**USING YOUR FEDERAL ESTATE TAX EXEMPTION AND ALLOWING SPOUSAL ACCESS (THE SLAT)**

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The current federal gift and estate tax exemption is $10 million, as adjusted for inflation ($11.58 million in 2020). Because the exemption is per individual, a married couple can transfer a little over $23 million to beneficiaries without paying gift or estate tax. The current exemption is schedule to sunset on January 1, 2026. That is the exemption will revert to $5 million, adjusted for inflation.

When the exemption was increased by the Tax Cuts and Jobs Act, many practitioners were concerned that if the exemption reverted to the pre-2018 amounts, individuals who utilized the exemption with lifetime gifts would have their gifts in excess of the exemption amount clawed back into their estate. Regulations have been issued that indicate that there will be no claw back for those taxpayers who take advantage of the higher exemption level prior to reversion.

Given the possible sunset of the current exemption level in 2026, along with concerns that a new administration might retroactively reduce the exemption level, many taxpayers have been looking for strategies to utilize the exemption; however, taxpayers are often concerned with gifting such significant amounts and possibly jeopardizing the finances of the gifting taxpayers.

There are various strategies that allow a taxpayer to take advantage of the exemption amounts while still having some access to the assets in the event of financial reverses or other circumstances that make such access necessary or desirable.

One such strategy is referred to as a spousal lifetime access trust (“SLAT”). The SLAT structure involves the donor spouse making a gift of assets to an irrevocable trust for beneficiaries other than the spouse but providing the spouse access during the beneficiary spouse’s life. Done correctly, the assets will be excluded from the estate of the donor spouse (and the beneficiary spouse) but will allow the beneficiary spouse to access assets in the SLAT if needed. Spousal access terminates upon the death of the beneficiary spouse. Thus, it is important to keep in mind that the donor spouse should have sufficient assets so that the donor spouse is not likely to need access to the SLAT upon the death of the beneficiary spouse.

<u>Valuation of Assets Being Transferred to a SLAT</u>

If the value of assets transferred to a SLAT are determined, at some point, to be in excess of the donor spouse’s gift tax exemption, a gift tax will be required to be paid. To avoid such a result, various strategies should be employed including appraising assets that are transferred and any discounts taken. Additionally, the trust can enter into an agreement with the donor providing that, if a determination results in a valuation in excess of the exemption, the excess amount will be distributed.

Income Distributions

A SLAT can provide that the trust income will be distributed to the spouse for life; however, such a provision is not necessary and often may not make sense. A SLAT is generally designed not to qualify for the estate tax marital deduction. Thus, providing that all income must be distributed to the beneficiary spouse, can fail to take advantage of the estate and income tax leverage of an irrevocable trust as well as minimize asset protection of the trust. Creditors typically have access to required trust distributions.

A common approach of the SLAT is to allow distributions to the spouse and various beneficiaries. Such an approach can allow the donor to leverage the estate tax exemption in that the SLAT is a grantor trust on which the donor pays income taxes while the beneficiaries receive the income. Although this approach does provide excellent estate tax leverage, many donors ultimately dislike paying income taxes on income they do not receive. Strategies to eliminate the grantor trust status should be considered when the trust is created.

Income distributions to the spouse may be limited by an ascertainable standard. Typically, an ascertainable standard provides that income may be distributed to the beneficiary spouse for health, education, maintenance and support. Although an ascertainable standard may subject income to claims of creditors, use of an ascertainable standard makes it possible for the beneficiary spouse to act as trustee of the SLAT.

Estate Tax Benefits of the SLAT

When a donor makes a gift to a SLAT, the donor allocates the donor's exemption to the gift. To the extent that an allocation of exemption is made at the time of the gift, the exemption amount is not available at death. As a result, the primary advantage is that the appreciation on such assets escapes federal gift and estate tax. Currently, an additional advantage of using the gift tax exemption is that, in the event the gift and estate tax exemption is reduced to a lower amount, the donor will not lose the exemption amount used while the exemption existed at higher levels. This is the result of the ruling that there will not be any claw back.

A SLAT will be a grantor trust while the beneficiary spouse is alive. That means that the donor spouse will pay income taxes on trust income. The payment of the income taxes on such income is not a gift for gift tax purposes and thus results in an estate tax leverage opportunity.

Steps to Achieve the Tax Benefits of the SLAT

The SLAT must be an irrevocable trust. The assets transferred to the trust by the donor spouse must be transferred irrevocably. It is important for these rules that the donor spouse not retain interests or control over the assets. To the extent that the donor spouse remains married to the beneficiary spouse and the beneficiary spouse is alive, the donor spouse effectively has access via the beneficiary spouse. From an estate tax perspective, if the beneficiary spouse takes distributions that are not consumed, such distribution amounts are added back to the estate of the spouse. Typically, distributions should only be taken if doing so is necessary, and the distributed amounts will be utilized in a way that doesn't increase the estate of the donor spouse and beneficiary spouse.

Grantor Trust Status

As noted, a SLAT is a grantor trust for income tax purposes. The donor spouse pays income taxes on the assets owned by the SLAT.

Asset Protection for Spouse and Beneficiaries

To the extent that the donor spouse transfers assets to an irrevocable trust, the donor spouse has removed the assets from creditor claims (with various exceptions that vary widely based on state law). The SLAT will also provide asset protection from the beneficiary spouse to the extent that distributions are discretionary. The SLAT also provides protection to beneficiaries other than the trust. The level of protection varies based on trust design and state law.

A standard provision included in trusts is a spendthrift clause. A SLAT should contain a carefully designed and unique spendthrift clause to enhance the asset protection of the SLAT.

Who Can Be the Trustee?

The donor spouse should not be a trustee of a SLAT. The beneficiary spouse can be the trustee if the trust limits income distributions to the beneficiary spouse based on an ascertainable standard. If the spouse is appointed as a trustee, provisions should be included that require an appointment of a non-spouse trustee to approve any discretionary distributions.

Make Sure Grantor Trust Status Can be Turned Off

In a variety of situations, it may desirable to turn off grantor trust status so that the donor spouse is not responsible for paying income taxes on income of the SLAT assets. For example, the SLAT might own significant stock in a closely held company that is sold, resulting in significant capital gain.

If grantor trust status is a result of Internal Revenue Code Section 677(a), which provides that "the grantor shall be treated as the owner of any portion of a trust … whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be … distributed to the grantor or the grantor's spouse;… [or] held or accumulated for future distribution to the grantor or the grantor's spouse," turning off grantor trust status requires a strategy such as requiring the consent of other beneficiaries for distributions to be made to the beneficiary spouse. If the donor spouse and beneficiary spouse named their three children as beneficiaries of the SLAT, requiring consent of the children beneficiaries to distributions to the beneficiary spouse would allow the grantor trust status to end. The reason is that the interest of the children beneficiaries will be reduced by distributions to the beneficiary spouse and that makes the children beneficiaries "adverse parties" for the purpose of Internal Revenue Code Section 677(a).

## Contribute Separate Assets to SLAT

The donor spouse should contribute individually owned assets to the SLAT. This avoids having the spouse being treated as having made a gift of some of the assets to the SLAT. Jointly held assets (or assets held as a tenancy by the entirety) can be severed into an interest of each spouse. In addition, the beneficiary spouse can make a gift of an asset to the donor spouse, which is then contributed to the SLAT. Generally, such a gift should not occur immediately before transfer to the SLAT. Do note that severing a tenancy by the entireties can result in subjecting some of the divided asset to creditors.

## Plan for the Possibility of a Divorce

One of the purposes of the SLAT is to create access to the income for the family unit. Given the donor spouse's access to the trust depends on the beneficiary spouse being alive and married to the donor spouse, a significant issue arises in the event of a divorce. The donor spouse could be in a situation where the donor spouse is paying tax on income that the beneficiary spouse has the right to receive. Various strategies can be employed to avoid this result.

## Avoid the Reciprocal Trust Doctrine

Often, married couples engage in planning at the same time and might decide that each should create a SLAT. The issue is that when each spouse creates a SLAT for the other, running afoul of the reciprocal trust doctrine can cause the value of the trust that each spouse created for the other spouse to be subjected to estate tax in the grantor spouse's estate.

The reciprocal trust doctrine can be avoided with careful planning. First, consider a time lapse of at least one year between creation of the trusts. Second, each trust should contain differences in dispositive provisions. For example, the provisions for distributions of income and principal could vary between trusts.

Testamentary powers of appointment to the beneficiary spouse are common in SLATs. There could be a variation in such power from one trust to the other.