Sham Trusts & Reciprocal Trusts:

How the government uses trust drafting and client behavior to attack trusts

1. Why does this matter to me?
   1. If you’re a trustee, trust company, or CPA, it could give you peace of mind because now you understand a topic most don’t.
   2. If you’re a lawyer, it will help you understand how to draft trusts so they do not violate these rules.
   3. If you’re a financial advisor, investment advisor, family office, etc., by learning the limits of planning you’ll also learn just how far a client could go with the right planning; so, you’ll understand what a client may be missing out on.
   4. **Example 1**: Using multiple NINGs for Section 1202 planning
2. Definitions. What is the difference between a sham trust and a reciprocal trust?
   1. They are the same in that in both cases the objective of the government (or possibly a creditor) is to unwind or reverse the trusts.
   2. Two types of sham trusts: Sham In Fact and Sham in Substance (or Economic Sham)
      1. Sham In Fact is a transaction that never actually took place, except on paper.
      2. Sham In Substance is “drawing up papers to characterize transactions contrary to objective economic realities and which have no economic substance beyond expected tax benefits.” Falsetti v. Comm’s, 85 T.C. 332 (1985).
         1. Generally treated as essentially the same as economic substance doctrine
   3. Reciprocal trusts are interrelated trusts that leave the settlors in the same economic position as if the trusts were uncrossed.
   4. So they are different in that sham trusts are unwound or treated as if they never occurred or do not exists. Reciprocal trusts exist and are respected as such, but the settlors are switched.
3. What are the consequences of a sham trust or reciprocal trust?
   1. For Sham Trusts: Trust will be treated as a quasi-grantor trust (e.g. Rev Rul 84-74 (1980) or Pfluger v. Comm’s, 840 F.2d 1239 (7th Cir. 1988)).
      1. All items of income and loss will be attributed to the person that controlled the trust. Some case law says both, some this statement, so grantor trust. Technically they are different but in the sham context, the difference is nonexistent.
   2. For Reciprocal Trusts: The settlor’s are switched and then taxation (if any) is determined from that position.
4. How do I identify a sham trust?
   1. Difference between sham trust and sham transaction
      1. Most of the case law regards sham transactions and, as stated earlier, is currently treated as essentially the same thing as the economic substance doctrine.
      2. A sham transaction is a papered transaction. A sham trust is a papered trust, nothing more. For obvious reason, sham trusts are rare, but we’ll discuss this later.
      3. Real cases involving pure sham trusts occurred frequently in the late 70s and early 80s involving foreign trusts because of the way the tax code was arranged at that time and, for some reason, there were a lot of successful, shady promoters at this time. I can only assume why the IRS attacked the trust instead of the transaction, because the case law does not explain the rationale, but I suppose its because the transaction was taxable as long as the trust did not exist. So the IRS would want to keep the transaction but get rid of the trust.
         1. Remember, the IRS will always argue whatever benefits it the most, not what is the most reasonable, consistent, or borne out by the facts.
   2. **Example 2**: Tax Haven Double Trust (Rev Rul 80-74 (1980))
   3. Drafting considerations
      1. Sham In Substance should be easy to avoid because trusts provide many other benefits.
         1. Probate avoidance
         2. Asset protection
         3. Estate planning
         4. Business planning
      2. Sham In Fact should be easy to avoid. Just create a trust.
         1. Requirements: Intent, trustee, beneficiary, corpus. Written agreement for trusts holding property.
         2. Very hard for the IRS to prevail on such an argument.
   4. Behavior considerations
      1. In most of the cases the court also mentioned that the client’s behavior contributed to the finding. If “real” things are going on, but the client is “controlling” them, that’s bad.
      2. **Example 3**: thought exercise
   5. **IP Transaction example** (if there is enough time)
5. How do I identify a reciprocal trust?
   1. Origins of the doctrine:
      1. Grantor trust rules have a provision causing grantor trust status if the spouse retains a power or string but no such provision exists in the estate/gift tax realm.
      2. **Example 5**
      3. Rule: The trusts are interrelated and the settlors would remain in the same economic position if the trusts were uncrossed. (Exch. Bank & Trust Co. of Fla. V. United States, 694 F.2d 1261)
      4. Interrelated:
         1. Question of time, terms, planning.
         2. **Example 6**
      5. Same economic position
         1. Question of terms and position before and after trust formation.
         2. **Example 6**
   2. Drafting considerations
      1. Easy to avoid with drafting but difficult to have your cake and eat it too. Need to have different trust terms. (PLR 200426008)
   3. Behavior considerations
      1. Seemingly impossible to avoid but also easily explainable for the same reason. It’s unreasonable to force clients to engage in poor planning. A good planner will consider the use of multiple trusts to improve a client’s planning / position. That a client used a planner who developed a plan should not hurt the client, but has been cited in some cases. Bad facts make bad law.
   4. **Example 7**
6. What do I do if I find a reciprocal trust or sham trust?
   1. Recommend cleaning it up.
      1. Decants
      2. Terminations
      3. Amended returns
      4. ILITs

Example 1

Client forms a corporation in 2012 that is taxed as a C Corporation in the business of developing game apps. In 2017, after five years of remarkable growth, Client decides he would prefer to exit the business through a sale sometime in the next five years. After consultation with his attorney Client forms 4 NINGs. Each NING is for the benefit of him and his wife and one of their four children. Upon death, each child is subject to a unique distribution scheme. Each Trust has a different trustee.

In 2019, Client and the 4 NINGs close on a stock sale of the corporation with sales price of $50,000,000.00. Each of the Client and the 4 NINGs have zero basis. Each report that the sale is subject to Section 1202’s 100% exclusion from gain.

If the trusts are reciprocal (or had the client not formed the 4 NINGs and sold the stock directly), Client would be responsible for long term capital gain on $40,000,000.00 of tax (approx. $8,000,000.00).

What would make these trusts reciprocal? Where do we draw the line?

Example 2

TP through promoter uses “Foreign Creator” to settle Trust 1 in Foreign Jurisdiction and transferred Assets to it. TP was Trustee of Trust 1 and beneficiary. Then Foreign Creator created Trust 2, naming Trust 1 as Trustee and TP as beneficiary. Income received by Trust 1 was automatically transferred to Trust 2 and, when needed, distributed to TP.

Example 3

Client forms a nongrantor trust, completed gift, GST exempt, for the benefit of her grandchildren appointing a trust company as the trustee, making a nominal gift to “seed” the trust. Client sells to the trust 99% of an LLC she wholly owns. The LLC owns a patentable design she personally created, taking back a promissory note, interest only at AFR with a balloon payment at the end. On her return she reports the sale on the installment method. Under section 1235, she reports the sale as long-term capital gains.

A short while after the sale, the LLC sells the patentable design to Buyer for approximately the same price as the trust purchased the 99% interest. Because a 754 election caused a step-up in basis of the design, the purchase price is washed out by basis resulting in no taxable gain.

As a result, the LLC can invest all of the sale proceeds and make interest only payments. In short, Client was able to sell the asset and defer the payment of tax, thereby invest the proceeds pre-tax with a minor interest drag.

Is this a sham trust?

Would it matter if:

* How nominal is the gift?
* A friend was trustee?
* Client is manager of the LLC?
* The Trust cannot fire her as manager of the LLC?
* The promissory note could be extended unilaterally by Client?
  + But it could also be prepaid by the trust without penalty?
* The LLC invests in real estate development projects directed by her nephew? Her son? Her boyfriend? Her great-uncle?

*Variation*

After the LLC interest is sold, the LLC hires Client to provide modifications and enhancements to the design for which she is paid a nominal fee. As a result of her efforts, the patent design appreciates in value by 30% and then it is sold to Buyer.

*Variation*

Because of a change in the market, the patent design appreciates in value between the first sale and the second.

Would it matter if Client could foresee this change? For example, what if the design pertained to car battery design for electric cars and Client was part of a lobby group that drafted a bill that was eventually passed, which provided car manufactures with a large credit for selling electric cars.

*Take Away*

Facts-and-circumstances is a story-telling adventure. No fact will have the same weight and value in every case. Bad-facts make bad law.

Example 4

IP Transaction

What set of facts (behavior or drafting) would cause the trust to be treated as a sham?

* Management of LLC?
* Trustee?
* Management of affairs of customer list?
* Nature of customer list?

Example 5

Client establishes an irrevocable, grantor trust for the benefit of her spouse during life and for the benefit of her children upon death. She transfers an amount of assets approximately equal to her remaining estate and gift tax exemption to the trust. The transfer is a completed gift. She is not a trustee nor a beneficiary and retains no power to cause inclusion under any other estate tax provision. Her spouse possesses no power to cause inclusion. As a result the assets are excluded from her estate and from the estate of her spouse.

What if, on the same day, her spouse created a trust nearly identical to her’s except the trust the spouse creates is for Client’s benefit?

How would the IRS attack this? The trusts are valid and proper. There is no income tax issue. No obvious no economic substance, sham trust, or assignment of income issue exists and even if it did, it’s likely unwinnable. Step transaction doctrine doesn’t really apply because there isn’t a simpler path to get to the same result. They could argue that the Trustee and the Settlor had a prearranged agreement, but that’s very subjective and difficult to prove. The reality is that two separate persons created two separate trusts and if you examine each separately, the IRS has no legal theory.

Example 6

Start with Example 1

How would you make the **reciprocal** trust argument? This is not an estate tax play, its an income tax play. There are not two settlors to switch? You’re not going to “uncross” anything. But the essence of the reciprocal trust doctrine is still an issue: is the Settlor in the same economic position if…the doctrine’s remedy is extended to (1) combine the trusts (then only one exclusion counts) or (2) make them completed gifts (How? Special Testamentary POA prevents it) or (3) make them grantor trusts (How? Client retained no power to cause grantor trust status).

What if the NINGs had the same six beneficiaries?

What if the NINGs had the same trustee? What if that was a friend? What if it was a trust company?

What if the distribution scheme post-death was the same?

Does any of this matter in this context?

What if section 1202 didn’t apply? Remember, the IRS will only take a position that benefits them.

Example 7

In 2006, Client1, Client2, and Client3 formed Company engaged in the construction industry. At the time of formation, Client3 was about to file bankruptcy and the parties decided to “leave him off” of Company as an owner. Therefore, ownership of Company was divided 50-50 between Client1 and Client2. K-1s were issued accordingly and Client3 was bonused each year to equalize profits.

In 2018 the parties see an attorney who advises them to get their affairs in order. In connection with various estate planning and business planning, Client1 forms a BDIT identifying Client3 as beneficiary; Client2 forms a BDIT identifying Client3 as beneficiary; Client1 forms a BDIT identifying Client2 as beneficiary; and Client2 forms a BDIT identifying Client1 as beneficiary.

Client1 transfers 37.5% of his shares to Client2 and 12.5% of his shares to Client3. Client2 transfers 37.5% of his shares to Client1 and 12.5% of his shares to Client3. All transfers are gifts and, at the time of the transfer, for values well below the estate/gift tax exemption limit.

Does it matter if:

* The value of the businesses decline between now and death?
* The value of the business stays the same but the estate tax exemption decreases?
* The value of the business increases but so does the exemption?
* The BDITs use friends as Trustees? Trust companies?
* Some BDITs allow the beneficiary to serve as investment trustee and others do not?
* Some BDITs grant the beneficiary a TPOA and others do not?
* The BDITs are signed days apart? Weeks? Months? Years?
* Some BDITs permit discretionary distributions, others distributions subject to an ascertain standard, and some mandatory distributions?
* Some client’s impose restrictions on the stock before their transfer and others do not, or impose different restrictions?
* Different amounts of cash are also gifted to the trusts?