5 T.C. 946 (1945)

The reciprocal trust doctrine dictates that when settlors create interrelated trusts, effectively granting each other powers they nominally relinquished, they may be treated as grantors of the trusts they control, triggering grantor trust rules for income tax purposes.

Summary

Werner and Pearl Wieboldt, husband and wife, each created trusts for their children, granting the other the power to alter, amend, or terminate the trust, albeit not for their own benefit. The trusts were established within days of each other, with similar terms and assets. The Tax Court held that the reciprocal nature of these trusts meant each spouse effectively retained control over the trust nominally created by the other. Consequently, each was taxable on the income from the trust they controlled under Section 22(a) of the Internal Revenue Code.

Facts

Werner and Pearl Wieboldt created separate trusts for their four children. Pearl's trust, established on December 13, 1934, held 10,000 shares of Wieboldt Stores, Inc. stock. Werner's trust, created on December 26, 1934, held real estate and Wieboldt Realty Trust debentures. Each trust granted the other spouse the power to alter, amend, or terminate the trust (but not to benefit themselves) and to direct the trustee regarding investments. The trusts had similar terms regarding income distribution and principal management. The ages of the children at the time of creation were 24, 21, 10 and 8.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Wieboldts' income tax for the years 1939, 1940, and 1941, holding each spouse taxable on the income from both trusts. The Wieboldts petitioned the Tax Court for redetermination. The Tax Court consolidated the cases for hearing and disposition.

Issue(s)

Whether the reciprocal trust doctrine applies such that each petitioner should be considered the grantor of the trust nominally created by the other, making them taxable on the income from that trust under Section 22(a) of the Internal Revenue Code.

Holding

Yes, because the reciprocal nature of the trusts, where each spouse granted the other powers equivalent to those they relinquished in their own trust, effectively allowed them to maintain control over the trust assets and income. The Tax Court

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held each petitioner taxable on the income from the trust nominally created by the other.

Court's Reasoning

The Tax Court found that while neither petitioner retained significant powers over their own trust, the power each granted to the other, namely the ability to alter, amend, or terminate the trust, coupled with the power to direct investments, meant they effectively retained control. The court emphasized the reality of the situation over the mere form of the trust documents. It cited *Lehman v. Commissioner, 109 F.2d 99*, for the principle that interrelated trusts can be treated as if the grantors had retained the powers themselves. The court stated, "The practical result of the exchange of rights was to leave each petitioner with powers as absolute and real as would have been the case had each provided for their exercise by himself in the instrument he executed." While acknowledging the trusts' explicit prohibition against benefiting the grantors, the court focused on the ability to shift beneficial interests among the children, considering this a significant attribute of property ownership. The court distinguished the facts from cases where the grantor's control was limited.

Practical Implications

This case illustrates the importance of analyzing the substance of trust arrangements, not just their form, particularly when reciprocal trusts are involved. Attorneys must advise clients that granting ostensibly independent powers to a related party (like a spouse) may be construed as retaining those powers for tax purposes. This decision reinforces the IRS's ability to collapse reciprocal trusts and apply grantor trust rules, even when the grantor is not a direct beneficiary. Later cases have cited *Wieboldt* to support the proposition that reciprocal arrangements designed to circumvent tax laws will be closely scrutinized. The case serves as a caution against indirect retention of control through related parties and highlights the potential for adverse tax consequences when creating interrelated trusts.

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