



# WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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## **TOPIC: Spousal Lifetime Access Trusts (SLATs)**

**MARKET TREND:** The increased gift and generation-skipping transfer tax exemptions provide greater opportunities to benefit future generations during life. Clients with a more modest net worth, however, need transfer planning options that balance a desire to make lifetime gifts with the need to retain adequate funds to support their needs. A spousal lifetime access trust (a so-called "SLAT") may provide one such option.

**SYNOPSIS:** The SLAT, a lifetime irrevocable trust created for the benefit of the donor's spouse, arguably allows the donor to indirectly benefit from the trust assets (through distributions to the spouse) should the need arise. Additionally, in states that do not levy gift taxes but still impose estate taxes, a lifetime gift to a SLAT can result in reduced state estate tax exposure. In addition, the trust can purchase life insurance on the donor's life. Following appropriate applicable tax principles and laws, growth within the policy generally is not subject to income or net investment income ("NII") taxes and policy death benefit proceeds typically are not subject to income or estate taxes. However, extreme care is required in crafting, implementing, and administering the SLAT.

**TAKE AWAYS:** SLATs may allow clients of more modest net worth to use their current \$5.43 million gift tax exemptions while indirectly benefiting from the funds through spousal distributions. However, the law regarding the use of SLATs is still developing, which means they may pose a risk of estate tax inclusion in the donor's estate even with careful planning. Thus, before creating a SLAT, the client and his or her advisors must carefully consider the risks along with what should happen in the event of divorce or the premature death of the client's spouse. Client-spouses creating mutually-beneficial SLATs may face greater exposure risk due to the possible application of the reciprocal trust doctrine and thus must proceed even more cautiously when structuring their SLATs.

## **PRIOR WRM REPORT: 13-50.**

For clients who have concerns about permanently giving away a significant part of their estate, SLATs may offer a solution, if proper care is taken in their implementation and administration.

## **WHAT IS A SLAT?**

A SLAT is an irrevocable trust created during the donor's lifetime for the benefit of his or her spouse, much like an irrevocable life insurance trust. The donor makes a gift to the SLAT using part or all of his or her current \$5.43 million gift tax exemption. The trust provides the spouse, as a trust beneficiary, access to the funds, if needed, during life (other current beneficiaries, such as the donor's descendants, can also be included). The beneficiary-spouse may serve as trustee, provided the power to make distributions to himself or herself is limited by an ascertainable standard (e.g., health, education, maintenance, and support).

*Example:* X, a married individual, has an estate valued in excess of the current federal estate tax exemption of \$5.43 million and is concerned that this exemption could be reduced before his death. He would like to use his current exemption amount to make lifetime gifts but is worried that he may need access to the funds prior to his death. If X creates a SLAT for the benefit of his spouse and makes a \$5.43 million gift to the trust, he will use his full gift tax exemption and arguably benefit indirectly from the funds through distributions made to his spouse.

Other reasons that clients may be interested in SLATs include the following:

- Because the spouse is a beneficiary, the trust is a grantor trust during the joint lifetimes of the donor and the beneficiary-spouse. The donor bears the income tax burden of the SLAT and SLAT assets typically grow without imposition of taxation. If appropriate, this tax treatment can extend over the donor's lifetime (even if the beneficiary-spouse predeceases the donor) if the donor is granted certain powers over the trust (such as the power to substitute assets or borrow from the trust without security).
- As an irrevocable trust, the SLAT also can protect assets from the beneficiaries' creditors. Further, if the donor allocates his or her generation-skipping transfer ("GST") tax exemption to the gifts to the SLAT, the donor can structure the SLAT as a dynasty trust that benefits multiple generations of his or her descendants without imposition of additional transfer taxes.

Note that, although SLATs offer potential estate planning benefits, they also carry a risk of estate tax inclusion. If there is an implied agreement that the beneficiary-spouse will use distributions for the benefit of the donor (or appoint the assets back to the donor at death, as discussed below), then the SLAT assets could be pulled into the donor's estate for estate tax purposes. Similarly, if the SLAT assets can be used to satisfy the donor's creditors or relieve the donor of his or her support obligations, then again the assets may be included in the donor's estate at death.

## **USE OF SLATS FOR PLANNING AT THE STATE LEVEL**

SLATs also may be an effective planning tool at the state level. While only one state (Connecticut) levies a gift tax on lifetime gifts and an estate tax, 18 states (and the District of Columbia) impose only estate and/or inheritance taxes. Many of these states set their estate tax exemption amounts well below the federal exemption, which can generate a state estate tax liability even when no federal estate tax is due. In these states, use of a SLAT could mitigate estate taxes that might otherwise be assessed at the donor's death.

*Simple Example:* H & W are residents of state X, which has an estate tax system with a top bracket of 16% and an exemption of \$1 million. Their combined estate, which they leave to each other, is valued at \$15 million. Upon the death of the survivor (assume they die in the same year, and H predeceases W), the state will assess an estate tax of \$1,902,500. If, instead, H creates a SLAT benefiting W and funds it with \$5,430,000 (his maximum federal gift tax exemption), their combined estate will be reduced to \$9,570,000. On W's death (after H, in the same year), state X will assess an estate tax of \$1,033,700.

### ***USE OF LIFE INSURANCE IN A SLAT***

Like an irrevocable life insurance trust, a SLAT can purchase life insurance on the donor's life, and when appropriate, the trustee can choose to take policy loans or withdrawals to supplement or support distributions to the beneficiary-spouse, if needed. Under appropriate applicable tax principles and laws, growth within the policy and policy loans and withdrawals (up to basis in the contract) generally are not subject to income or net investment income ("NII") taxes. Policy death benefits also should pass to the SLAT without being subjected to income or estate taxes.

*Example:* B creates a SLAT for the primary benefit of his spouse during her life, with the remainder passing to B's descendants. B funds the trust with his available gift tax exemption of \$5.43 million and also allocates his GST tax exemption to the gift. The SLAT acquires a life insurance policy on B's life with a \$5 million death benefit and a cash value component. The \$5 million death benefit is not subject to income, estate, or GST tax. As a trust fully exempt from GST tax, the SLAT assets can pass from generation to generation without the imposition of additional transfer taxes.

Note, however, that clients must take care when structuring SLATs that will acquire life insurance on the donor's life to ensure the donor does not have any "incidents of ownership" over the policies in the SLAT. For example, the donor should not serve as a trustee (who would typically hold full powers over the policy), retain the power to remove trustees and replace with trustees related or subordinate to the donor, etc.

### ***PLANNING FOR DIVORCE AND PREMATURE DEATH***

Without proper advanced planning, divorce or the premature death of the beneficiary-spouse will eliminate the donor's indirect access to the SLAT's assets. The donor can address these concerns by acquiring life insurance on the beneficiary-spouse, which is made payable to the donor or to a trust for the donor's benefit. Another option may be to grant the beneficiary-spouse a limited power of appointment that could be exercised in favor of the donor. Use of this technique, however, will need to be carefully crafted to avoid the donor's creditors and/or pulling the assets back into the donor's estate (which could occur, for example, if there is an understanding that the beneficiary-spouse will exercise the power in favor of the donor). In addition, any subsequent trust benefiting the donor should be placed in a state that allows self-settled asset protection trusts (such as Delaware, Nevada or Alaska) to protect the assets from the donor's creditors. Further, to avoid inclusion in the donor-spouse's estate under Internal Revenue Code § 2038, the beneficiary-spouse should not be able to exercise the power of appointment in a manner that grants the donor a power of appointment over the assets.

To protect against divorce, the SLAT could define “spouse” as the person to whom the donor is married at the time rather than specifically naming the current spouse. In the event of a divorce, the current spouse would cease to be a beneficiary and a subsequent spouse would be able to benefit from the SLAT assets.

Consideration also could be given to granting an independent protector or other third party the power to add the donor as a beneficiary at a future point in time. In the event of a divorce or the death of the beneficiary-spouse, the donor could be added as a discretionary beneficiary. If this option is included in the SLAT, care will need to be taken to ensure the donor is merely one of many beneficiaries, and the trust will need to be placed in a jurisdiction that authorizes self-settled asset protection trusts.

### ***RECIPROCAL TRUST ISSUES***

Some spouses may want to implement SLATs for the benefit of each other. However, spouses forming mutual SLATs must proceed carefully and closely consider the risks, including greater regulatory scrutiny. In addition, mutual SLATs must be carefully structured to avoid running afoul of the reciprocal trust doctrine. This doctrine applies to interrelated trusts that have substantially identical terms and are part of the same transaction or plan. Application of the doctrine effectively treats each spouse as having settled a trust for his or her own benefit, resulting in potential estate tax inclusion of the SLATs’ assets in the spouses’ estates at death.

Potential ways to limit exposure to the reciprocal trust doctrine include the following:

- Create the trusts at different points in time and pursuant to different plans (for example, create one SLAT now and the second SLAT a year later as part of additional planning undertaken by the spouses).
- Appoint different trustees and grant them different powers under the trusts.
- Allow the beneficiaries of one SLAT to serve as co-trustees upon a specified event, but not under the other SLAT.
- Fund the SLATs with different types of assets and/or different amounts (for example, use only one SLAT to acquire insurance on the donor).
- Grant each spouse a power of appointment, but use different classes of permissible appointees (for example, the power to appoint to anyone other than the power holder, his/her creditors, his/her estate and the creditors of his/her estate versus the power to appoint only to descendants or charity).
- Use different standards for trust distributions. For example: (1) require that one SLAT distribute all income annually with discretionary principal distributions while making all distributions discretionary in the other SLAT, (2) limit distributions in one SLAT to an ascertainable standard and use a broad standard for distributions, in the other SLAT, etc.
- Vary the current beneficiaries. For example, create a discretionary “pot trust” for the spouse and children in one SLAT and name the other spouse as the only beneficiary in the other.

- Name different remainder beneficiaries following the death of the beneficiary-spouse.
- Grant the beneficiary-spouse a five or five withdrawal right in one trust, but not the other.

### ***OTHER PLANNING CONSIDERATIONS***

To achieve the potential benefits offered by a SLAT, the following issues also should be considered:

- Only the donor's assets should be used to fund the SLAT. If the beneficiary-spouse is deemed to transfer assets to the trust, directly or indirectly, the trust assets could be included in the beneficiary-spouse's estate at death (this may be more of a consideration in community property states).
- The trust must be irrevocable, and the gift must be complete (for example, the donor cannot retain a power of appointment over the assets).
- To reduce the risk of estate tax inclusion in the donor's estate, the SLAT should provide that no distributions may be made during the donor's lifetime that would satisfy his or her legal obligation to support the beneficiaries of the SLAT.
- Because the SLAT is funded with a lifetime gift, assets transferred to the trust will have a carry-over basis for capital gains tax purposes. Further, since the assets will not be included in the beneficiary-spouse's estate, the assets will not receive a step-up in basis at the beneficiary-spouse's death.
- The beneficiary-spouse could be given a testamentary limited power of appointment to change how the assets are to be distributed at the beneficiary-spouse's death. This power could be broad enough to include the donor, subject to the limitations and risks discussed above.
- The beneficiary-spouse or another beneficiary may serve as a trustee of the SLAT provided the ability to make distributions to himself or herself is limited to an "ascertainable standard" (e.g., health, education, maintenance and support).

### ***TAKE AWAYS***

- SLATs may allow clients of more modest net worth to use the current \$5.43 million gift tax exemptions while indirectly benefiting from the funds through spousal distributions.
- However, the law regarding the use of SLATs is still developing, which means they may pose a risk of estate tax inclusion in the donor's estate even with careful planning. Thus, before creating a SLAT, the client and his or her advisors must carefully consider the risks along with what should happen in the event of divorce or the premature death of the client's spouse.
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