Estate Planning Toolbox: Spousal Lifetime Access Trust (SLAT)

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Transfers of appreciating assets to spousal lifetime access trusts (SLATs) have become an increasingly popular and flexible estate planning technique. By making a completed gift now, a donor can lock in gifts of amounts up to the current, historically high exemption ($11,580,000 per person) and avoid estate tax at death on the gifted assets as well as their appreciation, while enjoying the lifetime benefits from the trust payable to the beneficiary spouse.

How SLATs Work

The Grantor (donor) makes a completed gift funding the trust. A SLAT can be funded with any type of asset appropriate for a trust, such as marketable securities, cash or even life insurance on the Grantor's life. Many Grantors, however, prefer to fund these trusts with closely held, income producing stock or real estate, which typically require an appraisal to determine the value of the gift. The Grantor will file a gift tax return (Form 709) reporting the completed gift. This will start the three year statute of limitation running for the IRS to challenge the valuation of the assets placed in the trust. Depending on the nature of the asset(s) gifted to the SLAT, the value of the gifted assets can be discounted to reflect minority interest and/or lack of marketability. The gift can be structured to use the Grantor's remaining lifetime gift exemption and the gift tax return can possibly allocate Generation-Skipping Transfer Tax exemption (which also equals $11,580,000 in 2020) or a lesser amount appropriate, depending on the Grantor's circumstances. Because of how the SLAT is structured, the SLAT assets and any appreciation in value will be excluded from the gross estates of both the Grantor and the Grantor's spouse at death.

The SLAT is drafted so that the Grantor's spouse is the beneficiary during his or her lifetime. Other beneficiaries can include children, grandchildren, friends and charities. The trust's dispositive provisions will be tailored appropriately under the particular circumstances. If the goal in creating the trust is to ensure growth of the trust to primarily benefit subsequent generations, the SLAT may be drafted to initially limit discretionary income and principal distributions to the spouse and other beneficiaries. Alternatively, a SLAT may provide for more liberal distributions to the spouse and others beyond net income and allow invasions of principal for the health, education, maintenance and support (HEMS) of the spouse, children and grandchildren in the Independent Trustee's discretion. The terms can be flexible. During the Grantor's lifetime, an Independent Trustee is required to serve as trustee if there are discretionary invasions of principal above and beyond the previously mentioned HEMS standard.

If a SLAT is funded with closely held business or real estate interests held in an entity, such as a limited liability company (LLC) or a limited partnership (LP), the Grantor can still maintain managerial control of the entity, even though the portion of the entity owned by the trust and managed by the Grantor will not be subject to federal estate tax in the Grantor's estate or the Grantor's creditor's claims. In addition, the ability of the beneficiaries to exercise control over the interest held in the trust will be subject to the limitations provided in the trust, as well as in any applicable LLC or LP agreements.

SLAT Tax Implications

SLATs are taxed as grantor trusts for income tax purposes under Section 677(a) because the SLAT is held for the benefit of the Grantor's spouse. Therefore, the Grantor will pay the income taxes on income earned by the trust, thereby making an additional tax-free gift to the trust's remainder beneficiaries (see Revenue Ruling 2004-64). Upon the death of the spouse, the SLAT can be structured so

that the grantor trust status can be turned off. One way to do this is for the Grantor to waive the power of substitution. Alternatively, provisions that would avoid termination of grantor trust status upon the death of the spouse would be to include the power to add or remove beneficiaries under Section 674(a) by a nonadverse person and/or a provision in the trust permitting the Grantor to borrow trust funds without adequate interest and security under Section 675(2). This borrowing power can provide a method for the Grantor to access trust principal. The SLAT can also include provisions to permit the Trustee to reimburse the Grantor for income tax paid attributable to trust income, but Rev. Rul. 2004-64 warns that there must be no understanding that the trustee will reimburse the Grantor.

Under the grantor trust rules, SLATs frequently are drafted to include "swap" or "exchange" powers, which permit the Grantor to exchange (or buy) trust assets and "substitute" in the trust assets (cash) of an equivalent value as provided in Section 675(4)(c). This is an estate tax neutral transaction, as the same value remains in both the trust and Grantor's estate. The appreciated assets purchased by the Grantor, however, will qualify for an income tax basis step-up at Grantor's death, thus eliminating the unrealized appreciation in the assets held in the SLAT. These powers, therefore, can provide significant flexibility to maximize income tax basis goals.

SLAT Drawbacks

While there are many attractive aspects to this planning technique, there are also some drawbacks. Assets gifted or transferred to a SLAT do not receive a step-up in income tax basis at the Grantor's death since they are not included in the Grantor's taxable estate. Gifted assets instead retain the Grantor's carryover basis, potentially resulting in significant capital gains realization upon the subsequent sale of any appreciated assets within the SLAT.

Another drawback is that upon the death of the beneficiary spouse, the Grantor will lose the benefit of trust income and principal payable to the beneficiary spouse. If the Grantor's spouse were to die prematurely, the Grantor will lose the ability to share in the income generated by the gifted assets as well as any invasions of principal. Further, in the event of a divorce of the Grantor and his or her spouse, he/she will lose access to the assets in the trust that he/she created. Some Grantors may wish to define spouse in the agreement as the person who is then married to the Grantor for this very reason (good luck explaining this definition to the spouse!)

Best Practices for Using SLATs

Some planners suggest that each spouse create a SLAT for the benefit of the other to maximize use of their lifetime exemptions. The Grantor's spouse, therefore, may execute a similar, but not identical (non-reciprocal), SLAT for the Grantor's benefit. The SLAT for the Grantor's benefit must be carefully drafted with sufficient differences to avoid the *Reciprocal Trust Doctrine* or run the risk that the IRS views the SLATs as an arrangement between spouses to create self-settled trusts for themselves, despite the gift to the other's spouse because there is no real economic change in their position. For this reason, great care must be taken to avoid the *Reciprocal Trust Doctrine*. For example, the trusts can be created in different years, in different jurisdictions, with different assets and trustees and with very different dispositive provisions. It is important to remember that a SLAT **must** be funded with the Grantor's assets. A monied Grantor cannot gift assets to his or her spouse so that the spouse may create a SLAT for the benefit of the Grantor.

It is important to note that for a Grantor who wishes to take advantage of gifting to a SLAT in an amount up to the current high exemption, the exemption is scheduled to revert to pre-2018 amounts on January 1, 2026, or possibly earlier. Fortunately, anti-clawback provisions under Treasury Reg. §20.2010-1(c) prohibit any retroactive taxation of previously excluded gifts due to a lowering of the basic exclusion amount at the date of death of the Grantor.

Conclusion

SLATs are a useful tool for wealthy married couples to reduce estate, gift and generation skipping-transfer taxes while building in flexibility to an irrevocable trust. It may be the first step to help clients get comfortable with engaging in wealth transfer planning. Assets in a SLAT can receive protection from lawsuits and creditor claims while still being available for the lifetime of the spouse.

If you have questions or would like additional information, please contact Bridget La Rosa (larosab@whiteandwilliams.com; 212.714.3067), Susan W. O'Donnell (odonnells@whiteandwilliams.com; 215.864.6293) or another member of the Tax and Estates Group.

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