

**By Matthew Crider, JD  
Family Wealth Protection Attorney**

Some people are just naturally ingenious. The attorneys who came up with the idea for creating reciprocal trusts belong in that category. First things first: What is a reciprocal trust?

Let's look at an example. Assume that Bilbo Baggins and Frodo Baggins are cousins (I know . . . it's a stretch). Also assume that they are both relatively wealthy. Let's say they each have \$5 million in the bank (again, a long shot for hobbits, but pretend they found a very valuable ring that they were able to sell for \$10 million and that they split the proceeds).

Here's what they could do. Bilbo could set up and fund a trust and name Frodo as the sole beneficiary entitled to income, with the principal passing to Frodo's children after Frodo dies.

Frodo would set up an identical trust, only with Bilbo as the income beneficiary and Bilbo's children's as the ultimate beneficiaries of the principal.

## **The Benefits of the Arrangement**

The main benefit to setting up trusts like this is that the money contributed to the respective trusts by Bilbo and Frodo would be excluded from their taxable estates at their respective deaths. If, however, they had each set up identical trusts for their own benefit (i.e. if they had named themselves income beneficiaries of their own trusts), then the money in the trust would be included in their estates.

You can see that this is a rather ingenious way to avoid estate taxes by creating reciprocal trusts in times when the permissible unified tax credit is high (like it is through at least the rest of this year).

## **A Little Too Ingenious for the Courts to Stomach**

When smart people innovate to circumvent the "spirit of the law," the courts often intervene to close loopholes. In the case of reciprocal trusts, that's exactly what happened. Here's the reasoning they used: Money is obviously fungible. A dollar in my hands could be swapped for a dollar in your hands with neither of us feeling any impact whatsoever. So why should two people who have that obvious realization be permitted

to exempt themselves from estate taxes by taking advantage of an “I’ll scratch your back, you scratch mine” relationship?

They shouldn’t . . . or so the courts decided.

The general rule today is that if two trusts exist, the trusts will be “uncrossed” if they meet these three criteria:

- They have substantially identical terms,
- Were created at the same time, and
- Are part of the same transaction.

When trusts are uncrossed, it means that the money in the reciprocal trusts is treated as if it benefits the person from whom it came. In other words, the reciprocal nature of the trusts is undone. Now, if this happens after one of the two reciprocal trust creators dies (which is when it always happens), the results can be devastating, since there is then no opportunity to pursue effective estate tax strategies.

The bottom line is that you don’t want to pursue a strategy that has even a remote chance of not working, since the repercussions are irreversible once you’re deceased. That’s why you need an experienced, professional estate planning attorney in your corner.

## About Matthew Crider, J.D.

Matthew Crider formed [Crider Law PC](#) in 1999 so he could help individuals and business owners by providing creative solutions and be their trusted advisor and legal counselor. He serves his clients by listening closely to their goals, dreams and concerns and working with them to develop superior and comprehensive estate and asset protection plans. His estate planning practice focuses on preserving and growing wealth by providing comprehensive, highly personalized estate planning counsel to couples, families, individuals and businesses.

