Spousal Lifetime Access Trusts

With the potential for changes in party control of both Congress and the Presidency, wealthy taxpayers are now asking many questions about using Spousal Lifetime Access Trusts ("SLATs") to preserve existing estate tax exemptions, focus appreciation on gifted assets outside their taxable estates, and create a "nest egg" of assets protected from claims by potential future creditors. This article explains this estate tax-saving strategy.

Why SLATs Are Advantageous from a Tax Standpoint

Under the 2017 Tax Cuts and Jobs Act ("the 2017 Act"), Congress increased an individual's estate and gift tax exemption to $10,000,000 as adjusted for inflation back to 2010. For 2020, that exemption is $11,580,000. Married couples can currently pass to loved ones twice that amount free of estate tax. However, under the 2017 Act, that exemption will decrease on January 1, 2026 by approximately one-half to $5,000,000 as adjusted for inflation from 2010.

The 2017 Act directed the Secretary of the Treasury to prescribe regulations as to what would happen if a taxpayer made taxable gifts under the $10 million exemption regime but died after the $5 million exemption became effective. In response, the Secretary of the Treasury issued a final regulation last November that unequivocally announced that gifts made within the increased exemption amount used before the client's death won't be "clawed back" into the client's estate. Wealthy taxpayers may want take advantage of this new regulation by making significant taxable gifts now while the estate and gift tax exemption is at its current high level.

The problem with making gifts is that generally the donor needs to be able to do without the gifted assets after making the gift. In general, a donor cannot effectively avoid estate taxation by giving something away while at the same time retaining the benefit of having the gifted assets. However, a donor may in fact give assets to his or her spouse in a fashion that the spouse can access the gifted assets without having those assets included in her or his estate for tax purposes. Using this strategy, the couple as a unit retains the assets as long as both spouses remain alive.

This is the premise behind the "Spousal Lifetime Access Gift Trust" (SLAT) strategy. Each spouse makes a significant gift to an irrevocable trust for which the other is the trustee and a beneficiary. For income tax purposes, the trusts can be "grantor" trusts that are "owned" by the donor for income tax purposes but not included in the donor's estate when the donor dies. The donor pays all income taxes due with regard to the trust's income, and all trust income is allowed to compound inside the trust tax-free. Thus, in addition to preserving the taxpayers' maximum estate tax exemptions, they will be focusing all of the appreciation on the gifted assets outside of what will ultimately be their taxable estates. Any income taxes paid on trust asset income (which they would have had to pay anyway had they not transferred the assets to the trusts) will further reduce the size of their respective taxable estates.

In addition, the SLATs created can be trusts to receive maximized regular annual gifts that will qualify for the spousal annual gift tax exclusion in a fashion that does not reduce future remaining estate and gift tax exemptions. Because of the ease of qualifying for the gift tax marital deduction, few spouses recognize that, just as you can make annual gifts to other family members by trust that are excluded from federal gift and estate tax (see, e.g., irrevocable life insurance trusts), you can also make annual tax-excluded gifts to your spouse. These gifts can be up to the greater of $5,000 or "5 percent of the aggregate value of the assets out of which" the gift may be completed. SLATs make great receptacles for annual gifts by spouses to each other in continuing annual tax-free amounts equal to 5% of the value of the trust, up to the maximum of $15,000 per year.

The Benefits of Spousal Lifetime Access Trusts

The benefits that can be obtained from Spousal Lifetime Access Trusts are the following:

1. The appreciated value of the assets will be exempt from estate tax upon the death of both spouses.
2. As noted above, the gift tax exemption amount used to create the trust will not be "clawed back" into the donor's estate at death to the extent that it exceeds the estate tax exemption as then exists. The donor thereby retains the benefit of the currently larger estate and gift tax exemption.
3. A "nest egg" is provided for the donee spouse, over which he or she has control.
4. In the event of emergency or need by the couple during the donee spouse's lifetime, assets of the trust can be "recovered" by the donee spouse applying them for that spouse's support, maintenance, or health.
5. Upon the death of the donee spouse (or anytime sooner), the assets are distributed to children and/or other loved ones in a manner that is free of gift tax, income tax and estate tax.
6. As long as such creditors are not reasonably foreseeable at the time of the trust creation, the assets within the trust are protected from the claims of any potential creditors of both the donor and donee spouse.
7. Trust income is allowed to compound income tax-free since the maker of the trust is required to pay all income taxes on this income.
8. Since it will be a grantor trust for income tax purposes, a SLAT can also serve as the "intentionally defective grantor trust" in a further estate tax-saving strategy.

Some of the finer points of achieving these objectives are discussed below:

Choice of Trustees

Anyone that the trustmaker (the donor spouse) chooses can serve as trustee of a Spousal Lifetime Access Trust, other than the donor spouse himself or herself. Trustee options include the following:

- The donee spouse can serve as the sole trustee. If this option is elected, distributions of principal or income for the donee spouse must be subject to the four ascertainable standards related to the donee's health, education, maintenance and support.
- The donee spouse may be a cotrustee with another person or entity. This gives greater control over the assets by the donor than just having the donee spouse serve alone.
- The donee spouse need not be named as a trustee. Other individuals (or individual) and/or a corporate fiduciary may be named as trustee.

Generally, spouses will not wish to give up control over their assets, and the donee spouse is chosen to be the trustee of the Spousal Lifetime Access Trust. In this fashion, the couple knows that practically, while the assets of the trust are outside their estate for estate tax purposes, they can be recovered and used by the donee spouse for them in the event of emergency.

Grantor Trusts

A "grantor" trust is one for which the maker has reserved such extensive powers that Congress mandates the trust to be treated for tax purposes as the maker's *alter ego*. For example, if the maker reserves the right to borrow money from the trust without adequate interest or security or to reacquire trust property by substituting other property of equivalent value, the Internal Revenue Code treats the maker as the "owner" of the trust and its property. In these situations, any income earned by the trust is deemed to be earned by the maker and taxed to him or her at regular individual income tax rates.

Importantly, the rules for grantor trusts for income tax purposes are different from the rules for estate tax purposes. If the maker reserves the right to revoke a trust or to control the beneficial enjoyment of the trust, the trust will be deemed a grantor trust for both income and estate tax purposes. In this instance, the maker is taxed for all income earned by the trust and the value of all trust assets are included in the maker's estate for estate tax purposes when the maker dies. However, if the maker merely retains the right to borrow money from the trust without adequate interest or security, or to reacquire trust property by substituting other property of equal value, the Internal Revenue Code treats the maker as the "owner" of the trust and its property only for income tax purposes. Those "administrative" powers do not subject the trust assets to estate taxation in the decedent maker's estate.

Congress enacted the grantor trust income tax rules to curb perceived income tax avoidance by taxpayers. Prior to the compression of trust income brackets, grantor trust status was an anathema. Since incurring individual income tax liability was then thought to be disadvantageous, these rules were considered a burden that taxpayers would not want to shoulder.

What Congress did not realize was that, in some cases, it is advantageous for an individual to pay the tax of a trust. For instance, if one spouse establishes an irrevocable trust for the other, he or she can remove the assets of that trust from those taxable at the death of either of them. If the trust in question is a grantor trust for income tax purposes but not for estate tax purposes, it becomes an advantage to pay the income taxes that accrue on the trust's income (which is outside the donor spouse's taxable estate) with monies that will otherwise be taxable when the donor spouse dies. It therefore can become

advantageous to make a trust "intentionally defective" by including provisions in a trust's document that for only income tax purposes make it a grantor trust.

SLATs are not required to be grantor trusts. However, the benefit of having income taxed at individual rates rather than at the compressed rate brackets used by non-grantor trusts makes grantor trusts popular. Note that SLATs can also be written to start off as grantor trusts but later changed to non-grantor trust status.

The "Reciprocal Trust" Doctrine

When spouses create separate Spousal Lifetime Access Trusts for each other, care must be taken that the terms of each of the trusts differ materially. This is to avoid a common law doctrine called "the reciprocal trust doctrine". Under that doctrine, if two makers create identical trusts for the other, these trusts are disregarded, and each trust is deemed to be a trust that the maker created for himself. Consequently, two Spousal Lifetime Access Trusts by spouses for each other must have somewhat different distribution terms in the future.

Such variations can include:

- having different beneficiaries for each trust during the lifetimes of the donee spouses (e.g., one trust can be just for the lifetime benefit of the donee spouse while the other is for the donee spouse and your descendants),
- having different beneficiaries for each trust after the death of the donee spouse,
- giving one spouse the power to determine future trust beneficiaries while in the other having the determination of these beneficiaries locked in place irrevocably,
- using one trust as an education trust for beneficiaries after the death of the donee spouse while the other is distributed to family members for other purposes, and
- leaving one trust's assets to trusts for its beneficiaries while the other trust's assets are distributed outright.

Creditor Protection

The assets within the Spousal Lifetime Access Trust are generally protected from the claims of creditors. This can be true for all claims asserted against the donor spouse, claims asserted against the donee spouse, and claims asserted against the remainder beneficiaries (i.e. children).

The assets may not be protected if the conveyance to the trust was made with the intent to defraud known or reasonably foreseeable creditors of the donor spouse. All states have a form of statute regarding conveyances with the intent to defraud creditors, and care must be taken to avoid transfers resulting in a violation of these statutes.

In addition to the creditor protection, the donee spouse may have protection from marital claims by any new spouse after the death of the donor and the remainder beneficiaries will be protected from losing trust assets as a result of failed marriages. If a beneficiary is going through a divorce, the assets within the trust will not be subject to court division between the divorcing parties.

Use of the Donor's Generation-Skipping Transfer Tax Exemption

The donor spouse's generation skipping transfer tax (GST) exemption may be used if the he or she wishes to keep the assets creditor protected, failed marriage protected, and free from estate taxation for future generations. However, in every year an additional gift is made to the trust, a federal gift tax return (Form 709) will need to be filed by the donor that reports the gift and the use of a part of the donor's GST exemption.

If GST exemption is applied to the donor's gift to the SLAT, a disadvantage of this technique is that if the assets in the trust are used for the benefit of the donee spouse, some of the donor's GST exemption may be wasted.

Detriments and Pitfalls

In general, other than loss by one spouse of access to the assets in the other's SLAT when the first spouse dies, most of the potential detriments to using Spousal Lifetime Access Trusts are such that the makers are in no worse a situation than had they not undertaken the strategy at the outset. These detriments and pitfalls include:

- First and foremost, each donor spouse must be aware that upon the death of the donee spouse, he or she will lose the indirect access to the gifted assets and their appreciation. Each spouse must make sure that he or she has enough other assets to provide for lifestyle expenses if he or she is the survivor after the first spouse dies.
- In the event that the spouses subsequently separate or divorce, each will similarly lose this indirect access to the assets of the trust established for the other. In effect, the spouses have already divided these assets for their respective benefits.
- Obviously, if the SLATs are grantor-type trusts, each donor spouse must be aware of his or her liability for income tax on the income of the Spousal Lifetime Access Trust that he or she creates and have sufficient cash flow to make the tax payments on behalf of the trust. In this regard, however, the trustee can be given the discretion to repay the maker for any income taxes he or she pays on trust income.
- While limiting annual contributions for the spouse to the 5 and 5 limit avoids making that spouse the owner of trust assets for estate tax purposes, the lapse of annual withdrawal powers may make a portion of the trust a "grantor trust" for income tax purposes as to the donee spouse. Computation of what this portion is can be complicated when contributions are made for multiple years. However, if spouses file joint income tax returns, such computations are unnecessary since all trust income is taxed in the same return. And, after the death of the donor spouse, making the one-time computation will be extremely worthwhile. If a portion of the Spousal Lifetime Access Trust is a grantor trust as to the grantee spouse for income tax purposes, he or she can pay some of the income taxes on trust assets using funds that will otherwise be taxable at the donee spouse's death. To the extent that income is paid by the donee spouse, it will compound tax-free for future distributions to family members.

- This strategy has been devised based on current law and prior Treasury rulings on what that law means. As with any current strategy, its underpinnings might be lost if the law changes or the prior rulings are reversed. For example, while it has thus far been unsuccessful in convincing courts that this argument is valid, the Internal Revenue Service might attempt to have Congress characterize the payments of income tax by the maker on the trust's income as an additional gift to the trust.

If you are married and concerned about losing your current estate and gift tax exemptions, wish to shelter assets from potential creditors, or want to start making annual gift tax excludable gifts to your spouse in a fashion that will augment the protection of whatever the estate and gift tax exemption may be in the future, SLATs may be a strategy you can use to address these challenges. We would welcome an opportunity to help you with this process.