JUST WHEN I THOUGHT I KNEW ALL OF THE ESTATE PLANNING ACRONYMS, ALONG COMES THE SLAT!

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I. INTRODUCTION

A. What is it?

1. SLAT is an acronym for "Spousal Lifetime Access Trust" or "Spousal Limited Access Trust."

2. It is an irrevocable trust for the benefit of the donor's spouse and remainder beneficiaries (e.g., children, grandchildren, other family members, charities, etc.)

B. What does it do?

1. It uses the donor's gift/estate tax exemption.

2. It provides direct economic benefits to the donor's spouse and remainder beneficiaries.

3. It can provide indirect economic benefits to the donor.

C. Why do I care?

1. You may have heard the estate tax exemption may be reduced from the current $11.7 million down to $5 million (inflation adjusted).

2. If that happens, the opportunity to use that "excess" exemption will be lost.

3. SLATs are a popular way to use "excess" exemption while retaining economic benefits within the "family unit."

II. BASICS OF FEDERAL GIFT AND ESTATE TAX LAW

A. Federal gift and estate (and GST) tax.

1. Gifts during life and upon death (i.e., testamentary gifts) are subject to federal gift and estate tax.

2. If the beneficiary is two or more generations below the donor, these gifts may also be subject to federal generation skipping transfer tax.

3. These taxes are separate from, and in addition to, federal income taxes.

B. Gift and estate (and GST) tax exemption.

1. Currently, each individual has an $11.7 million exemption from federal gift and estate tax.

2. The exemption is "unified," meaning it applies to both lifetime gifts and testamentary gifts.

3. Gifts in excess of the exemption are taxed at a rate of 40% (although the rates are graduated, 40% is the marginal rate that applies to gifts in excess of the exemption amount).

4. For example, assume an individual made a gift of $3 million during 2020 and died in 2021 owning assets worth $10 million. The individual will have used $3 million of exemption in 2020, will have $8.7 million of remaining exemption at death, leaving a taxable estate of $1.3 million and an estate tax liability of $520,000. The individual must file a gift tax return on Form 709 to report the 2020 gift. The personal representative of the individual's estate must file an estate tax return on Form 706 within nine months (without extension) after death.

5. Currently, each individual also has an $11.7 million exemption from federal generation skipping transfer tax.

C. Annual exclusion.

1. The first $15,000 of gifts per year given to any one person do not count against the exemption.

2. This amount doubles to $30,000 per year if the donor is married and the donor's spouse agrees to "split" the gift.

D. Other exclusions.

1. Certain gifts do not count against either the gift/estate tax exemption or the annual exclusion (i.e., these gifts are "freebies").

   a. Tuition paid on behalf of an individual directly to a "qualifying educational organization."

   b. "Qualifying medical expenses" paid on behalf of an individual directly to the provider.

III. OPTIONS FOR USING EXEMPTION

A. Why use exemption now?

1. In light of the possibility of the exemption decreasing from $11.7 million to $5 million, advisors should recommend to wealthy clients to consider making large taxable gifts before the end of 2021.

2. Note that to take advantage of this "use it or lose it" strategy, the client will need to make a gift in excess of the new exemption amount (some are anticipating the exemption would be $6.2 million after the inflation adjustment).

3. For example, if an individual makes a gift of $5 million today, and the exemption declines to $6.2 million, none of the "excess" $5.5 million exemption ($11.7 million less $6.2 million) will have been used and the excess exemption will be lost.

4. Of course, taxes are not the sole consideration and for some clients, even wealthy ones, making such a gift is not appropriate, considering the client's level of wealth (e.g., a couple with a combined $9 million net worth) and the client's economic circumstances (e.g., cash flow needs and sources of income).

B. SLAT.

1. A SLAT is a gift from one spouse (the donor spouse) to an irrevocable trust for the benefit of the other spouse (the beneficiary spouse).

2. The donor spouse makes a taxable gift on funding the SLAT that intentionally does not qualify for the marital deduction, thereby using exemption.

3. The beneficiary spouse receives distributions from the SLAT.

4. The donor spouse receives the indirect economic benefit of distributions made to the beneficiary spouse.

5. Upon the passing of the beneficiary spouse, the remaining SLAT assets are typically distributed to the couple's beneficiaries (e.g., children) and the donor spouse likely loses those indirect benefits.

6. The SLAT is designed to avoid inclusion of the SLAT assets in the beneficiary spouse's taxable estate.

C. Other options to use exemption.

1. Outright gifts.

2. Gifts in trusts for beneficiaries other than spouses.

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IV. SLAT STRUCTURE

A. Irrevocable trust.

1. It's important to remember a SLAT is an irrevocable trust, which has inherent inflexibility.

2. The donor spouse cannot retain any right to amend or revoke the SLAT.

3. To add flexibility, the beneficiary spouse can be given a power of appointment and a "trust protector" or "trust director" can be given the right to amend the SLAT.

B. Trustee.

1. The donor spouse should not be trustee of the SLAT.

a. Otherwise the SLAT assets almost certainly will be brought back into the donor spouse's taxable estate.

b. This would completely frustrate the purpose of the gift.

c. The donor spouse may be able to retain some administrative functions like managing the trust assets and retaining the right to remove and replace the trustee.

d. However, great care must be taken to avoid an inclusion problem.

2. The beneficiary spouse can be trustee of the SLAT. However, you want to ensure the SLAT assets will not be included in the beneficiary spouse's taxable estate. You also want to ensure the beneficiary spouse will not be deemed to have made a taxable gift when making distributions to beneficiaries other than the beneficiary spouse.

a. Distributions can be mandatory (e.g., all of the income).

b. Distributions can be for an "ascertainable standard" (health, education, maintenance, and support).

c. Distributions cannot be discretionary (e.g., best interests).

3. Consideration can be given to appointing a trustee or co-trustee who does not have an interest in the SLAT (i.e., an "independent" trustee) to make discretionary distributions to the beneficiaries, including the beneficiary spouse.

C. Dispositive Provisions.

1. Income and principal.

a. The beneficiary spouse often receives all income and principal for health, education, maintenance, and support.

b. Income and principal can also be distributed to the couple's children and grandchildren for those or other purposes (subject to the identity of the trustee, discussed above).

c. Consider using "floating spouse" provisions to protect the donor spouse against divorce.

2. Remainder.

a. Usually, after the death of the beneficiary spouse, the remaining assets are allocated/distributed equally among the couple's children.

b. Other beneficiaries, such as other family members, loved ones, and charities can also be included.

3. Power of appointment.

a. The beneficiary spouse can be given a power of appointment to change the distribution of assets upon the beneficiary spouse's death.

b. This provides significant flexibility because the beneficiary spouse can change the beneficiaries and the manner of distribution if circumstances warrant.

c. However, the power of appointment can frustrate the donor spouse's intent if the couple's interests are not aligned.

4. Dynasty trust.

a. Consideration should be given to using dynasty trust provisions upon the passing of the beneficiary spouse.

b. In a dynasty trust, no outright distributions are made (e.g., based on age or passage of time) and the trust is designed to last for multiple generations.

c. This leverages use of the donor spouse's gift/estate and generation skipping transfer tax exemptions.

d. Assets left in the trust will be protected from the claims of the beneficiary's creditors.

e. The dynasty trust can be thought of as a "family bank" that will last multiple generations.

f. Dispositive terms can supplement the ordinary support and maintenance standards and can include best interests and enjoying a comfortable lifestyle (e.g., recreation, cultural pursuits, and travel), but not in a manner that will discourage beneficiaries from assuming the responsibilities of self-support.

D. Grantor trust.

1. SLATs are usually created as "grantor trusts" for income tax purposes.

2. This means the SLAT and the donor spouse are treated as the same person for federal income tax purposes (i.e., the SLAT is not a separate taxpayer).

3. As such, the income from the SLAT's assets is included in the donor spouse's gross income, requiring the donor spouse to pay any resulting income tax.

4. This allows the earnings on the SLAT's assets to compound without being diminished by income taxes.

5. In addition, the tax payments are not subject to gift tax (i.e., the donor spouse is making indirect gifts by paying the taxes but the payments do not count as gifts).

E. Funding.

1. SLATs should be funded with assets that are expected to appreciate the most to leverage use of the exemption (aka the "freeze").

2. Because the SLAT is not subject to estate tax when either spouse dies, the tax basis of the assets in the SLAT will not be adjusted to their fair market values at either spouse's death (i.e., there is no step-up in basis).

3. Therefore, low basis assets should not be contributed to the SLAT unless no other assets are available.

4. The beneficiary spouse's assets should not be used to fund the SLAT.

F. Asset protection.

1. Transferring assets to a SLAT can provide significant creditor protection.

2. If funding the SLAT is not a fraudulent transfer, the transferred assets should be free from the claims of the donor spouse's creditors.

3. If the SLAT includes a "spendthrift clause" (preventing the beneficiaries from voluntarily or involuntarily assigning their interests in the SLAT), the SLAT assets will be protected from the claims of the beneficiaries' creditors.

4. However, creditor protection is lost if the assets are distributed to a beneficiary or if the beneficiary has a right to withdraw assets.

V. CAUTION WHEN USING SLATS

A. Donor spouse cannot retain any direct interest in the SLAT.

1. If the donor spouse retains the right to receive income or principal, the SLAT assets will be included in the donor spouse's taxable estate.

2. This would completely frustrate the purpose of making the gift.

B. Grantor trust status may create problems.

1. The donor spouse must be financially able to pay all income taxes attributable to the SLAT.

2. Although the beneficiary spouse often receives all income of the SLAT, capital gains are typically allocated to principal and may not be distributed to the beneficiary spouse.

3. Grantor trust status can be "turned off," but it is difficult to do in the context of a SLAT (see Internal Revenue Code 677).

4. In addition, Congress is considering changes that would significantly reduce the advantages of, and significantly increase the dangers of, grantor trusts.

C. Avoid application of the reciprocal trust doctrine.

1. Often, each spouse creates a SLAT for the other.

2. In that instance, great care must be taken to avoid application of the reciprocal trust doctrine, which would result in the SLATs being taxed in the donor spouses' estates and leaving them in the same position as if no gift had been made.

3. Depending on the couple's circumstances, it may be preferable to create and fund one SLAT with the full exemption amount rather than creating and funding two SLATs each with substantially less than the full exemption amount.