Nebraska Law Review

Volume 36 | Issue 4 Article 4

1957

Reciprocal Trusts—A Tax Avoidance Device with Recuperative Powers

Philip G. Johnson
Philip G. Johnson & Co., Lincoln, Nebraska

Reciprocal Trusts—A Tax Avoidance Device With Recuperative Powers

Philip G. Johnson*

Why are ye fearful, O ye of little faith? Matthew VIII:26

The Technical Changes Act of 1949[1] supposedly conferred the last rites of a sympathetic and forgiving administration upon a tax avoidance device which had apparently been dealt a mortal blow by judicial opinion.[2] Developments since 1949 seem to indicate that the requiem was sung too early and the corpse will not lie down and play dead.[3]

The device, the use of reciprocal or converse trusts, had its greatest period of development in the years prior to 1940. In that year a decision of the United States Court of Appeals for the Second Circuit, in *Lehman v. Commissioner*,[4] and subsequent decisions of other courts and the Board of Tax Appeals indicated that the tax avoidance possibilities of the device were illusory.[5] As the decision in the *Lehman* case caught many taxpayers unawares, the Technical Changes Act of 1949 included relief provisions for persons in this situation. Under the act, persons who had created reciprocal trusts prior to January 1, 1940, were permitted to release certain powers retained in such trusts free of gift tax and without having the relinquishment considered as in contemplation of death. The relinquishment of the powers had to be before January 1, 1951, and applied only if a gift tax had been paid by the person who made the

* B.S. 1932, Iowa State College; LL.B. 1957, University of Nebraska; C.P.A.; Member, Council of American Institute of Accountants; presently Senior partner, Philip G. Johnson & Co., Lincoln, Nebraska.

1 Act of Oct. 25, 1949, c. 720, § 6, 63 Stat. 893.

2 "The use of reciprocal trusts as an informed mode of tax avoidance has thus been dead for some eight full years. But . . . it may be said of those same converse trusts . . . that they still rule from their new fully taxable graves." Colgan and Molloy, Converse Trusts—The Rise and Fall of a Tax Avoidance Device, 3 Tax L. Rev 271, 273 (1948).

3 Tobin v. Commissioner, 183 F.2d 919 (5th Cir. 1950); Newberry's Estate v. Commissioner, 201 F.2d 874 (3d Cir. 1953), *reversing* 17 T.C. 597 (1951); McLain v. Jarecki, 232 F.2d 211 (7th Cir. 1956).

4 109 F.2d 99 (2d Cir. 1940), *cert. denied,* 310 U.S. 637 (1940).

5 For a detailed and documented analysis of the development of the *Lehman* doctrine prior to 1949 see Colgan and Molloy, supra note 2, and Callan, The Lehman Doctrine—Its Significance and Application, 26 Taxes 233 (1948)

reciprocal transfers.[6] Some of the decisions of the courts since the Technical Changes Act of 1949 indicate that the legislature would have been better advised to have considered methods of eliminating a loophole, rather than providing relief for taxpayers who had apparently made a mistake in judgment in adopting methods of minimizing estate taxes.[7]

The device of reciprocal trusts is relatively simple. *A* and *B* are husband and wife. *A* would like to create a trust for his children, but is reluctant to give up complete control over the funds he wishes to give them. He would like to retain the right to change his mind and to alter, amend, or revoke; perhaps he would like to retain the income for his life. The retention of any of these rights, however, would result in making the transfer ineffective as a means of reducing taxes. If he gives the income to his spouse, or gives her the right to alter, amend, or revoke, the estate tax saving can be accomplished. But this gives the power over the funds to his wife, *B*. Assuming the wife has property of her own, she can create a similar trust and gives the income and the powers to alter, amend, and revoke her trust to *A*. Considering the trust created by *B* alone, *B* has not retained any of the rights that will cause it to be taxed in her estate, and looking at *A*'s trust, *A* has not retained any such rights in his trust. If the trusts are of the same size, each settlor will have the same income and the same rights of control over funds as each might have retained in his own trust, but will have income from and rights in the converse or reciprocal trust only.

I. THE LEHMAN DOCTRINE PRIOR TO THE TECHNICAL CHANGES ACT OF 1949

The decision of the Second Circuit in 1940 in *Lehman v. Commissioner*,[8] has become the leading case on reciprocal trusts and has provided the name for the doctrine. In that case, two brothers, Harold and Allan Lehman, owned equal shares in certain stocks and bonds. Harold transferred his interest in the securities to two trusts under which Allan was entitled to the income for life with remainders to his issue, and Allan was given the power to withdraw up to

[6] The relief did not apply to the release of a life estate. Sen. Rep. No. 831, 81st Cong., 1st Sess. 6 (1949).

[7] "If the reasoning in the Newberry case is followed, legislation may be needed to prevent a deficiency in the present scope of the estate law from developing." Warren and Surrey, Federal Estate and Gift Taxation 343 (1956) commenting on Newberry's Estate v. Commissioner, 201 F.2d 874 (3d Cir. 1953). In McLain v. Jarecki, 232 F.2d 211 (7th Cir. 1956), the court indicated it followed *Newberry*, supra.

[8] 109 F.2d 99 (2d Cir. 1940), *cert. denied,* 310 U.S. 637 (1940).

$75,000 in principal from each trust. Allan created two similar trusts of his interest in the stocks and bonds, under which Harold was entitled to the income from the trusts for life with remainders to Harold's issue, and Harold was given the power to withdraw up to $75,000 from each trust. It was admitted that Allan had created his trusts in consideration of Harold creating his.

The court held that, in substance, the situation was the same as if Harold had reserved the right to withdraw $150,000 from his own trust, stating:

> .... The fact that the trusts were reciprocated or "crossed" is a trifle, quite lacking in practical or legal significance. . . . The decisive point is that the decedent by transfer of his share to the brother or for the brother's use or according to the brother's direction caused the brother to make a transfer of property in trust under which the decedent had the right to withdraw $150,000 from principal.[9]

Harold was therefore the settlor of the trusts in which he had the power to invade the corpus to the extent of $150,000, and was taxable to that extent upon the theory that he had retained the power to revoke this part of the trusts.[10] The court relied upon a quotation from Scott, *The Law of Trusts* which reads as follows: "A person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another person." [11]

It is interesting to note that twice before this doctrine had been urged upon a judicial body in a tax case. Each time, once by a taxpayer,[12] and once by the Commissioner,[13] the argument had been made that trusts with reciprocal provisions had been created in consideration of each other. The Court of Appeals for the Third Circuit in 1928, and the Board of Tax Appeals in 1933, each rejected the contention.

Once the doctrine had been expounded, many opportunities were found to apply it. Although the foundation of the doctrine

9 Lehman v. Commissioner, 109 F.2d 99, 100 (2d Cir. 1940).

10 "The fact that the transfers took place prior to the Revenue Act of 1932, wherein section 302(c) was amended 26 U.S.C.A. sec. 411(c) prevented imposition of estate tax on entire property put in trust by the brother for the decedent's life use." Lehman v. Commissioner, 109 F.2d 99, 101 (2d Cir. 1940).

11 1 Scott, Trusts § 156.3 (1939). The citation has now gone the full circle. The 1956 edition cites Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940), 2 Scott, Trusts § 156.3 n.3 (2d ed. 1956).

12 Phillips v. Gnichtel, 27 F.2d 662 (3d Cir. 1928), *cert. denied,* 278 U.S. 636 (1928).

13 Margaret A. Holmes, 27 B.T.A. 660 (1933).

was attacked on the theory that the reference from Scott, *The Law of Trusts,* was applicable only to spendthrift trusts,[14] and the doctrine was called a "desecration of the principles of trusts and contracts," [15] by 1948 it could be said that ". . . the converse trust doctrine thus enunciated has won wide if not universal acceptance." [16]

The principal difficulty in applying the doctrine has been the determination of whether or not the transfers in trust were made in consideration of each other. The presence or absence of consideration has been based on the subjective intent of the parties.[17] As in *Lehman,* some taxpayers have been obliging enough to stipulate the fact of consideration.[18] But in other cases it has been necessary for the courts to determine its presence or absence from evidence or by inference from objective facts. The Tax Court,[19] and the Courts of Appeal for the Second[20] and Eighth[21] Circuits, have considered simultaneous creation and reciprocal provisions as prima facie proof of consideration. The inference from reciprocal provisions was determined to outweigh vague evidence that the trusts were not intended to be converse.[22] Evidence that the wife did not know the size of her husband's trust was immaterial.[23] Simultaneous creation of the trusts was not considered necessary. A two-day interval was not material,[24] and six-day[25] and thirteen-day[26] intervals did not prevent the application of the doctrine. The extreme

[14] Marx, The Switching of Settlors in Inter-vivos Trusts, 26 Taxes 622, 629 (1948).

[15] Marx, supra note 14, at 623.

[16] Colgan and Molloy, supra note 2, at 276.

[17] Lowndes and Kramer, Federal Estate and Gift Taxes 211 (1956).

[18] Estate of Thomas Neal, 2 T.C.M. 1137 (1943); Estate of Olive H. Oliver, 3 T.C.M. 408 (1944), *aff'd per curiam,* 148 F.2d 210 (3d Cir. 1945); Estate of Frederick S. Fish, 45 B. T. A. 120 (1940). See also Estate of Carolyn Peck Boardman, 20 T.C. 871 (1953) (taxpayer stipulated consideration).

[19] Estate of John H. Eckhardt, 5 T.C. 673 (1945); Estate of Henry S. Downe, 2 T.C. 967 (1943); Estate of Clothilde K. Lueders, 6 T.C. 587 (1946), *rev'd,* 164 F.2d 128 (3d Cir. 1947) even though not simultaneous creation.

[20] Hanauer's Estate v. Commissioner, 149 F.2d 857 (2d Cir. 1945).

[21] Cole's Estate v. Commissioner, 140 F.2d 636 (8th Cir. 1944).

[22] Hanauer's Estate v. Commissioner, 149 F.2d 857 (2d Cir. 1945), *cert. denied,* 326 U.S. 770 (1945); Estate of John Eckhardt, 5 T.C. 673 (1945).

[23] Hanauer's Estate v. Commissioner, 149 F.2d 847 (2d Cir. 1945), *cert. denied,* 326 U.S. 770 (1945).

[24] Purdon Smith Whitely, 42 B.T.A. 316 (1940).

[25] Estate of John H. Eckhardt, 5 T.C. 673 (1945).

[26] Werner A. Wieboldt, 5 T.C. 946 (1945).

situation occurred in *In re Leuders' Estate*,[27] where the Tax Court found that a transfer in trust by the decedent was consideration for a trust created by her husband fifteen months previously.

The fact that the trusts were not of the same size did not prevent a finding of reciprocity.[28] In that event the courts have held the trusts to be reciprocal only to the extent of the smaller trust. In *Cole's Estate v. Commissioner*,[29] the trust created by the husband consisted of 600 shares of St. Paul Fire and Marine Insurance stock, later increased to 700 shares. The trust created by the wife consisted of 300 shares of the same stock. At the death of the husband the wife's trust was taxed to him, and at the death of the wife the husband's trust was held taxable in her estate to the extent of the 300 shares of stock.

Taxpayers have been singularly unable to succeed in either proving that the trusts were not in consideration of each other or that they were.[30] Prior to 1947, the taxpayer had only once successfully borne the burden of proving an intent that would yield a favorable tax result.[31] The successful attempt was in *Estate of Samuel Lindsay*.[32] In that case the husband created a trust under which he gave his wife a life estate and at approximately the same time the wife transferred a similar amount of property to a trust under which her husband took a life interest. The wife knew of the husband's trust, but the husband did not know of the wife's. The Tax Court held that since the husband did not know of the wife's trust, there could be no intention to create trusts in consideration of each other[33] and the reciprocal doctrine does not apply. The court said:

> . . . But the fact that the trusts were executed about the same time, were in substantially equal amounts, and had similar pro-

[27] 5 T.C. 587 (1946), *rev'd*, 164 F.2d 128 (3d Cir. 1947).

[28] Cole's Estate v. Commissioner, 140 F.2d 636 (8th Cir. 1944); Estate of Frederick S. Fish, 45 B.T.A. 120 (1940).

[29] 140 F.2d 636 (8th Cir. 1944).

[30] Marrs McLean, 41 B.T.A. 1266 (1940), *aff'd on this point*, 127 F.2d 942 (5th Cir. 1942).

[31] Colgan and Molloy, supra note 2, at 282.

[32] 2 T.C. 174 (1943).

[33] A text writer points out that if there was any consideration involved in this case, the husband's trust was consideration for the creation of the wife's trust, of which he had no knowledge. Taxing her trust in his estate would be "predicated upon the absurd assumption that a man may furnish the consideration for a transfer of which he is entirely unaware." Lowndes and Kramer, op. cit. supra note 17, at 213.

visions are not conclusive that the trusts were interdependent and were executed in consideration of each other.[34]

The *Lehman* doctrine was carried to its greatest extreme in *Estate of Clothilde K. Lueders.*[35] In that case the busband transferred all of his property, worth some $640,000, to an irrevocable trust on July 2, 1930. His wife, the decedent, was given a life estate and the power to alter, amend, or revoke, or to vest corpus in herself. Fifteen months later, at a time when the husband's trust was worth $373,000, the decedent created a trust worth $349,200 for her husband. When she created this trust, her husband was in financial difficulties and within a month called for and received the entire corpus of the decedent's trust. Despite the fifteen-month lapse of time, the Tax Court held the transfers reciprocal, saying:

> These facts compel the conclusion that the decedent furnished consideration for the trust which was in existence at the date of her death. . . . This conclusion is impelled by the effects of the transactions of the decedent and her husband relating to their respective assets. The two trusts which were created were reciprocal upon the creation in 1931 of the second trust. This is because, under a practical view of the facts, the creation of a trust by the decedent in 1931 made it feasible for the 1930 trust to be continued in existence. Furthermore, the circumstances strongly indicate that Frederick Lueders had some assurance in 1930, when he transferred all of his assets to a trust, that the decedent would not fail to provide him with some assets, in return, if necessary. She did this a little over one year thereafter.[36]

The Third Circuit, however, reversed and placed the burden of proving the trusts reciprocal upon the government where "under the stipulation of facts, the trust created by the decedent's husband was on its face a prima facie gift." [37] The circuit court also found that the Tax Court had "made no specific finding either in its finding of facts or in its opinion, that the decedent and her husband had ever entered into an agreement, express or implied, to make reciprocal transfers of property." [38]

II. THE LEHMAN DOCTRINE SUBSEQUENT TO THE TECHNICAL CHANGES ACT OF 1949

At this stage of the development of the doctrine, the Technical Changes Act of 1949 was passed in order to afford relief to the unfortunate individuals who had availed themselves of the promising

[34] Estate of Samuel S. Lindsay, 2 T.C. 174, 178 (1943).

[35] 6 T.C. 587 (1946).

[36] Id. at 592.

[37] In re Lueders' Estate, 164 F.2d 128, 133 (3d Cir. 1947).

[38] Id. at 132.

device of reciprocal trusts and had been frustrated by the *Lehman* doctrine.[39]

The first decision handed down by a court of appeals after the adoption of the Act was the decision of the Second Circuit in *Orvis v. Higgins*,[40] overruling a district court decision.[41] In that case the husband's trust was created six days after that of the wife. The provisions of the trusts were reciprocal, with life estates granted to each spouse and remainders to the children. Sufficient evidence was introduced at the hearing in the district court to convince the trial judge that Mr. and Mrs. Orvis "each pursued an independent course" in creating the trusts, and that no reciprocity was intended. In reversing, the circuit court speaking through Judge Frank said:

> . . . [T]he undisputed facts are such that we have a "definite and firm conviction" that the trial judge was mistaken . . . We therefore hold that finding "clearly erroneous" and hold, rather, that each of those trusts was made in consideration of the other. . . .
>
> . . . [T]here is nothing in the testimony which in any manner offsets what we believe to be the virtually irresistible inference drawn from the undisputed facts. To offset that inference the trial judge relied on no positive testimony that Mr. and Mrs. Orvis acted independently but relied on negative testimony as to the absence of an expressed intention to act reciprocally. . . .[42]

It is interesting to compare this case, overruling a district court decision, with *In re Lueders' Estate*, overruling a Tax Court decision. In the *Lueders'* case, the court reasoned that it was not overruling a finding of fact, but said that the Tax Court had erred in its interpretation of the legal import of "consideration."[43] In *Orvis v. Higgins*, the court reasoned that it could reverse a finding of fact in a situation where ". . . the finding is that of a trial judge, and the evidence consists in large part of facts neither side disputes, in circumstances such that the trial judge's evaluation of credibility becomes unimportant."[44] Judge Frank placed the burden of proof on the issue of reciprocity squarely upon the plaintiff, in contrast to the attitude of the Third Circuit in *In re Lueders' Estate*, where the trusts were considered as on their face prima facie gifts.[45]

Shortly after the *Orvis* case the Court of Appeals for the Fifth

[39] Sen. Rep. No. 831, 81st Cong., 1st Sess. 6 (1949).

[40] 180 F.2d 537 (2d Cir. 1950).

[41] 80 F. Supp. 64 (S.D.N.Y. 1948).

[42] 180 F.2d 537, 540 (2d Cir. 1950).

[43] In re Lueders' Estate, 164 F.2d 128 (3d Cir. 1947).

[44] 180 F.2d 537, 540 (2d Cir. 1950).

[45] 164 F.2d 128, 133 (3d Cir. 1947).

Circuit, in *Tobin v. Commissioner*,[46] without citing the *Lueders'* case also deemed that the language of the trusts created a presumption for the Commissioner to overcome, saying:

> We do not consider the doctrine of "reciprocal trusts," as enunciated in Lehman v. Commissioner, 2 Cir., 109 F.2d 99, applicable or controlling in favor of the Commissioner here. In so holding, and in resorting to the strained fiction of reciprocal or cross trusts in order to tax the trust income to these taxpayers, we believe the Tax Court has disregarded the plain language of the trust agreements.[47]

In *Estate of Myrtle H. Newberry*,[48] the Tax Court continued to apply "the strained fiction of reciprocal or crossed trusts." In that case the Newberrys were deeply concerned for the welfare of their young children, a son and a daughter, neither of whom had independent means. John J. Newberry wished to set up trusts for the two children. The children were quite young and he wanted to retain control over the trust property in case they made unfortunate marriages. The idea of creating the trusts was first suggested to John J. Newberry by his brother. After discussing the matter with him, Newberry called in his attorney and discussed the plan with him. Shortly after discussing the plan with his attorney and after he had the idea "pretty well" fixed in his mind he discussed it with his wife. Mrs. Newberry thought the idea a good one, and wanted to do the same thing.

In 1934 John J. Newberry created an irrevocable trust of 2,500 shares of J. J. Newberry Company common stock for his daughter and a like trust for his son. In 1935 he repeated the process. In each trust he named himself and his wife as trustees and gave Mrs. Newberry alone broad power to alter, amend, or terminate the trusts, but in no event to revest principal or income in him. On each occasion when Mr. Newberry executed one of these trusts, Mrs. Newberry executed a similar trust. In each case she named herself and her husband as trustees and gave him the same powers of alteration as she was granted in the trusts created by him. As the trusts were originally set up, the Newberrys had contingent life interests in each other's trusts. From time to time Mr. and Mrs. Newberry amended the trusts, always making identical amendments. In the course of these amendments their contingent life estates were eliminated and the power to alter, amend, or revoke was limited to a power to shift interests among the Newberry issue, spouses of such issue, and charities.

[46] 183 F.2d 919 (5th Cir. 1950).
[47] Id. at 921.
[48] 17 T.C. 597 (1951), *rev'd*, 201 F.2d 874 (3d Cir. 1953).

Mr. Newberry testified, and his testimony was not rebutted, that he would have created his trusts regardless of whether Mrs. Newberry had created hers. He also testified that the property placed in trust represented only a small fraction of the wealth of either spouse, and that neither of them contemplated any personal benefit or gain from the corpus or income of any of the trusts. The Tax Court upheld the Commissioner, however, and determined that Mr. Newberry's trusts were taxable in Mrs. Newberry's estate. The court said:

> The essential consideration here is that, if the power to change beneficiaries had been reserved in decedent's own trust, there could be no doubt that the case would fall under section 811(d)(2) and, therefore, the trust corpus falls within gross estate; and the result is the same if there are crossed trusts, exchanging the same power, so that there is in substance transfer by the decedent. *Lehman* v. *Commissioner, supra.* As we said, in an income tax case involving reciprocal trusts: "What petitioner lost by the transfer to the trust created by her for Smith's benefit she recovered as beneficiary of Smith's trusts." *Purdon Smith Whiteley,* 42 BTA 316 (321).[49]

The court of appeals reversed the Tax Court on the grounds that the consideration for Mr. Newberry's trusts was not the trusts set up by his wife, since Mr. Newberry would have set up his trusts irrespective of Mrs. Newberry and since the purpose of the trusts was not to confer cross benefits upon each other, but to confer a benefit upon the children. The court said:

> . . . The essential picture which the crossed trusts must reveal to justify the result reached by the Tax Court in the present case is a declared grantor induced to establish a trust giving the party now to be treated for tax purposes as the grantor, a power which the latter has wanted and has paid for by setting up another trust to accomplish something desired by the declared grantor. Such in our views are the rather strict confines of the *Lehman* doctrine.[50]

The court found that "spouses in mutual confidence and common interest work out together what each is going to do with his own money to provide for their children," [51] and if similarity of action occurs because "each spouse is confident that they together have arrived at a wise and benevolent decision concerning the welfare of their children" [52] this is not the "unity" and "interdependence" of action which would invoke the *Lehman* doctrine. The court granted that "there may be policy considerations favorable to legislation which for particular tax purposes would treat crossed

[49] Estate of Myrtle H. Newberry, 17 T.C. 597, 606 (1951).

[50] Newberry's Estate v. Commissioner, 201 F.2d 874, 877 (3d Cir. 1953).

[51] Id. at 877.

[52] Id. at 877.

trusts of spouses like a single joint transaction with both spouses pro tanto transferors of the property over which each will thereafter have certain control." But in absence of such legislation, "when on the facts the conclusion is inescapable that each spouse by a distinct and bona fide transaction has dispensed with his own personal estate in accordance with his own personal desires, and without receiving a *quid pro quo* from the other," the court did not think that it could "justifiably refuse to recognize each spouse as the real transferor of the trust he has formally created." [53]

In *Estate of Samuel Lindsay,*[54] in 1943, the taxpayer was successful in convincing the Tax Court that trusts with reciprocal provisions were not created in consideration of each other. It was almost ten years later, in *Estate of Louise D. Ruxton v. Commissioner,*[55] before the taxpayer was again successful in such a contention before the Tax Court. In that case, as in the *Lindsay* case, the taxpayer was able to produce sufficient evidence to convince the court that in spite of reciprocal provisions the converse trust doctrine was not applicable.

The case involved the Estate of Louise DeWitt Ruxton. Prior to 1934 her husband, Philip Ruxton, was a member of the board of directors of the Harriman National Bank of New York City. Early in 1934 he was apprehensive at the possibilities of suits being filed against the directors of the bank for alleged mismanagement. He consulted his attorney as to the advisability of creating a trust for the benefit of each of his two daughters in order to provide for their security and to protect them in the event he should be wiped out financially as a result of the anticipated litigation. The decedent, who was independently wealthy and was also worried about the bank situation, had a separate consultation with the same attorney relative to her husband's possible financial difficulties. She told the attorney that she wanted to create a trust to protect her husband in the event he should lose his fortune as a result of the litigation. Both the decedent and her husband were aware of the other's plans with reference to the trusts.

On August 19, 1935, the decedent created a trust with the income payable for life to her husband. In addition, the capital gains from sales of securities held in the trust were to be paid to him upon his written request. Upon the death of Philip Ruxton the remainder was to go to the children in trust or to their issue. The

[53] Id. at 878.
[54] 2 T.C. 174 (1943).
[55] 20 T.C. 487 (1953).

trust instrument contained a spendthrift clause applicable to principal and income. The securities transferred to this trust aggregated $250,149.97 and came from the separate estate of Mrs. Ruxton. After the transfer she retained properties valued far in excess of the value of the properties transferred in trust. On the same date, August 19, 1935, Philip Ruxton executed two separate trust agreements. The trusts were identical except for the interchange of the names of the grantor's two daughters. Each trust instrument gave the net income to the daughter for life with remainders over to his wife should the daughter predecease her. If the wife was not living at the death of one daughter the remainder went to the other daughter. The trusts included a spendthrift clause. Philip Ruxton died on January 8, 1945. His federal estate tax return showed a gross estate in excess of one million dollars not including the value of the corpus of either of the trusts created by him on August 19, 1935. Louise DeWitt Ruxton died on June 16, 1948, and the Commissioner determined that the portion of the property owned by the husband and transferred to the two trusts was taxable in her estate.[56]

The petitioner contended that the reciprocal trust doctrine was not applicable for the reason that there was no concert of action, no consideration between the decedent and her husband, and no reciprocity or equivalence of rights. Petitioner also argued that there was no close relationship between the value of the transfers, in that the primary life income estate granted to her husband had an actuarial value of $66,369 whereas both of the two trusts created by decedent's husband had a total actuarial value to the decedent, if she survived the daughters, of only $11,581 on the date the trusts were created, and $6,442.85 on the date of her death. In holding for the petitioner, the Tax Court said:

> In the instant case we have before us the trust instruments, evidence of the circumstances which motivated the execution thereof, and the testimony of the lawyer who advised both the decedent and her husband. We think the motives of the parties certainly have a bearing on their intentions with respect to unity of purpose, interdependence, and consideration, or the lack thereof. On this record we strongly infer and therefore conclude that the

[56] The Commissioner valued the decedent's interest in the two trusts created by her husband as being the total value of the corpora of the two trusts amounting to $532,403.83 less the amount of $252,892.23 which represented the total value of the two primary life estates. This left a balance of $279,511.60, but he limited the amount includible to $270,315.16 which was the value of the property actually transferred by decedent to the trust created by her on August 19, 1935.

> decedent acted independently in dictating the substantive terms she desired to impose on her transfer in trust for the primary and immediate benefit of her husband during his life time and thereafter for her daughters and grandchildren; that the decedent determined to make the character of the transfer she made without regard to any action on the part of her husband; . . . The only concept of action by them was in the final stages when decedent advised the attorney that she wanted the details of her trust discussed with her husband and the fact that the instruments were executed on the same date. Such limited concert of action does not place the decedent and her husband in proper juxtaposition to have reciprocated on the trust.[57]

The court indicated, in reaching its conclusion, that the trusts were not executed in consideration of each other. They were influenced by the apparent lack of a *quid pro quo* as evidenced by the trust instruments, the Court saying:

> . . . In the *Lehman, Cole's Estate, Hanauer's Estate,* and *Orvis* cases, *supra,* the uncrossing of the trusts and the transposition of the respective grantors left each with substantially the same degree of beneficial right in or power of control over the respective properties transferred, limited in value for tax purposes by the value of the lesser corpus transferred. In the instant case the uncrossing of the trusts and the transposition of the decedent and her husband as the grantor of the other's trusts would place each of them in a position entirely untenable with the givng of a *quid pro quo* to induce the action of the other and also untenable with the materially different expressed desire or purpose of each as evidenced by the respective trusts.[58]

In 1956 the Court of Appeals for the Seventh Circuit, taking its first look at the *Lehman* doctrine in *McLain v. Jarecki,*[59] with one judge dissenting, decided to line up with the Third Circuit in its antagonism to the *Lehman* doctrine, and refused to infer consideration from the reciprocal nature of the trusts.[60] The decision of the circuit court affirmed the decision of a district court.[61] All of the evidence in the district court was stipulated. The two trusts in question were both created on the same date, December 27, 1934, and both were amended on December 18, 1935. As amended, the trust created by the husband, referred to as the Dorothy trust, provided that the net income of the trust was to be accumulated

[57] Estate of Louise D. Ruxton, 20 T.C. 487, 494 (1953).

[58] Id. at 495.

[59] 232 F.2d 211 (7th Cir. 1956).

[60] The court refused to follow *Orvis v. Higgins,* but chose to follow the 3d Circuit decision in *Newberry.* The majority opinion does not comment on the presence of evidence negativing reciprocity in *Newberry* and the absence of such evidence in *Orvis v. Higgins.*

[61] McLain v. Jarecki, 126 F. Supp. 621 (N.D. Ill. 1955).

and added to the principal of the trust until the death of the grantor, Albert O. McLain. After his death the income was to be paid to his wife during her life time, and after the death of the grantor and his wife, the income was to be paid to Dorothy Cole, their daughter or to her issue. The Dorothy trust could be revoked during the life time of the grantor, while either Mrs. McLain or their two children were living, by an instrument in writing signed by Mrs. McLain and their two children, or such of them as were living and by all persons affected thereby. The amendment in 1935 permitted Harold O. McLain, a son, and Mrs. McLain to terminate the trust during the life time of Dorothy or any of her issue. If it was terminated, the trust estate was to be distributed to Dorothy Cole, if living, or, if not then living, to her issue. The other trust created by Minnie A. McLain, the wife, contained similar conditions providing for the accumulation of the income during her life time, thereafter payment of the income to her husband, and finally termination and distribution to their son, Harold O. McLain or to his issue. It contained similar revocation and termination provisions as in the Dorothy trust.

The court analyzed the *Lehman* case as follows:

> The short of Lehman is that a person becomes a settlor of a trust if he supplies the consideration, in spite of another person's mechanical declaration of the trust, hence the Lehman court searched for consideration moving from the decedent to his brother, and having found it affirmed the Board's decision holding the trusts includable in decedent's estate.[62]

The court found that among the stipulated facts there were:

> . . . [N]one expressly showing that Albert O. McLain, decedent here, brought about the transfer from his wife, Minnie A. McLain. Because the McLains had substantially identical trusts created concurrently and prepared by their mutual lawyers, the government would have us infer an element of consideration from which to hold that decedent was the actual grantor of the trust in which his wife declared herself to be the grantor. . . . To reach the inference, indispensable for the government's position, would mean compounding probabilities on the subjective impression we have of the objective stipulated facts. . . . These trusts, and the stipulated facts can also be read as articulating a donative state of mind once extant between the McLains, *Newberry Estate v. Commissioner*, 201 F.2d 874 (3rd Cir. 1953); *Estate of L. D. Ruxton v. Commissioner* 20 T. C. 847 (1953). . . .[63]

In a vigorous dissenting opinion, Judge Schnackenberg distinguished the *Newberry* case on the grounds that in that case

[62] McLain v. Jarecki, 232 F.2d 211, 212 (7th Cir. 1956).

[63] Id. at 213.

neither settlor created any beneficial interest therein for his or her spouse, whereas in the McLain trust there was a beneficial interest "contemporaneously bestowed upon the maker by the maker of the other trust." Judge Schnackenberg said:

> . . . It is an undue taxing of our credulity to ask us to believe that this transaction lacked consideration. The only logical inference to be drawn from the stipulated facts is that when Albert gave to Minnie a life estate in the trust he then created, and she contemporaneously did the same for him, the act of one was the consideration for the act of the other. . . . Both reason and the law place upon him who would rebut this reasonable inference the burden of introducing evidence to that end. The competent attorneys who devised the plan now reviewed before us and their assistants or office associates were certainly in a position to introduce evidence on this subject, the nature of which is exemplified in the Newberry case. However, it is well to point out that even such testimony, to be effective, must counterbalance the fact of the execution of the trusts agreements and their contents. In the case at bar, such evidence would have to explain why each of the trusts set up a life estate in the spouse of the maker of the trust.[64]

III. CONCLUSION

All of the courts are apparently in agreement on the basic proposition of the *Lehman* doctrine. They agree that if the creation of one trust is paid for and brought about by the creation of the other, the doctrine applies. As said in *McLain v. Jarecki*, "consideration is essential to a finding of reciprocity."[65]

The disagreement between the tribunals is over whether or not consideration exists. The Court of Appeals for the Second Circuit[66] and the Tax Court[67] will infer consideration from the terms of the trusts and the circumstances surrounding their creation, unless evidence to the contrary is convincing.[68] The Eighth Circuit,[69] at least in the absence of evidence, will infer considera-

[64] Id. at 214.

[65] McLain v Jarecki, 126 F. Supp. 621, 624 (N.D. Ill. 1955).

[66] Orvis v. Higgins, 180 F.2d 537 (2d Cir. 1950); Hanauer's Estate v. Commissioner, 149 F.2d 857 (2d Cir. 1945), *cert. denied*, 326 U.S. 770 (1945).

[67] Among others, Estate of John H. Eckardt, 5 T.C. 673 (1945); Estate of Henry S. Downe, 2 T.C. 967 (1943); Estate of Myrtle H. Newberry, 17 T.C. 597 (1951), *rev'd*, 201 F.2d 874 (3d Cir. 1953); Estate of Clothilde K. Lueders, 6 T.C. 587 (1946), *rev'd*, 164 F.2d 128 (3d Cir. 1947).

[68] Estate of Louise D. Ruxton, 20 T.C. 487 (1953); Estate of Samuel S. Lindsay, 2 T.C. 174 (1943).

[69] Cole's Estate v. Commissioner, 140 F.2d 636 (8th Cir. 1944).

tion from the objective facts. The Third Circuit[70] will not infer consideration if any evidence is introduced to the contrary. The Fifth[71] and Seventh Circuits,[72] more or less emphatically, have refused to make any such inference, in the absence of evidence of consideration. The square conflict between the circuits on this point has resulted from making the concept of consideration dependent upon the subjective intent of the transferors and the difficulty of determining subjective intent from objective facts. The opinions of the Second Circuit and of the Tax Court indicate that they find it highly improbable that settlors would create trusts with provisions for each other's benefit unless induced to do so by a *quid pro quo* provided by the spouse's transfer.[73]

This cynical attitude overlooks the fact that many irrevocable trusts were created by husbands giving their spouses life estates and powers to alter, amend, and revoke, when the wife had no property to give her husband in return. Such trusts were created for the purpose of making a gift to avoid estate taxes and were an accepted method of doing so. Undoubtedly such trusts were also created by wives whose husbands were not financially able to reciprocate, and such trusts are not questionable. It is not too difficult to conceive of a situation where both husband and wife have a desire to conserve their respective estate for their children, and each were willing to create trusts even though the other did not.

It is entirely plausible that the court in *Lehman* was not really thinking of the common law meaning of "consideration" when it reached its conclusion, but was influenced by the same underlying principles as produced the *Clifford*[74] doctrine a month later.[75] The presence of consideration, which was conveniently stipulated

[70] Newberry's Estate v. Commissioner, 201 F.2d 874 (3d Cir. 1953); In re Lueder's Estate, 164 F.2d 128 (3d Cir. 1947).

[71] Tobin v. Commissioner, 183 F.2d 919 (5th Cir. 1950).

[72] McLain v. Jarecki, 232 F.2d 211 (7th Cir. 1956).

[73] In Orvis v. Higgins, 180 F.2d 537, 540 (2d Cir. 1950), the court stated that any inference that the trusts were not reciprocal "must rest on a belief in the purely chance concurrence of several events, although the coincidental occurrence of those events would ordinarily be highly improbable. Such a belief ought not to be the foundation of a trial judge's finding on a fact issue, in favor of the side having (like the plaintiff's here) the burden of proof as to that issue, unless the purely chance character of those events is positively confirmed by clear evidence."

[74] Helvering v. Clifford, 309 U.S. 331 (1940).

[75] The *Lehman* decision was handed down on January 22, 1940, the *Clifford* decision on February 26, 1940.

by the taxpayer, perhaps only provided a convenient device that the court could use to rationalize its opinion.

In the *Clifford* case a husband was taxed upon the income from a short term trust which he had created for his wife, upon the theory that he remained substantial owner of the trust property because there was merely a "temporary reallocation of income within an intimate family group" which did "not effect any substantial change in his economic position." The court stated:

> . . . Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus. . . . [T]he answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation.[76]

A basic feature of reciprocal trusts is, of course, that it is only the legal position of the transferors that has changed and the economic position has not been materially altered. As indicated by Colgan and Malloy[77] the Board of Tax appeals has invoked the *Lehman* and *Clifford* cases jointly to justify tax on income of converse trusts and has used the *Clifford* rule to tax the income of reciprocal trusts to the grantors where employment of the *Lehman* doctrine alone would have resulted in no tax. But in *Estate of Frederick S. Fish*[78] the Board specifically rejected it although it did invoke the *Lehman* doctrine. In *Cole's Estate,* the Court of Appeals for the Eighth Circuit reinforced its affirmation of the decision of the Tax Court as follows:

> . . . Each decedent by the trusts created may be regarded as having "retained for his life * * * the right to income from" the 300 shares which he himself transferred to the trust created by him on the theory of family relationship and equivalents. For, as a result of the terms of the identical and simultaneous trusts and of the "familial relationship," each decedent "retained the substance of full enjoyment of all the rights [for life] which previously he had in the property." *Helvering v. Clifford,* 309 U.S. 331, 336, 60 S.Ct. 554, 557, 84 L. Ed. 788. To the extent of the income from 300 shares of the stock there was no change in the economic position of either grantor.[79]

The application of *Clifford* principles would also explain the results in the Second Circuit,[80] and the Tax Court decisions in

[76] Helvering v. Clifford, 309 U.S. 331, 334 (1940).

[77] Colgan and Molloy, supra note 2, at 292.

[78] 45 B.T.A. 120 (1941).

[79] Cole's Estate v. Commissioner, 140 F.2d 636, 638 (8th Cir. 1944).

[80] See note 73, supra.

Newberry[81] and *Lueders' Estate.*[82] A reluctance to apply the principles would explain the decision in the Third Circuit in *Newberry's Estate*[83] and in *In re Lueders' Estate,*[84] in the Fifth Circuit in *Tobin*[85] and in the *McLain*[86] case in the Seventh Circuit. The *Ruxton* and *Lindsay* cases[87] in the Tax Court are not so easily explainable. The *Lindsay* case would clearly have a different result under the *Clifford* rules, but the *Ruxton* case, on the clear finding of absence of tax saving motive and relative lack of equivalence of the transfers might still be valid under *Clifford* principles. [88]

The application of the *Clifford* rule expounded by the Supreme Court has proved difficult to administer and has involved great uncertainty and a vast amount of litigation. It is no wonder that the *Lehman* doctrine, which is based upon similar equitable principles, but rationalized on a common law definition of consideration by a court with less authority, is not universally accepted. It is doubtful if the conflict will be resolved without legislative or Supreme Court intervention. All nine Supreme Court Justices could not agree on the *Clifford* rule.[89] It is too much to expect all eleven courts of appeal to agree on an issue involving similar principles.[90]

[81] Estate of Myrtle H. Newberry, 17 T.C. 597 (1951), *rev'd,* 201 F.2d 874 (3d Cir. 1953).

[82] Estate of Clothide K. Lueders, 6 T.C. 587 (1946), *rev'd,* 164 F.2d 128 (3d Cir. 1947).

[83] Newberry's Estate v. Commissioner, 201 F.2d 874 (3d Cir. 1953).

[84] In re Lueders' Estate, 164 F.2d 128 .3d Cir. 1947). In this case, O'Connell, C.J. in his dissenting opinion expressed the opinion that the case should be remanded to the tax court in order to have the body consider the effect of the *Clifford* rule.

[85] Tobin v. Commissioner, 183 F.2d 919 (5th Cir. 1950).

[86] McLain v. Jarecki, 232 F.2d 211 (7th Cir. 1956).

[87] Estate of Louise D. Ruxton, 20 T. C. 487 (1953); Estate of Samuel S. Lindsay, 2 T.C. 174 (1943).

[88] The Court of Appeals for the Seventh Circuit, in a much criticized opinion, once held the regulations of the Treasury department isued to interpret the *Clifford* rule to be unconstitutional. Commissioner v. Clarke, 202 F.2d 94 (7th Cir. 1953).

[89] Mr. Justice Roberts, in a dissent in which he was joined by Mr. Justice McReynolds, expressed the opinion that the majority decision was a judicial amendment of the Revenue Act of 1934 and such legislation should have been left to Congress.

[90] The foundation of the doctrine on the equitable principles of the *Clifford* rule, rather than on the common law definition of consideration, would explain the ineffectiveness of taxpayers' attempts to invoke the rule.