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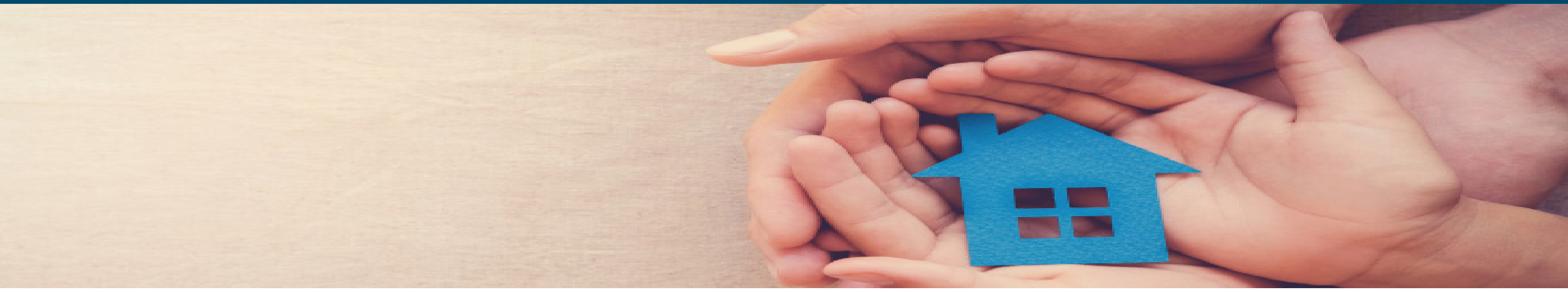

SLAT: Is It Possible to Have Access to Trust Assets Without Estate Inclusion?

Situation: With the amount sheltered from estate tax (exemption) at a historic high of $11.7M ($23.4M for a couple), many high net worth households are looking for opportunities to minimize their federal or state death tax exposure by gifting assets during their lifetime. By gifting assets when the exemption is high, a high net worth couple can avoid both federal and state "death taxes" on the transferred amount (and the growth on the asset) even if the exemption amount is less at time of death. With President Biden proposing to reduce the exemption amount to somewhere between $3.5M to $5M, time is running out to take advantage of this gifting opportunity. However, even high net worth couples can be reluctant to give away assets. They fear that one day they may need the property if circumstances change. Of course, clients of more modest net worth are going to be reluctant to give up access.

If you have married clients who are concerned about giving up access to gifted property, a strategy referred to as the Spousal Limited Access Trust, or Spousal Lifetime Access Trust (SLAT) might be appealing. It's important for financial advisors to be aware of this planning technique because life insurance is typically purchased as part of the strategy. This Counselor's Corner will outline the primary planning and tax issues associated with implementing and administering a SLAT, as well as, discuss the use of life insurance in the arrangement.

Solution: A SLAT is a lifetime irrevocable trust established by one spouse (the donor spouse) for the benefit of the other spouse (beneficiary spouse) and children (and possibly grandchildren). The trust document is written to allow for distributions to the beneficiary spouse which arguably allows the donor spouse to indirectly benefit from the trust assets. While the trust is written to permit distributions that can benefit the donor spouse it is best to put only those funds in the trust that a donor can reasonably expect to do without. A SLAT can also function as a life insurance trust and acquire a single life policy on the donor's life or survivorship policy on both spouses.

The terms of a SLAT usually give broad control to the beneficiary spouse similar to a credit shelter trust. For example, the following provisions can be included:

- The beneficiary spouse can be the trustee provided the power to make distributions to him or herself is limited by ascertainable standards of health, education, maintenance, and support (HEMS) assuming the trust does not own a policy insuring the beneficiary spouse (i.e., survivorship policy). Alternatively, if looking for the most flexibility and asset protection an independent trustee may have absolute discretion to make distributions to trust beneficiaries. In both cases, the trust should provide that no distributions can be made to satisfy the donor's legal obligations of support during the donor's lifetime to reduce the risk of estate tax inclusion in the donor spouse's estate.
- The trust can direct that the beneficiary spouse receives a mandatory income interest.
- The beneficiary spouse can have a 5% or 5,000 annual withdrawal power.
- The beneficiary spouse can have a limited power of appointment exercisable at death or in life. In some states, this power can be broad enough to appoint the assets back to the donor spouse as one of many discretionary beneficiaries.

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The transfer of assets by the spouse establishing the trust is considered a gift, but sheltered from gift tax through the use of some, or all, of the donor spouse's gift tax exemption (which may be as large as $11.7M). The assets transferred to the trust, along with their future appreciation, eventually pass to future generations without being included in either the donor spouse's or beneficiary spouse's estate for death tax purposes. In the current environment of uncertainty, SLATs can provide several benefits that are attractive for a range of clients from the modest estates needing life insurance to the ultra-high net worth client requiring aggressive estate planning.

Primary Benefits of a SLAT

While a SLAT is primarily promoted as a way to avoid transfer taxes while still retaining access to trust assets following are some of its key benefits:

1. ***Avoids Probate***
Assets in a SLAT avoid probate which should reduce settlement costs and time delays since assets in the trust can be available for immediate post-death distribution.

2. ***Later life planning***
Several safeguards can be included in SLATs to provide later life planning. For example, a SLAT can have a separate tax ID which can protect identity theft risk. Naming a trust protector to act in a fiduciary capacity can provide an independent person to monitor the trustee performance.

3. ***Asset protection***
A SLAT can be structured to provide asset protection from claims of creditors for assets transferred to the trust. This is assuming the transfer is not characterized as a fraudulent conveyance.

4. ***Serves as an ILIT***
SLATs can function as an ILIT.

5. ***Reduces federal estate and state death tax***
Properly implemented and administered assets transferred to the SLAT, along with their appreciation, avoid both the donor and beneficiary spouse's estate for estate tax purposes.

6. ***Grantor trust status***
SLATs are generally structured as grantor trusts for income tax purposes; thus, the donor spouse is taxed on the trust income. This further reduces the couple's estate and permits the trust to effectively grow tax-free.

A SLAT may seem like a fairly easy way to use a client's gift tax exemption while still providing a safety net in the event of an unforeseen need. However, there are some factors to consider before deciding if it's ideal for your client's situation. Specifically, the law regarding the use of SLATs is still developing so there is a risk of estate inclusion, especially if proper care is not taken in its implementation and administration. In addition, since the donor spouse's ability to benefit from the trust is indirectly through the distributions received by the beneficiary spouse practical considerations such as what should happen in the event of the death or divorce of the beneficiary spouse should be addressed.

Major Drawback of SLATs

The primary drawback of a SLAT is that the donor spouse's ability to benefit from the trust comes only through the beneficiary spouse's interest in the trust. If the beneficiary spouse dies before the donor spouse, or if there is a divorce, the access can be lost. This is one reason why it is best to put only those funds in the trust that a donor can reasonably expect to do without. In addition, advanced planning can address both concerns.

One simple way of addressing the death of the beneficiary spouse, prior to the donor spouse, would be to have life insurance on the beneficiary spouse payable to the donor or to the donor's trust. Another option may be to grant the beneficiary spouse a limited testamentary power of appointment with the donor spouse as one of many discretionary beneficiaries. However, the use of this technique requires careful drafting to avoid access by the donor's creditors and/or pulling the trust back into the donor's estate.

To protect against divorce, the SLAT could define "spouse" as the person to whom the donor is married to at the time, rather than naming a specific person. In the event of a divorce, the ex-spouse would cease being the beneficiary and a subsequent spouse would be able to benefit from the trust. Of course, if the donor spouse does not remarry this strategy does not solve the problem.

If the donor spouse does not remarry, or the beneficiary spouse predeceases the donor spouse, the trust could include a provision granting an independent trustee or trust protector the ability to add the donor spouse as a beneficiary. If this provision is included in the SLAT, care must be taken to ensure that the donor is one of several beneficiaries. There is no implied understanding as to how the protector will exercise the power and the trust situs is in a jurisdiction that authorizes self-settled asset protection trusts.

Life Insurance Considerations

Life insurance enjoys many tax-favored benefits that make it an attractive asset to be owned by a SLAT. Specifically, during the lifetime of the insured, policy values accumulate income tax-free; withdrawals from a life insurance policy are not taxable to the extent they do not exceed the cost basis of the policy, and loans of any amount permitted by the insurance carrier can be taken income tax-free. Because of the tax-favored treatment of withdrawals and loans from a life insurance policy many strategies, including SLATs, promote the use of taking withdrawals equal to basis then loans thereafter as a way to access policy cash. The practical effect of such a strategy is that the beneficiary spouse is able to enjoy the policy cash value without income tax consequences. In contrast, investment assets such as stocks, bonds, and mutual funds owned by a SLAT will result in taxation either at the high trust tax rates or to the donor spouse where the trust is a grantor trust.

In addition, life insurance death benefit is generally received income tax-free and in a properly maintained SLAT estate tax-free. In contrast, investment asset owned by a SLAT do not get a "step-up in basis." Consequently, after the death of the donor spouse (who is also the insured) investment asset will be subject to income tax either at the high trust tax rates or the beneficiary spouse's tax rate depending on whether the earnings are retained in the trust or distributed to the spouse.

However, these life insurance tax benefits can be lost. Following are the most common ways to lose the favorable tax treatment of life insurance.

1

Avoid creating a MEC

One way the tax-favored treatment of life insurance can be lost is by paying too much premium during the first seven years of the contract (or in the 7-pay period after a material change) causing the policy to be classified as a modified endowment contract (MEC). Death benefits from a MEC are still generally received income tax-free under IRC § 101(a). However, lifetime distributions from a MEC are taxed differently than distributions from non-MEC policies. Common policy distributions include withdrawals, loans, and assignments. Distributions from a MEC are taxed as income to the extent of gain first and recovery of basis second. Furthermore, the portion of any distribution that is included in the policy owner's gross income may be subject to a 10% tax penalty if the policy owner is under the age of 59½. If the SLAT is structured as a grantor trust, the carrier may treat the donor spouse as the policy owner for purposes of determining whether the penalty applies. If it's contemplated that policy cash values will be accessed to satisfy distributions from the SLAT, you will want to avoid creating a MEC.

It should be noted that the recently passed Consolidated Appropriations Act of 2021 included provisions changing the interest assumptions used in calculating the amount of premium that can be paid before a policy becomes a MEC. As a result of the current low-interest rates, it will be possible to put more premium into a policy for the same amount of death benefit; potentially making the IRR of cash value more attractive.

2

Avoid taking withdrawals in the first 15 years on a "cash rich" policy

As previously noted, a withdrawal from a life insurance policy is generally treated as a reduction of basis first and is not subject to tax until the amount withdrawn exceeds the investment in the contract/basis. However, a withdrawal in the first 15 years of a "cash rich policy" is treated as a distribution of gain first, taxable as ordinary income. So, if the trustee of the SLAT desires to take withdrawals from a policy in the first 15-years, it is best to first check with the carrier to determine if the gain will be taxable first under the cash rich rules. Note, assuming the policy is not a MEC, but the cash rich rules apply to make withdrawals taxable it is possible to borrow on a cash rich policy in the first 15-years and avoid income tax under the rule.

3

Avoid having an incident of ownership causing estate inclusion of the death benefit

Inclusion of life insurance death benefit in the insured's estate will occur if the insured holds any incidents of ownership in a policy on his/her life. Incidents of ownership encompass far more rights than actual policy ownership. Incidents of ownership can be attributed to the insured indirectly, such as a corporate owned policy where the insured is a majority owner and where the insured is a trustee of a trust owned policy. Because ownership of a trust owned policy can be attributed to the insured in a SLAT with a single life policy, the donor spouse cannot be the trustee (since s/he is the insured), but it is possible for either the beneficiary spouse or adult children to be the trustee. Of course, where a beneficiary spouse is a trustee, the powers over the trust property must be limited to avoid inclusion of the trust in his/her estate.

With a survivorship life insurance policy in a SLAT, neither the donor nor the beneficiary spouse can be a trustee, since both are insureds. In a survivorship SLAT situation, one of the insureds will be the donor spouse and the other will be the beneficiary spouse (typically the spouse with the longer life expectancy). There are several other ways that an improperly designed or administered SLAT can end up being included in the taxable estate of the donor or beneficiary spouse. There are other ways that a SLAT can be subject to estate tax. This is just the primary one directly involving life insurance. The other ways will be discussed under "planning considerations."

4

Manage policy distributions to avoid lapse

Taking withdrawals and loans from a policy can reduce the policy death benefit, the cash value, and may cause the policy to lapse. The lapse of a policy can cause income tax. When accessing policy values to satisfy distributions in a SLAT, it's important to request inforce policy illustrations on an ongoing basis so the policy can be managed to avoid unintended lapse. It should be noted that some policies have a safety net usually called an overloan protection rider. This rider essentially freezes the policy when the loan's balances exceed a certain threshold, as a percentage of cash value to prevent policy lapse. If a policy includes this feature, it is important to know when and how to exercise the rider. Most of these riders require a proactive action by the policy owner and require the insured to be at least a specific age.

5

Monitor policy performance to avoid policy lapse

When taking loans or withdrawals from a policy, it's not only important to avoid the tax land-mines, you also need to consider the practical things like the impact changes in crediting rates and loan assumptions can have on the long-term viability of the arrangement. For example, recently I saw an illustration where a mere decrease in crediting rate from 7.7% to 7.0% caused a policy (with prior distributions) to lapse at the insured's age 83. Even more problematic, the policy would not accept additional premiums because the policy used the GPT (guideline premium test) life insurance definitional test with a maximum non-MEC premium funding structure which, unlike CVAT (cash value accumulation test), limits the amount of premium. Unable to prevent the policy from lapse, significant phantom income would be recognized. Consequently, it's very important to conduct ongoing policy performance reviews.

6

Survivorship funding issue

When designing a SLAT with a survivorship policy if the policy is to be funded with annual gifts from the donor spouse, consideration should be given to an alternative funding strategy in the event the donor spouse before premiums on the survivorship policy are fully paid. Otherwise, if the donor spouse is the first of the two to die the SLAT may lack the funds it needs to maintain the policy. One strategy is to purchase a single life policy on the donor spouse or a first-to-die term rider. Another option would be for the donor spouse to bequeath additional funds to the SLAT to complete the funding of the policy.

7

Understand potential issues associated with long-term care riders

Because the risk that more than 50% of the population of the United States will need long-term care at some point in their life, long-term care planning has become a hot topic. With the recent development of long-term care and chronic illness riders on life insurance policies, it was only a matter of time before insureds began putting the rider on policies owned by SLATs. Since the policy in a SLAT is on the donor spouse, the benefits are triggered because of his/her health status. This raises numerous tax questions such as, "Is the benefit still income tax free? Does the payment of benefit cause estate inclusion?"

Unfortunately, there is no specific guidance from the Internal Revenue Service as to the tax effect of long-term care benefits for trust ownership. This is true whether the rider is classified as a reimbursement or indemnity rider. Most commentators raise concerns about using a reimbursement style rider in a trust because bills for the long-term care of the insured are submitted to the insurance company by the trust (which owns the policy). The insurance company then pays the bill to the care provider for expenses incurred on behalf of the insured. This chain of events provides a direct monetary benefit from the trust to the insured and likely will cause estate inclusion.[1] In contrast, there is less concern with an indemnity style of rider because payment is not tied to expenses of the insured and the benefit is paid directly to the owner of the contract, which in the case of trust ownership would be the trustee. The payment is essentially an acceleration of death benefit.

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Planning Considerations

Fund the trust using separate property. When funding a SLAT, it is important that the donor spouse use only his/her separate assets. If any contributions to the trust are from the beneficiary spouse, the beneficiary spouse would be treated as grantor of the trust. Their status as both grantor and beneficiary may cause inclusion of the trust property within the beneficiary spouse's taxable estate. Some commentators suggest that it is best to organize SLATs in DAPT (domestic asset protection) states to protect against such slip-ups. It is particularly important to take preventative measures to avoid contributing assets of the beneficiary spouse in community/marital property states where both spouses are considered to own half of all community property. This may be accomplished by partitioning assets for contributions to the trust.

Avoid using split gift election when funding the SLAT

Some have suggested that one spouse can make the entire gift by having the beneficiary spouse make a split gift election. Split gift is not allowed when the consenting spouse is a beneficiary of the trust unless the beneficiary spouse's interest in the trust is ascertainable, severable, and de minimums.

One SLAT per couple is preferred to avoid "reciprocal trust doctrine" concerns

At first blush, it may appear that with each spouse establishing a SLAT for the other's benefit, you can achieve greater benefit. However, spouses making mutual trusts must proceed carefully to avoid running afoul of the reciprocal trust doctrine.[2] This doctrine applies to interrelated trusts that have substantially identical terms and are part of the same transaction or plan. This doctrine assumes that each spouse established a trust for his or her own benefit, thus resulting in estate inclusion for each spouse. If the client can get by creating one SLAT, that is preferable. But, if the client wants two trusts, it is possible to avoid the reciprocal trust doctrine by making the two trusts sufficiently different.

Estate concerns where SLAT beneficiary appoints trust asset for benefit of original donor spouse

When the trust includes a provision giving the beneficiary spouse (or other beneficiaries) the power to appoint the trust assets back to the original donor spouse, the IRS might seek to include the trust in the donor spouse's estate under either IRC §§ 2036 and 2038. This is especially true if it can be established that there is an implied agreement that the beneficiary spouse would leave the trust back to the original donor spouse.

Possibility trust may be subject to donor's creditors.

Despite the tax rules, for state law purposes, where the trust includes a provision giving the beneficiary spouse the power to appoint the trust assets back to the donor spouse, the trust may be treated as a self-settled trust and subject to the claims of the donor's creditors. If the donor's creditors can reach the trust assets, that would cause estate inclusion in the donor spouse's estate. Therefore, it may be important for the beneficiary spouse to exercise the limited power to establish a new trust in a self-settled trust state.

In Summary

The SLAT can be a useful planning technique to help provide estate tax-free death benefits to heirs, while also providing indirect asses to trust assets. However, the law is still developing. Consequently, clients and their advisors should consider the risks.

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[1] Old Point National Bank v. Commissioner, 39 B.T.A. 343 (1939). Where the right to receive disability, benefits were held to be an incident of ownership at least to the extent it reduced the amount of death benefit.
[2] United States v. Grace, 395 U.S. 316 (1969).

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