except a Marital Trust, Husband cannot be a beneficiary until three years after Wife's death and then will only be a beneficiary at any time when his net worth is under \$a and his income from personal services is under \$a. Distributions to Husband under this provision are limited to an amount equal to \$b reduced by Husband's income from personal services during the calendar year of the distribution.

Thus, we conclude that Husband's Trust and Wife's Trust are not interrelated. As in Levy, there is no need to consider the second test. Accordingly, based on the facts submitted and the representations made, we rule as follows:

1. Neither the Husband's Trust nor the Wife's Trust will be includible in the Husband's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.

2. Neither the Husband's Trust nor the Wife's Trust will be includible in the Wife's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the modification under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure

Copy for section 6110 purposes