Folks:

Take-Away: As an individual considers the propriety of making lifetime gifts while their *bonus* gift tax exemption is still available, he/she may consider making a split-gift with their spouse, so that each spouse's applicable exemption amount can be used to shelter the donor's gift from gift tax. This is also true if married individuals consider the creation and funding of a spousal lifetime access trust, or a SLAT. Spouses can elect to gift-split transfers of assets to a SLAT where one of the donor-spouses is also a beneficiary, but only if certain conditions are met.

Background: The Tax Code provides that a gift made by one spouse to any other person will be made one-half by the donor-spouse and one-half by the non-donor spouse if specific requirements are met. [IRC 2513.] This is referred to as *gift-splitting* by the spouses. To qualify for *gift-splitting* the requirements are:

(i) Both spouses are U.S. citizens or residents;
(ii) The spouses are married at the time of the gift. If the spouses subsequently divorce, or one spouse dies later in the year of the gift, *gift-splitting* will still be permitted so long as neither spouse, nor the survivor, remarries in that same calendar year;
(iii) Both spouses must consent to *gift-splitting* on a properly filed Form 709 Federal Gift Tax Return; and
(iv) The donor-spouse transfers property to someone *other than* the donor's spouse.

Example: Joe and Jill have a son. Joe transfers $1.0 million in trust for the benefit of their son. Jill signs the Form 709 consenting that she be treated as the donor for one-half of the $1.0 million gift to the trust for their son's benefit. Joe is treated as gifting $500,000 to the

irrevocable trust. Jill is treated as having made a gift of the other $500,000 to the same trust. Joe and Jill's respective applicable exemption amounts are used to shelter the $1.0 million gift to the trust, and no gift tax is paid.

Donor-Spouse as Trust Beneficiary: Eligibility for *gift-splitting* gets more complicated when the donor's spouse is a trust beneficiary, such as when a SLAT is funded by one spouse. The Regulations provide that when a donor transfers property to their spouse and other third-parties, the transfer would qualify for *gift-splitting* if the interest transferred to those third-parties is **ascertainable and severable from the interest transferred to the donor spouse.** [Regulation 25.2513-1(b)(4).] The portion that allocated to the third-party beneficiaries qualifies for *gift-splitting;* the portion allocated to the donor's spouse does not qualify for *gift-splitting*. Alternatively, if these respective portions cannot be ascertained, then no part of the transfer will qualify for *gift-splitting*. Consequently, the availability of *gift-splitting* to the donor ultimately turns on whether the interests of the donee-spouse and third-party trust beneficiaries are ascertainable and severable, which is then where the IRS and the courts come in.

Tax Court-Severable and Ascertainable: Over a series of Tax Court decisions a 'two-step test' has evolved to determine if a donee-spouse's interest in the trust is ascertainable and severable sufficient to enable the donor-spouse to *gift-split* transfers to the trust where the donor's spouse is a beneficiary.

1. The first step determines whether a measurable distribution standard sufficiently limits the trustee's distribution power, i.e., whether an **ascertainable standard** constrains the trustee's discretion, such as 'health, education, support and maintenance'.

2. The second step is a much more fact intensive analysis that seeks to determine whether the trustee will likely exercise its discretion and will distribute trust principal to the donor's spouse. In short, a

‘**probability**’ test is applied. [*Robertson v. Commissioner, 26 Tax Court 246 (1956.)*]

Example: A trust instrument gave to the trustee complete discretion to distribute trust income and trust principal to the donor’s spouse, lineal descendants, and the spouses of lineal descendants. The gift in trust to the donor’s spouse was not severable from the donor’s gift to the third-party lineal descendants, such that no part of the donor’s transfer to the trust qualified for *gift-splitting*. [Revenue Ruling 56-439.]

Example: A trust instrument provided for mandatory distributions of income to the donor’s spouse, and discretionary distributions of trust principal to the donor’s spouse for her general welfare. At the beneficiary-spouse’s death the remaining trust assets were to continue to be held in trust for the benefit of children. The Tax Court addressed both whether the trustee’s distribution power was sufficiently limited and the probability that the trustee would distribute trust property to the donor’s spouse. When looking at the probability that the trust’s principal would be distributed to the donor’s spouse the court said that the burden to demonstrate the ‘unlikeliness’ of a discretionary distribution is on the donor. Since there was no evidence introduced of the beneficiary-spouse’s standard-of-living and her financial security held ‘outside’ of the trust, the transfer to the third-party beneficiaries was neither severable nor ascertainable from the interest conveyed to the donor’s spouse, and therefore *gift-splitting* was not available. [*Kass v. Commission, Tax Court Memo 1957-227 (1957.)*]

Example: A trust instrument gave to the trustee the discretion to distribute principal for the’ proper care, comfort, support, maintenance, and general welfare’ of the donor’s spouse and their descendants, but only after considering other funds available for those beneficiaries. The Tax Court found that the discretionary distribution standard was sufficiently limited to meet the first test

'step.' The court also determined that the possibility of such principal distribution to the donor's spouse was 'remote, based on the financial lifestyle and other facts presented by the donor.' Accordingly, an ascertainable standard was found to exist when the specific language of the trust instrument allowed for the distribution of principal only to the extent 'necessary to sustain the beneficiary's customary and present standard of living.' [*Falk v. Commissioner, Tax Court Memo 1965-22 (1965.)*]

Example: A trust instrument required the trustee to distribute 'all trust income to the donor's spouse' during her lifetime. After the donor's death the trust instrument then authorized the trustee to distribute trust principal to the donor's spouse for her 'proper support, care, and health, or any emergency affecting the donor's spouse or her family.' After the donor's spouse's death, the trust assets were to be distributed to the donor's children. The Tax Court denied any *gift-splitting* because the inclusion of the distribution standard for an *emergency* was 'too broad to constitute an ascertainable standard' and accordingly, the interest transferred by the donor to the third-parties (his children) was not severable from the interest that was conveyed to his wife. With this decision, the Tax Court did not even get to the second 'step' of analyzing the donor's spouse's finances; rather, the court initially found that the trustee's distribution authority was not sufficiently limited, so there was no need to delve into the probability that trust assets would ever be distributed to the donor's spouse. [*Wang v. Commissioner, Tax Court Memo 1972-143 (1972.)*]

Drafting SLATs: If an individual wants to create a SLAT for his/her spouse, and he/she would like to be able to make *split-gifts* when the SLAT is funded, some of the following should considered:

Stick with HEMS: The trustee's discretionary principal distribution authority regarding the donor's spouse should be limited to the conventional ascertainable standard like 'health, education,

maintenance and support.' [Regulation 20.2041-1(c)(2).] If the trust instrument departs from this ascertainable distribution standard, thus invoking state law interpretations, e.g., *comfort or welfare,* then it is more problematic that the IRS will find the trust's distribution standard to third-party beneficiaries will be ascertainable and severable.

Other Financial Resources: The trust instrument should require the trustee to first consider the donor's spouse's other independent sources of financial support. Such a provision addresses, to some extent, the analysis of the probability that the trustee will invade trust principal for the donor's spouse.

Document Financial Resources: The donor, who carries the burden of proof, should document their spouse's financial situation when the SLAT is funded. This financial information will establish that it is highly unlikely that the trustee will exercise its discretion and distribute trust principal to the donor's spouse- making that exercise of discretion to invade trust principal 'remote.'

Allocate GST Exemption: The donor should allocate his/her GST exemption to the SLAT, maybe even 'opting out' of the automatic GST allocation rules, and affirmatively electing to treat the SLAT as a GST Trust. [IRC 2632(e).] The donor's elections will help to demonstrate his/her clear intent that the SLAT is primarily intended to benefit future generations and not the donor's spouse.

Crummey **Withdrawal Rights:** Whenever possible use *Crummey* withdrawal powers to shelter the donor's gifts to the SLAT. The trustee's discretion should be made subordinate to a beneficiary's *Crummey* withdrawal right. The trustee's authority to make discretionary distributions to the donor's spouse will then be subordinate to the right of the powerholders' exercise of their withdrawal rights. This, again, demonstrates an intent to benefit third-parties other than exclusively the donor's spouse.

Income Only: The donor's spouse as a beneficiary of the SLAT should be limited to trust income only, perhaps as a matter of right, or perhaps a fixed unitrust amount that is used to address inflation concerns. Or the trust instrument could expressly prohibit the trustee's invasion of trust principal for the beneficiary-spouse. This would then require that sufficient financial resources remain 'outside' of the SLAT and thus be available to the beneficiary-spouse to satisfy the 'probability test.'

Add the Spouse as a Beneficiary 'Later:' As an alternative to naming the spouse as a current beneficiary of the non-grantor trust, instead give a non-adverse party the authority to add the donor's spouse as a beneficiary later, or later add beneficiaries from a class of individuals, which includes the donor's spouse. If this approach is considered, it is imperative that there be no documents or communications that suggest that the addition of the donor's spouse as a beneficiary was prearranged.

Conclusion: *Gift-splitting* allows a married couple to use the currently large *bonus* applicable exemption amount of both spouses for a gift made by one spouse. This opportunity enables one spouse to make a large gift that exceeds his/her available exemption amount, or to maintain a balance of remaining applicable exemptions between the spouses. *Gift-splitting* can be used to fund a SLAT for one spouse, but care will be required in both prescribing an ascertainable standard to constrain the trustee's discretion to make distributions to the donor's spouse, and the need to retain sufficient financial resources 'outside' the SLAT and thus available to the beneficiary-spouse to make the probability of a principal distribution to the beneficiary-spouse 'remote.'