

Tread carefully if you and your spouse have similar trusts

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When spouses have similar irrevocable trusts for each other's benefit, they can be subject to the "reciprocal trust" doctrine. It prohibits tax avoidance through trusts that (1) are interrelated, and (2) place both grantors in the same economic position as if they'd each created trusts naming themselves as life beneficiaries.

What not to do

Suppose that your 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 identical provisions, naming you as life beneficiary. This arrangement would violate the reciprocal trust doctrine, so 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

To avoid unintended tax consequences, trusts should be designed to avoid the reciprocal trust doctrine. There are many ways to accomplish this, but essentially the goal is to vary factors related to each trust, such as the trust assets or terms, trustees, beneficiaries, or creation dates, so that the two trusts aren't deemed "substantially similar" by the IRS. If you and your spouse have separate trusts, allow us to review them to ensure they don't invoke the reciprocal trust doctrine.

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