WRMarketplace

An AALU Washington Report

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TOPIC: Harnessing the Pandemic Pandemonium: Focus on Spousal Lifetime Access Trusts

MARKET TREND: COVID-19 induced market turbulence has created an opportune environment for strategic asset transfer approaches but also has triggered fears of further market declines, leaving many clients wary of taking advantage of such opportunities. Spousal Lifetime Access Trusts ("SLATs") may be the answer.

SYNOPSIS: SLATs represent one of the most effective approaches available to families seeking to transfer assets to lower generations while leaving themselves an escape valve if they experience future declines in their remaining net worth. SLAT assets can be accessed, if needed, through distributions to the spousal beneficiary. The spouse also can serve as the trustee and have the power to make distributions to himself or herself based on an ascertainable standard. In addition to this flexibility, SLATs can serve as vehicles for dynastic planning if designed as multi-generational trusts.

TAKE AWAY: The combination of depressed asset values, persistently low interest rates, and historically high federal transfer tax exemptions make conditions ripe for SLATs, which allow clients to simultaneously capitalize on current market conditions while maintaining protection against further pandemic market volatility. SLATs also can remove asset appreciation from the donor's estate as the market recovers and provide lower generations with current access to wealth.

THE TCJA REVISITED

As discussed in prior reports, the Tax Cuts and Jobs Act ("**TCJA**")[1] currently permits individuals to pass up to $11.58 million (in 2020) free of federal transfer taxes to future generations. This amount is doubled for a married couple. On January 1, 2026, however, the federal gift, estate, and generation-skipping transfer ("**GST**") tax exemptions will drop back to $5 million, adjusted for inflation, unless Congress intervenes (the "**TCJA sunset**"). Individuals must use or lose the increased portion of the exemptions – i.e., a client using only $5 million of exemption prior to the TCJA sunset would not be able to take advantage of the presently available "extra" exemption after the TCJA sunset.

AN OVERVIEW OF SLATS

The Basics. As detailed more thoroughly in *WRMarketplace No. 15-07*, a SLAT is a lifetime irrevocable trust for the benefit of a donor's spouse. Assets transferred to a properly designed SLAT (and, critically, the appreciation on such assets) will be removed from the donor's estate. The donor's descendants, charities, or anyone else also may be included as beneficiaries. However, removing assets from the estate comes with a cost, as assets in the trust will not receive an adjustment to basis at the donor's passing.

Maximum Flexibility. The terms of a SLAT can be flexible. A spouse can serve as trustee with the authority to make distributions to himself/herself or others, without the consent of any other trustee so long as such distributions are made subject to an ascertainable standard, most commonly for health, education, maintenance, and support.[2] An independent trustee could be vested with the authority to make distributions for broader purposes. As a result, while the donor and his/her spouse remain married, SLATs allow for indirect access to the assets, since distributions can be made to the donor's spouse in accordance with the provisions of the trust agreement (or other governing document). The spouse also can have a testamentary limited power to appoint the SLAT assets among designated individuals, effectively allowing the spouse to modify the SLAT's dispositive terms upon passing, if desired. Such a limited power of appointment will not cause inclusion of the SLAT's assets in the spouse's estate.

Dynastic Trusts. If created in a compatible jurisdiction, a donor may allocate his/her GST exemption to a SLAT designed as a perpetual or long-term trust. Such a technique can amplify the benefits of creating a SLAT, allowing the assets to grow and be passed down through generations of the donor's descendants (to the extent not distributed). Depending on the jurisdiction selected, a SLAT can also include creditor protection elements to help safeguard the assets for the donor's family.

Exercise Caution

Divorce. Upon divorce, the donor's indirect access to the assets of a SLAT will end. There are, nevertheless, steps that can be taken when creating a SLAT to account for the possibility of a divorce. For example, the trust may define the term "spouse" to mean the donor's spouse at any relevant time (as opposed to a specific individual). In this way, a later marriage could reestablish the original concept of indirect access lost upon divorce. Another potential option may be to grant a lifetime power of appointment to an independent party broad enough to include the donor as a permissible appointee. Doing so, however, raises potential tax and creditor protection issues that are

beyond the scope of this report. Accordingly, clients should consult closely with their advisors and consider the various tax and state law implications before pursuing any potential mitigation approach.

Spouse's Passing. Life insurance strategies can address the mortality risk of the donor's spouse passing before the donor. For example:

Example 1. Tim and Sandra are a married couple in their late 40s with four children and a combined net worth of $20 million, mostly generated through Tim's employment as a public company executive. Tim earns an annual salary in excess of $1 million. Sandra currently does not earn additional income. Tim and Sandra want to each create and fund a SLAT with their remaining exemption amounts. However, they are concerned about how Sandra would maintain her standard of living if Tim predeceases her, as she would simultaneously lose her access (through Tim) to his income and to the assets in the SLAT she created for his benefit. As protection against Tim's untimely passing, they decide to purchase a $10 million policy insuring Tim's life using a separate irrevocable life insurance trust created by Tim for Sandra's benefit. This trust provides Sandra with an additional pool of assets to tap into should the need arise and keeps the death benefit outside of their estates.

Reciprocal Trust Doctrine.[3] The reciprocal trust doctrine is a judicial concept that applies to donors who have made interrelated transfers to trusts that effectively leave them in the same position, economically, as they would have been if no transfers had occurred. In such instances, the reciprocal trust doctrine "unwinds" those transfers, potentially resulting in the inclusion of transferred assets in the donor's estate. The following examples illustrate how the reciprocal trust doctrine may be applied:

***Example 2*.** Assume the same facts as Example 1, with Tim and Sandra each creating a SLAT for the other's benefit. The dispositive provisions (e.g., beneficiaries and terms for making distributions to them) are identical. Tim is the sole trustee of the trust created by Sandra, and Sandra is the sole trustee of the trust created by Tim. The SLATs are both created on the same date and simultaneously funded with identical cash gifts. Given all these similarities, if the IRS determines that the SLATs are reciprocal, each spouse will be deemed to be the trustee of the trust he/she created, resulting in inclusion of the assets of that trust in his/her respective estate.

Example 3. Assume the same facts as Example 2, except that Tim creates SLAT #1 in April 2020 with a concentrated position in the stock of his employer. Sandra creates SLAT #2 in September 2020 with a diversified portfolio of marketable securities.

Sandra is the sole beneficiary of SLAT #1 during her lifetime and serves as a co-trustee with a financial institution. The trust agreement gives Sandra the power to make distributions to herself, subject to an ascertainable standard, without requiring the consent of the co-trustee. She also is granted a testamentary limited power of appointment exercisable among the couple's descendants.

SLAT #2 is held for the benefit of Tim and their descendants during Tim's lifetime. Tim serves as trustee of SLAT #2 along with his friend and CPA, Jeff. Tim does not have authority to make distributions from SLAT #2 without the consent of his co-trustee. Tim also possesses a testamentary power of appointment, but it is exercisable in favor of charitable organizations and certain extended family members in addition to the couple's descendants.

Given the difference in the trusts' funding dates and assets, dispositive provisions, and trustee appointments and powers, the SLATs arguably should not be deemed sufficiently interrelated to trigger the reciprocal trust doctrine.

While these examples present more extreme cases in either direction, the best course of action when drafting SLATs for both spouses is to ensure that there are enough differentiating factors between them to prevent applicability of the reciprocal trust doctrine.

WHY SLATS AND WHY NOW?

SLATs offer clients the opportunity to find a silver lining in the chaos of the current pandemic, as depressed asset values, persistently low interest rates, and historically high federal transfer tax exemptions create an opportune environment for these plans. A properly designed SLAT can be an excellent receptacle for the deployment of expiring federal transfer tax exemptions, as it allows a family to continue to benefit from the assets while meeting a donor's overall planning objectives. Consider the following example:

Example 4: Sam and Wanda are a married couple with two children. They have a combined net worth of $40 million, including $35 million in marketable securities. Neither has made prior taxable gifts. If they passed away today, their federal estate tax exposure would exceed $6 million. Susan and Wanda desire to utilize their federal transfer tax exemption amounts to take advantage of the recent dip in their portfolio value and freeze a large portion of the portfolio's expected recovery for estate tax purposes. Susan and Wanda also wish to retain access to the assets to the extent possible.

Sam and Wanda each create and fund a SLAT with $10 million from investments. The SLATs are treated as grantor trusts, so Sam and Wanda each remain responsible for the income tax liability associated with the trust she created. In exchange for Wanda's continued responsibility for such taxes, the trust assets grow unencumbered. The below chart illustrates the growth potential of one such SLAT:

Annual Growth	**3%**	**5%**	**7%**
SLAT Value – 10 years	$13,439,164	$16,288,947	$19,671,512
SLAT Value – 20 years	$18,061,112	$26,532,978	$38,696,840
SLAT Value – 30 years	$24,272,623	$43,219,425	$76,122,541

The SLATs' value also should remain outside of Sam and Wanda's estates at their passing.

After funding the trusts, Sam and Wanda retain $15 million of their investments in their individual names. Each also has access to the SLAT created for her benefit. If Sam passes while Wanda is still relatively young, Wanda will lose access to the assets of the SLAT she created for Sam's benefit, but those assets can be used to help fund education, home purchases, and other milestones for her children and grandchildren. Wanda can then use the assets remaining in her own name and the SLAT created by Sam for her benefit to maintain her standard of living.

WHAT ABOUT CLIENTS WITH LITTLE OR NO EXEMPTION REMAINING?

Even individuals who do not have significant lifetime gift tax exemption remaining can take advantage of the benefits of using SLATs in the current market environment. Couples lacking sufficient gift tax exemption can establish a SLAT as the remainder beneficiary of a grantor retained annuity trust ("**GRAT**").[4]

As noted in more detail in *WRMarketplace No. 20-06*, the success or failure of a GRAT is tied to the assumption that assets will appreciate at the "7520" rate published by the IRS each month. If the overall asset appreciation during the annuity term of the GRAT exceeds the applicable 7520 rate, the GRAT will be successful. A higher 7520 rate requires greater annuity payments from the GRAT, meaning more appreciation is needed to "clear" the hurdle rate. The current 7520 rate is extremely low, 1.2% in April 2020 (down from 1.8% in March).

Example 5. Assume the same facts as Example 4, except that Sam and Wanda have already used most of their federal lifetime gift tax exemptions and have a total of $15 million remaining in their respective names. Sam and Wanda each decide to fund separate two-year GRATs with $6 million in securities with the hope that the assets will recover rapidly. After the final annuity payment, the remaining GRAT assets will pass to SLATs created by each spouse. Consider the outcome if assets recover by 20% in the first year of the GRAT and grow an additional 10% in the second year:

Year	Appreciation	Annuity Payment	Principal Remaining
			$6,000,000
Year 1	$ 1,200,000 (20%)	($2,777,906)	$4,422,094
Year 2	$ 442,209 (10%)	($3,333,487)	**$1,530,816**

Based on these assumptions, after the second annuity payment, over $3 million total will pass to Susan and Wanda's SLATs. If each SLAT is a grantor trust for income tax purposes, consider the potential growth on $1.5 million in assets which would be available for use in an emergency for later years by each spouse:

Annual Growth	**3%**	**5%**	**7%**
SLAT Value – 10 years	$2,015,875	$2,443,343	$2,950,729
SLAT Value – 20 years	$2,709,169	$3,979,950	$5,804,531
SLAT Value – 30 years	$3,640,897	$6,482,922	$11,418,388

With such a low 7520 rate, this freeze technique can be especially useful for clients who want to preserve access to the appreciation on their assets with the option to keep it out of their estates. Note, however, that GRAT strategies are not compatible with the use of GST exemption and dynastic trusts.

TAKE AWAY

The combination of depressed asset values, persistently low interest rates, and historically high federal transfer tax exemptions make conditions ripe for SLATs, which allow clients to simultaneously capitalize on current market conditions while maintaining protection against further pandemic market volatility. SLATs also can remove asset appreciation from the donor's estate as the market recovers and provide lower generations with current access to wealth.

NOTES

[1] *See e.g., WRMarketplace Nos. 20-06 and 18-01.*

[2] *If the spouse's ability to make distributions to himself/herself is not limited by an ascertainable standard, the spouse will be considered to have a general power of appointment over the SLAT's assets, rendering it includable in the spouse's estate upon passing.*

[3] *The reciprocal trust doctrine is discussed in greater detail in WRMarketplace No. 17-49.*

[4] The advantages of using GRATs during this period of persistently low interest rates are discussed in greater detail in WRMarketplace No. 20-06.