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THE BENEFITS OF A SLAT: EFFICIENCY AND ACCESS

Spousal Lifetime Access Trusts (SLATs) provide clients with the potential to remove assets from their estate and still maintain indirect access to trust assets through the spousal beneficiary.

When properly drafted, this indirect access to trust assets may provide reassurance to high net worth (HNW) clients who are reluctant to make irrevocable transfers. By incorporating permanent cash value life insurance into this plan, clients can provide immediate liquidity at death for trust beneficiaries and the potential for tax-advantaged asset accumulation and income.

THE CONCERN

For HNW families, it generally makes economic sense to implement a robust estate plan and begin transferring assets (and any subsequent appreciation) out of their estates as soon as possible. However, it is a principle of trust planning that the grantor(s) may not have any retained interest in trust assets or else risk inclusion of some or all of their trust's assets in their estate.[1] It is commonly understood that in order to remove an asset from one's estate, clients must give up future control or access which can raise the following concerns:

- Large irrevocable gifts may simply be emotionally difficult.
- What happens if a change in financial or personal circumstances causes a need to access trust funds (e.g., assets stretched thin by extreme old age, or a long-term care event)?
- What if changes in tax law make the trust unnecessary?

A SLAT can ease these concerns.

THE SOLUTION

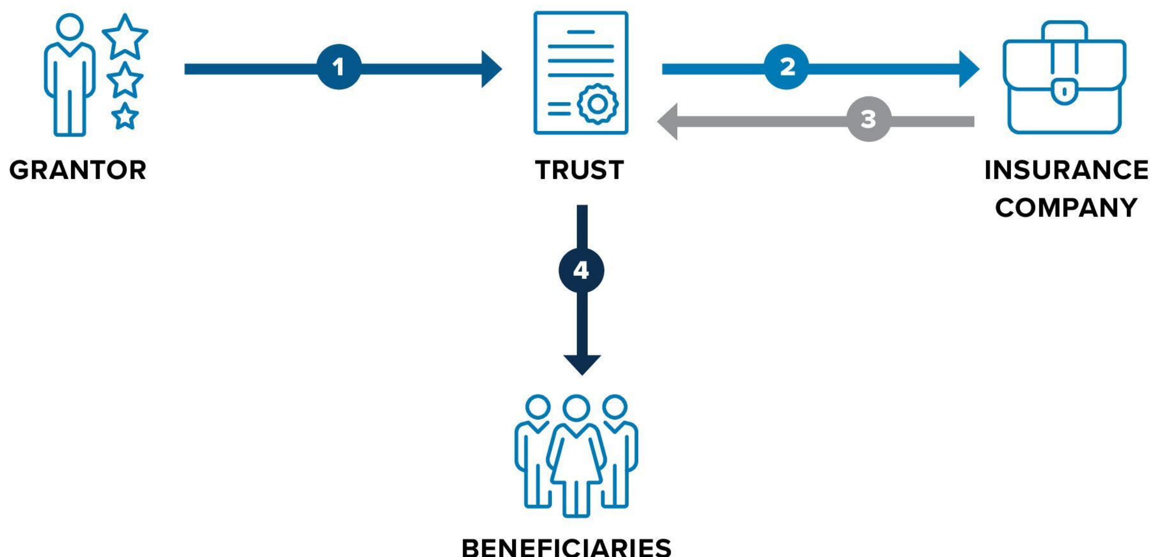
A SLAT is a form of irrevocable trust that, when properly structured and managed, enables a married individual to gift their assets to a trust (removing it from their estate and that of their spouse) and still maintain indirect access to trust assets via a spousal beneficiary.

SLATs accomplish this by defining a married couple as separate entities: grantor spouse and non-grantor spouse. The grantor spouse transfers their own property to trust. As a grantor, they cannot be a beneficiary, a trustee, or have any retained interest in trust assets without risking estate tax inclusion of trust assets. The trustee will invest the funds for the benefit of trust beneficiaries, and this may include a life insurance policy insuring the life of one or both spouses.

However, when properly structured, the non-grantor spouse, who has not established or funded the trust, may be a trust beneficiary without causing trust assets to be included in their estate. The grantor retains indirect access to trust assets via their spouse. The couple's children (current and/or future) are also beneficiaries, although they may not receive a benefit until both spouses have passed.

[1] IRC Secs. 2036, 2038, 2041 and 2042

SPOUSAL LIFETIME ACCESS TRUST (SLAT)



1. Grantor-spouse establishes and funds a SLAT.
2. SLAT Trustee invests trust funds, which can be invested in multiple asset types. In this case, the trustee uses some or all of the trust funds to pay the premium on a life insurance policy insuring the life of the grantor-spouse.
3. During the grantor's life the trustee may take distributions from the life insurance policy on a tax-advantaged basis[2] for the benefit of trust beneficiaries, including the non-grantor spouse, per the terms of the trust.
4. At the insured's death, the policy proceeds will be received income tax-free by the trustee.[3] The trustee will invest those funds and/or make distributions to trust beneficiaries, per the terms of the trust.

WHY LIFE INSURANCE

While a SLAT trustee may be empowered to invest in any number of different asset types, permanent life insurance provides benefits that may improve the overall plan.

- Generally, SLATs are taxed as grantor trusts. That is, the grantor is responsible for recognizing income tax on taxable activity occurring at the trust level. Permanent insurance may accumulate cash value on a tax-deferred basis,[4] reducing the financial impact of taxes paid by the grantor.
- Assuming the policy is not a modified endowment contract (MEC), the policy owner may generally withdraw policy cash values up to the basis in the policy without incurring income tax liability and may borrow against the policy. Policy loans are not generally includable as income.
- Appreciated capital assets typically receive a step-up in basis when owned by the decedent at their death (or are includable in their taxable estate). Assets held in an irrevocable trust do not generally receive this step-up when the grantor dies. Life insurance proceeds are generally received income tax-free by the beneficiary, approximating a step-up in basis in an irrevocable trust.
- Life insurance provides immediate death benefit protection that can be reinvested by the trustee per the terms of the trust, for the benefit of trust beneficiaries.
- Life insurance may offer long-term care or chronic illness riders.

[2] Assumes that the policy does not fail the testing requirements of IRC Sec. 7702(a) and become a modified endowment contract (MEC), and that the policy remains in-force at death.

[3] Life insurance death benefits are received income tax-free by the beneficiary, IRC Sec. 101(a). There are exceptions for policies transferred for valuable consideration (IRC Sec. 101(a)(2), the "transfer for value rule"), an employer-owned policy under IRC Sec. 101(j) unless an exception is made, and if there is a lack of insurable interest under state law.

[4] Policies that meet the statutory definition of life insurance under IRC Sec. 7702(a) may accumulate cash on a tax-deferred basis.

CHOICE OF LIFE INSURANCE POLICY

If the client and their advisors desire life insurance as a trust asset, it is critical they work with a qualified and experienced life insurance professional to help guide them through the process of selecting an appropriate policy that best fits the client's needs. As indirect access to trust assets is a key component of this plan, it is advantageous to purchase an insurance policy that is designed to accumulate cash value.

Generally, this will be a permanent life insurance policy on the life of the grantor. However, in some circumstances, a survivorship policy (a life insurance policy that insures both spouses) may be advisable. A survivorship policy insures two lives, and as a result, may have lower costs of insurance and the potential for greater death benefit protection. While survivorship insurance is a common choice for irrevocable life insurance trusts (ILITs), when a SLAT design is selected, it requires additional consideration.

When a SLAT purchases a survivorship life insurance policy, it is critical to avoid any incidents of ownership by the non-grantor spouse/insured. Under IRC. Sec. 2042, if an insured holds incidents of ownership in a life insurance policy held in trust, the value of the life insurance policy will be includable in their estate at death. In short, the insured should not have any ability or right to direct the use or disposition of the life insurance policy. So, the insured should not be a trustee, have a demand right over trust assets, or hold a power of appointment over trust assets, as all are generally considered to be incidents of ownership of a trust-owned policy.

WHAT A SLAT ACCOMPLISHES

SLATs are a flexible tool that help balance the often-competing concerns of estate tax management, and loss of access and/or control over one's assets.

Some benefits of SLATs include:

- A properly structured SLAT provides all of the benefits of a traditional ILIT, including:
  - The exclusion of trust assets from the grantor's taxable estate and that of their spouse.
  - The opportunity for professional management of trust assets.
  - The potential for enhanced creditor protection over trust assets.
- Access to trust assets should the need arise.
  - The trustee may make distributions of trust assets to the beneficiary spouse as appropriate.
  - If the client is concerned over the possibility of estate tax repeal, the trustee may be empowered to make a complete distribution of all trust assets to the spousal beneficiary should circumstances dictate this course of action.
- Flexibility. The ability to receive indirect access to SLAT assets may provide clients with the peace of mind necessary to transfer assets to trust. In practical terms, it may be best if clients never use the trust's access provisions. That is, a HNW family may find it more efficient to spend down their taxable estate before using assets held in a SLAT to meet their financial needs. Nonetheless, SLATs provide clients the option of recapturing trust assets where necessary.

CONSIDERATIONS

Properly structured and managed SLATs can provide the flexibility that makes clients comfortable with irrevocable trust planning. However, it is important to consider:

- Clients must be married. SLAT planning is predicated on the idea that the economic needs of spouses are intertwined, and that transfers between them will not be subject to gift tax due to the unlimited marital deduction. If the couple is unmarried, the transfer of assets between them could require gift tax reporting. Note that this strategy does work for same sex married couples.
- Grantor trust status.[5] A spousal beneficiary will generally cause the trust to be a grantor trust, and trust investment activity will be taxable to the grantor.

[5] A note on grantor trust taxation: If the client or their advisors are concerned over future tax treatment of grantor trusts, it is important to draft the trust with sufficient flexibility to convert to a non-grantor trust. "Toggle" provisions may enable the trustee to "turn off" sections of the trust that create grantor trust status. A trust protector should also be appointed and given discretion to modify the trust in the event of changes to the tax code. In the case of a SLAT, care should be taken to fully "toggle off" those powers in IRC Sec. 677 that create grantor trust status. Note that this may result in additional restrictions on the trustee's ability to make distributions of trust income to the spousal beneficiary.

- A non-grantor spouse should be careful to avoid becoming a grantor. Should the beneficiary be deemed a grantor, trust assets will be includable in their estate.[6] The non-grantor spouse should not make gifts to the SLAT. Inadvertent gifts can be made if jointly-owned property is contributed to the trust. This concern is most acute in community property states. Care should be taken to ensure that the intended grantor transfers only their own separate property to the SLAT.
- SLAT distributions should not be used to directly benefit the grantor. Specifically, the trust should provide that no distributions be made that would have the effect of satisfying the grantor's legal obligation of support to a beneficiary, or to satisfy the claims of the grantor's creditors.
- Trusteeship. The non-grantor spouse may be both beneficiary and trustee, but not without added complication. The proposed trustee must not be an insured on a trust-owned policy or risk estate tax inclusion of the policy proceeds in the trustee's estate.[7] If a trustee is also a beneficiary, the trust must be carefully drafted to limit trust distributions to the trustee-beneficiary to an ascertainable standard — for their health, education, maintenance, or support. Otherwise, the trustee-beneficiary may be deemed to have a general appointment over trust assets. Alternatively, a third party as trustee may be elected and provided with sole discretion over distributions to the non-grantor spouse.
- What happens in the event of divorce? The SLAT should be carefully drafted to broadly define the spousal beneficiary as a class of beneficiary to whom the grantor is married to at any given time. In the event of divorce, the former spouse would no longer be a beneficiary of the trust. Should the grantor remarry, the current spouse would be deemed a beneficiary.
- What happens if the non-grantor spouse/beneficiary predeceases the grantor? If the non-grantor spouse predeceases the grantor, the grantor will lose indirect access to trust assets. To help mitigate this risk, some SLATs provide the trustee with the discretion to make bona fide, arm's-length loans to the grantor. Alternatively, some couples establish two SLATs — one for each spouse. This approach is sometimes referred to as "cross SLATs."

CROSS SLATS AND THE RECIPROCAL TRUST DILEMMA

While it is typical for a married couple to establish a single SLAT, in some instances, both spouses may wish to create their own SLATs to benefit each other. This helps to mitigate the concern over loss of access to trust assets should the non-grantor spouse predecease the grantor.

However, it raises other complications — principally, the "reciprocal trust doctrine."

This doctrine may apply where the spouses establish two trusts that are interrelated, have been made as part of the same plan/transaction, and have substantially identical terms. In this case, the doctrine would dictate that each client did not establish a trust for the spouse's benefit, but rather for their own benefit. As a deemed beneficiary of the trust they created, trust assets would be includable in their respective estates at death.[8]

If the clients wish to implement cross SLATs, careful consideration must be given to avoiding this potentially catastrophic failure. While a matter of common law, there are some commonly used methods for potentially limiting the application of the reciprocal trust doctrine:

- One SLAT provides the spousal beneficiary with a limited power of appointment, but the other does not
- Name different remainder beneficiaries for each trust
- Appoint different trustees with different discretionary powers to each trust
- Grant the beneficiary spouse a "5 or 5" withdrawal right on one trust, but not the other
- Create the trusts at separate points of time as part of two distinct estate plans for each spouse
- Fund with disparate and unequal assets

It is imperative that the client work with experienced and qualified legal counsel in crafting a plan that does not run afoul of the reciprocal trust doctrine.

[6] IRC Sec. 2041

[7] IRC Sec. 2042

ASSET EFFICIENCY AND ACCESS

For clients who desire flexibility in their estate plan, SLATs can be a valuable tool. Properly drafted and managed, they provide clients with the ability to transfer assets into trust and outside of their estate, while maintaining indirect access to trust assets via their spouse. This trust design may provide both practical benefits and the comfort needed to encourage clients to begin planning.

[8] Lehman v. Comm'r., 109 F.2d 99 (2nd Cir. 1940), cert denied; United States vs Estate of Grace, 395 U.S. 316 (1969).

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