



WRMarketplace

An AALU Washington Report

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TOPIC: Spousal Lifetime Access Trusts (SLATs) and Divorce – What You Don’t Know....

MARKET TREND: SLATs have become increasingly popular in legacy planning for married couples but may have unanticipated consequences if the marriage ends.

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. A subsequent divorce, however, typically results in the loss of this indirect benefit for the donor, although he or she may remain liable for taxes on the SLAT income payable to the former spouse, based on changes made by the Tax Cuts and Jobs Act to the taxation of divorce settlements. Depending on the interpretation of certain grantor trust provisions under the Internal Revenue Code (“Code”), terminating a SLAT’s grantor trust status post-divorce may be difficult, unless the trust agreement eliminates the former spouse’s interests, or the spouse agrees to relinquish them.

TAKE AWAYS: Per Notice 2018-37, the IRS plans to issue future guidance that could impact the income taxation of SLATs post-divorce. Regardless, clients and advisors should be proactive in addressing these issues when planning with SLATs. New SLATs should incorporate trust provisions specifically dealing with spousal trust rights in the event of a divorce. Existing SLATs should be reviewed to confirm the impact of divorce, with consideration given to addressing spousal rights in a post-nuptial agreement if the SLAT fails to do so. Clients with existing SLATs that are contemplating divorce should review the SLAT’s tax ramifications as part of their

negotiations, well in advance of a final settlement, and consult with a tax advisor in collaboration with the divorce attorney to coordinate the technical tax aspects of any settlement.

PRIOR REPORTS: 15-07

SLAT BASICS

Spousal Benefit. A SLAT is an irrevocable trust created during the trust creator's ("grantor's") lifetime for the benefit of the grantor's spouse. The trust is not intended to qualify for the gift or estate tax marital deduction (which would result in inclusion of the trust assets in the spouse's estate); rather, the SLAT is designed to remove the trust assets from both the grantor and grantor's spouse's estate.¹

Indirect Access. With a SLAT, the grantor's spouse (and indirectly, the grantor) continues to have access to the trust funds through distributions during the grantor's spouse's life. This feature provides flexibility by permitting a grantor to make a gift while retaining some comfort that the trust assets can be accessed by the family, if needed. The SLAT also can provide for other current beneficiaries, such as the grantor's descendants.

Example 1: Mark and Mary are a married couple with three children. Mark is the owner of MM Inc., a successful IT services business that he founded 10 years ago. MM Inc. has an estimated current value of \$25 million, and Marcus expects that value to grow over the next 5 years. MM Inc. comprises the majority of Mark and Mary's net worth and is a key source of their cash flow.

In 2016, Mark transferred \$5 million of non-voting interests into a SLAT, naming Mary and their descendants as discretionary beneficiaries. This SLAT permitted Mark and Mary to take advantage of Mark's then available federal estate tax exemption and transfer some of the value of MM Inc. before it reached its peak, while preserving potential access to cash flow through Mary's beneficial interest in the trust.

To further enhance access, the grantor's spouse may serve as a trustee, provided the power to make distributions to himself or herself is limited by an ascertainable standard (e.g., health, education, maintenance, and support). See *WRMarketplace No. 15-07* for a further overview of the planning benefits and considerations for SLATs.

Grantor Trust Status. Because the spouse is a beneficiary, the SLAT is taxed as a grantor trust,² so the grantor must recognize and pay income tax on the trust's income as part of his or her personal income. Other rights and powers held by the grantor or the grantor's spouse also can

trigger grantor trust status under the Code, such as a nonfiduciary power to substitute trust assets. Notably, the so-called “spousal unity rule” under Code §672(e)(1)(A) provides that the grantor is considered to hold any power or interest held by any individual who was the grantor’s spouse **at the time of the creation of the power or interest**. So certain trust interests or powers held by the grantor’s spouse will trigger grantor trust status based on attribution to the grantor (spousal interests and powers in a SLAT, including those that may trigger grantor trust status, are collectively referred to below as “**spousal trust rights**”).

POTENTIAL IMPACT OF DIVORCE

SLATs can be effective tools in legacy planning for married couples but may generate unintended and adverse consequences upon a later legal separation or divorce.

Grantor’s Loss of Indirect Trust Access. Divorce typically will mean the end of the grantor’s indirect access to the SLAT assets through the former spouse.

Changes to Spousal Interests. The SLAT agreement may directly address divorce by including a provision that terminates any spousal trust rights upon divorce.³ Not all SLATs contain these provisions, however, especially if the grantor and spouse were reluctant to discuss the ramifications of divorce when the SLAT was created. In such cases, the former spouse may retain spousal trust rights post-divorce, unless addressed in a subsequent postnuptial agreement or divorce settlement or renounced by the former spouse.

Continuing Taxation as a Grantor Trust. One may assume that the grantor’s divorce would eliminate spousal trust rights as possible triggers for a SLAT’s grantor trust status. ***If the former spouse retains spousal trust rights post-divorce, however, they may continue to trigger grantor trust status as to the grantor***, even if no other grantor trust powers exist. Some commentators believe this results from application of the spousal unity rule, which looks at an individual’s status as the grantor’s spouse at the time of creation of the spousal trust rights, not at the time of a subsequent divorce. This position is generally based on the failure of Code §672(e) to address directly the question of whether the spousal unity rule ends when the marriage ends.⁴

Example 2: Assume the same facts as Example 1, except Marcus and Mary divorce after the SLAT’s creation. Mary, however, remains a SLAT beneficiary. Depending on the interpretation of the spousal unity rule, Mary’s on-going beneficial interest in the SLAT may continue to trigger grantor trust status as to Mark, even though Mary is no longer Mark’s spouse.

Prior Code §682 minimized some of these concerns by taxing the legally-separated or former spouse on any grantor trust income payable to that individual. The grantor was not required to pay taxes on that trust income, regardless of whether spousal trust rights continued to trigger grantor trust status post-divorce. The Tax Cuts and Jobs Act, however, repealed Code §682 effective for divorces or separation agreements executed after December 31, 2018.

Accordingly, after 2018, a grantor could remain liable for the taxes on the SLAT income payable to a former spouse.

Example 3: Assume in Example 2, Mark and Mary divorced in 2017. Code §682 will apply to tax Mary (and not Mark) on income payable to her from the SLAT. If Mark and Mary divorce in 2019, however, Code §682 no longer applies, and Mark may be personally liable for the income taxes attributable to that SLAT income.

Termination of Grantor Trust Status. Many grantors likely will not want to pay income tax on SLAT income payable to a former spouse. They also may want to terminate the SLAT's grantor trust status for other reasons -- for example, because the income tax liability has or will become overly burdensome (such as when the SLAT expects a significant gain recognition event). But depending on the SLAT's terms and the interpretation of the spousal unity rule, the SLAT's grantor trust status may not be terminated unless the former spouse renounces or otherwise agrees to relinquish any triggering spousal trust rights in the SLAT (which a former spouse may be unwilling to do post-divorce).⁵

Example 4: Assume the same facts as in Example 2, except Mark anticipates a sale of MM Inc. in the next few years, which would include the SLAT's MM interests. The SLAT could receive over \$10 million of recognizable capital gain from the sale. Mark holds a power of substitution over the SLAT assets, but he does not have sufficient or desirable assets of equivalent value to swap for the SLAT's MM interests before the sale. Accordingly, Mark wants to relinquish his substitution power and terminate the SLAT's grantor trust status. Mary, however, remains a SLAT beneficiary and refuses to renounce her interest. If the spousal unity rule applies post-divorce, the SLAT could remain a grantor trust as to Mark, making him personally taxable on the capital gain recognized by the SLAT upon the sale of MM, Inc.

HOW TO PROCEED

Review Existing SLATs. Even if there is no current marital discord, clients and advisors should review existing SLATs to confirm what happens in the event of divorce. If the SLAT does not terminate spousal trust rights upon divorce, the grantor and spouse may want to negotiate a post-nuptial agreement that addresses these issues.

Consider SLATs in Divorce Negotiations. Clients with existing SLATs that are contemplating divorce should carefully review the SLAT benefits and tax ramifications as part of their negotiations, well before the final execution of any settlement or issuance of a final court order. The negotiations should address whether or not spousal trust rights will continue and the potential impact of continuing grantor trust status as to the grantor.⁶ Clients should consult with a tax advisor in collaboration with the divorce attorney to coordinate the technical tax aspects of any settlement.

Consider Including Termination Provisions for SLATs. In crafting a new SLAT, clients should consider termination or other trust provisions that address spousal trust rights in the event of a divorce and/or upon the release of other grantor trust powers if the grantor seeks to voluntarily terminate grantor trust status.

Incorporate Flexibility in Trust Beneficiaries. To protect against divorce, the SLAT could define “spouse” as the person to whom the grantor is married at the time, rather than specifically naming the current spouse. Upon divorce, the current spouse would cease to be a beneficiary and a subsequent spouse would be able to benefit from the SLAT assets, reinstating the grantor’s indirect access. Indirect benefit also could be provided to the grantor by including descendants as discretionary beneficiaries. Trust distributions to them may reduce the personal assets that the grantor otherwise would have used for their benefit, potentially limiting the grantor’s expenditures.⁷

Watch for IRS Guidance. Recognizing that the repeal of Code §682 could have unintended tax consequences, the IRS issued Notice 2018-37, indicating that the IRS intends to issue regulations providing clarification of the effective date provisions concerning the repeal of Code §682 and requesting comments on whether guidance was needed regarding the application of the spousal unity rule and the impact of other spousal trust rights on grantor trust status post-divorce. Comments to the IRS have noted the ambiguity and requested that the guidance clarify that divorce terminates application of the spousal unity rule.⁸ The IRS guidance is pending.

TAKE AWAYS

Per Notice 2018-37, the IRS plans to issue future guidance that could help clarify the income taxation of SLATs, post-divorce. Regardless, clients and advisors should be proactive in addressing these issues when planning with SLATs. New SLATs should incorporate trust provisions that specifically address spousal trust rights in the event of a divorce. Existing SLATs should be reviewed to confirm the impact of divorce, with consideration given to addressing spousal trust rights in a post-nuptial agreement if the SLAT fails to do so. Clients with existing SLATs that are contemplating divorce should review the SLAT’s tax ramifications as part of their negotiations, well before any final settlement, and consult with a tax advisor in collaboration with the divorce attorney to coordinate the technical tax aspects of any settlement.

NOTES

¹ Note that many irrevocable life insurance trusts (“ILITs”) that hold single life policies on a trust donor would qualify as SLATs, since they typically name the non-insured spouse as a trust beneficiary.

² Code §677

³ The provision may take different forms. For example, the SLAT may: (1) state that the named spousal beneficiary will be deemed to have predeceased the donor upon divorce; (2) specify the spousal rights and interests that terminate upon divorce; or (3) define the spousal beneficiary generically as the individual then married to and living with the donor, rather than limiting the definition of spouse to a specific individual. The provision also could take

effect not only upon divorce, but upon the filing of the divorce petition or the couple's legal separation or failure to cohabite.

⁴ See e.g., The American College of Trust and Estates Counsel (ACTEC), "Comments on Guidance in Connection with the Repeal of Section 622," Submitted to the Internal Revenue Service, July 2, 2018; but see also Les Raatz, "Divorce, SLATs, and the Grantor Trust Section 677 Ghost," Trust and Estates, August 2015, which reasons that divorce should eliminate most spousal trust rights as grantor trust triggers when held by a former spouse.

⁵ As noted in the ACTEC comments at note 5, Code §682 "operated only to shift the taxability of income payable to a former spouse from the grantor to the former spouse. It did not stop the operation of the grantor trust rules. For example, the repeal [of Code §682] will have no effect on the application of the grantor trust rules to the extent grantor trust status is caused by the mere existence of a power held by a spouse or former spouse."

⁶ Note that, if termination of a SLAT's grantor trust status is contemplated, the SLAT's assets and liabilities should be reviewed to assess any potential tax consequences to the grantor of any lifetime termination of such status.

⁷ Provided that the SLAT cannot make distributions that would satisfy any of the grantor's legal support obligations, as that could risk inclusion of the SLAT assets in the grantor's estate. As discussed in *WRMarketplace No. 15-07*, an independent protector or other third party also could be given the power to add the grantor as a beneficiary in the future. In the event of a divorce, the donor could be added as a discretionary beneficiary. If this option is included in the SLAT, however, care will need to be taken to ensure the grantor is merely one of many beneficiaries, and the trust will need to be placed in a jurisdiction that authorizes self-settled asset protection trusts.

⁸ See e.g., ACTEC comments at note 5.