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The reciprocal trust doctrine reached the United States Supreme Court in 1969 in *United States v. Estate of Grace*.[1] The Court in *Grace* acknowledged the importance of the doctrine "to the administration of the federal estate tax laws" and sought to develop a more objective test for its application.[2] The nearly fifty years following *Grace* have demonstrated that the Court's decision was a step toward objectivity, but that it failed to deliver sufficient clarity to maintain consistency in the lower courts' interpretations of its holding.

On December 15, 1931, Joseph Grace created the "Joseph Grace trust" for the lifetime benefit of his wife, Janet Grace.[3] Mr. Grace funded the Joseph Grace trust with corporate stock, real estate, and an interest in a joint venture.[4] On December 30, 1931, Mrs. Grace created the "Janet Grace trust" for the benefit of her husband, which was nearly identical to the trust created by Mr. Grace fifteen days earlier. Mrs. Grace funded this trust with the family homestead and certain corporate securities, both of which she had received from her husband in preceding years.[5] The trusts were created and funded in anticipation of the enactment of the gift tax in 1932.[6]

Mrs. Grace died in 1937.[7] The estate tax return filed by her estate's representatives disclosed the Janet Grace trust and reported her transfers to the trust as nontaxable. The Internal Revenue Service assessed a

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1 United States v. Estate of Grace, 395 U.S. 316 (1969).

2 *Id.* at 318.

3 *Id.* at 318-19.

4 Estate of Grace v. United States, 393 F.2d 939, 943 (1968), *rev'd*, 395 U.S. 316 (1969).

5 *Estate of Grace*, 395 U.S. at 319.

6 *Id.*; *Estate of Grace*, 393 F.2d at 943 (stating, "decedent believed that a new gift tax would probably be enacted and become effective early in 1932, and he had decided that additional trusts for the benefit of the family should be created prior to the close of 1931 in order to avoid paying the new gift tax in connection with transfers of assets to such trusts.")

7 United States v. Estate of Grace, 395 U.S. 316, 319 (1969).

deficiency against Mrs. Grace's estate on the premise that the Joseph and Janet Grace trusts were reciprocal, and thus Mrs. Grace effectively retained a life estate that must be included in her gross estate. Mrs. Grace's estate entered into a compromise agreement with the Internal Revenue Service under which fifty-five percent of the Janet Grace trust was included in her taxable estate.[8]

Mr. Grace died in 1950.[9] His estate tax return reported the Joseph Grace trust as a nontaxable transfer and reported the Janet Grace trust as a trust over which Mr. Grace held a limited power of appointment.[10] The Internal Revenue Service assessed a deficiency against Mr. Grace's estate on the basis that the Janet Grace trust was includible in Joseph's estate as a reciprocal trust.[11] Mr. Grace's estate paid the deficiency and filed a claim for refund.[12]

The Court of Claims concluded that the Janet Grace trust should not have been included in the estate of Mr. Grace because the decedent had not created the Joseph Grace trust in consideration for his wife's creation of the Janet Grace trust, and that the lack of a "quid pro quo" was the determinative factor.[13] In reaching this conclusion,[14] the Court of Claims considered the origin of the reciprocal trust doctrine in *Lehman v. Commissioner*.[15] In *Lehman*, the Court of Appeals for the Second Circuit stated that the decisive factor in its determination that a trust should be included in the decedent's estate was that the transfer of property by the decedent caused his brother to make a nearly identical transfer.[16] The Court of Claims applied the *Lehman* quid pro quo test and concluded that the Janet Grace trust was not funded in consideration for the trust previously funded by Mr. Grace.[17]

The United States Supreme Court granted certiorari in order to resolve what it considered to be a conflict among the courts regarding the proper interpretation of *Lehman*.[18] The Court reversed the Court of

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8 *Id*. The Court of Claims noted in its opinion that Mr. Grace preferred not to litigate the reciprocal trust issue and instructed counsel for the Estate of Janet Grace to make the best settlement possible. The Court further determined that this willingness to compromise should not be considered an admission that the trusts were reciprocal. *Estate of Grace*, 393 F.2d at 947.

9 *Estate of Grace*, 395 U.S. at 319.

10 *Id.* at 319-20.

11 *Id.* at 320.

12 Estate of Grace v. United States, 393 F.2d 939, 944-45 (1968), *rev'd*, 395 U.S. 316 (1969).

13 *Estate of Grace*, 395 U.S. at 321-22.

14 *Id.* at 321.

15 Lehman v. Comm'r, 109 F.2d 99 (1940).

16 *Id.* at 100.

17 *Estate of Grace*, 393 F.2d at 945-46.

18 United States v. Estate of Grace, 395 U.S. 316, 318 (1969).

Claims approximately nineteen years after the death of Mr. Grace.[19] In its opinion, the Court held that the reciprocal trust doctrine does not require a quid pro quo or a tax avoidance motive. The reciprocal trust doctrine "requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."[20] The Court concluded that to require consideration or a tax avoidance motive is to require an inquiry into the subjective intentions of the grantors, and that such a subjective inquiry is not workable under the federal tax law.[21]

The Supreme Court decided *Grace* under section 811(c)(1)(B) of the Internal Revenue Code of 1939.[22] Section 811(c)(1)(B), as in effect at Mr. Grace's death in 1950, provided that the value of the gross estate shall include all property transferred by a decedent during his lifetime (other than in a bona fide sale for full and adequate consideration) under which the decedent retained the right to the income from the property or the right to designate the persons who may enjoy the property or the income therefrom.[23] Section 811(c)(1)(B), as in effect in 1950, is substantively identical to the current section 2036(a).[24]

The Court in *Grace* rejected the *Lehman* consideration test in favor of the two-pronged interrelatedness and economic position approach because the consideration test relied on the subjective intent of the parties.[25] The Court also rejected the consideration test because of the difficulty of applying the notion of bargained for consideration to the intrafamily context.[26] The Court moved to what it presumably saw as a more mechanical test, which relied less on subjective intent and more on an objective view of the facts of the transaction. The Court, however, gave limited guidance on the application of this test beyond the facts that were present in *Grace*. In reaching its conclusion that the *Grace* trusts were interrelated, the Court cited to the substantially identical terms of the trusts, the proximity in time of the creation of the trusts, and, most importantly, that the trusts' creation and funding were all part of a single plan developed by Mr. Grace.[27] Having reached the conclusion that

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19 *Id.* at 317-18.

20 *Id.* at 324.

21 *Id.*

22 *Id.* at 317. This section is codified today at I.R.C. § 2036.

23 I.R.C. § 811(c)(1)(B) (1939).

24 I.R.C. § 2036(a).

25 *See* United States v. Estate of Grace, 395 U.S. 316, 323-24 (1969).

26 *Id.* at 324. The Court in *Grace* does footnote that while consideration is not a requirement, it may be a relevant factor in the application of the reciprocal trust doctrine. *Id.* at 324 n.10.

27 *Id.* at 325.

the trusts were interrelated, the Court succinctly found that the transfers left the parties in the same economic position as before.[28]

A multitude of questions remain after *Grace*. The Court describes the Joseph and Janet Grace trusts as virtually or substantially identical, but provides no guidance relating to whether substantive differences in the trusts could have overcome the other factors that it considered. Fifteen days apart was deemed to be "approximately the same time."[29] How far apart in time would have made a difference, or would any break in time have been rendered irrelevant by the determination that both trusts were part of a single plan? Further, the Court did not wholly abandon the importance of the subjective intent of the parties, footnoting that the intention of the settlors is a factor to be considered in the interrelatedness determination.[30] If the Court had given guidance on the application of its two-pronged approach beyond its direct application to the facts of *Grace*, lower courts' subsequent interpretations of *Grace* may have developed with greater consistency.

The United States Tax Court in *Bischoff v. Commissioner*[31] expanded the strict language of *Grace* by uncrossing trusts created by a husband and a wife for the benefit of grandchildren.[32] The Tax Court concluded that the Supreme Court could not have intended by its holding in *Grace* to limit the application of the reciprocal trust doctrine to estate inclusion under Section 2036(a)(1), and held the trusts to be includible in the husband's and wife's respective estates pursuant to sections 2036(a)(2) and 2038(a)(1).[33]

In contrast, the Sixth Circuit in *Green v. United States*[34] rejected the application of the reciprocal trust doctrine to trusts created by a husband and wife for the benefit of their granddaughters because the settlors were not beneficiaries and retained no economic benefits.[35] The court reached this conclusion despite that the trusts, if uncrossed, would have been includible in the settlors' estates under sections 2036(a)(2) and 2038(a)(1).[36] In *Green*, the Sixth Circuit specifically rejected *Bisch-*

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28 *Id.*

29 *Id.*

30 *Id.* at 324 n.10 (noting that "inquiries into the settlor's reasons for creating the trusts may be helpful in establishing the requisite link between the two trusts.").

31 69 T.C. 32 (1977).

32 *See id.* at 43.

33 *Id.* at 48.

34 68 F.3d 151 (6th Cir. 1995).

35 *Id.* at 153-54.

36 *Id.* The government argued that interrelated trusts are taxable by virtue of the reciprocal doctrine pursuant to I.R.C. § 2036(a)(2) and asserted that "the only condition precedent required to apply the doctrine and uncross the trusts was a finding of retained settlor/trustee fiduciary powers" which leave "the settlors in approximately the same eco-

off as a "strained and attenuated interpretation" of *Grace*.[37] The courts in *Green* and *Bischoff*, both relying on *Grace*, reached contrasting conclusions on similar facts.

Practitioners have long sought in the language of *Grace* and its progeny a safe harbor from the application of the reciprocal trust doctrine, and practitioners have long been disappointed that no such safe harbor has evolved. The two-pronged approach set forth in *Grace* remains the starting point in any analysis of the doctrine. Neither *Grace* nor its successors, however, have provided a clear test for the determination of whether trusts are interrelated. The second prong of the *Grace* holding, whether parties remain in the same economic position as before the transfers, has been followed quite literally by some courts and in others it has been reimagined to have a broader application.[38]

The *Grace* Court sought to provide a more objective test for the application of the reciprocal trust doctrine in the estate tax context, but history has shown the opinion in *Grace* to be an imperfect roadmap.

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nomic position they would have been in had they created he trusts naming themselves as beneficiaries." *See* I.R.C. § 2036.

[37] *Green*, 68 F.3d at 153.

[38] *Compare* Bischoff v. Comm'r, 69 T.C. 32, 45 (1977) (rejecting the limitation of the application of the reciprocal doctrine to situations when settlors would be left in approximately the same economic position as by creating trusts naming themselves as beneficiaries, and focusing on whether the crossing of substantial economic interests, and not merely crossing powers, had occurred) *with Green*, 63 F.3d at 153 (requiring that the settlor also retain economic benefit).