Vacation Home in a SLAT

Take-Away: Choosing the right asset to place in a spousal lifetime access trust is important. If a residence is transferred to the SLAT, while that might make sense from an asset protection/legacy perspective, it could also bring with it a high level of IRS scrutiny. Once again, we find ourselves dealing with IRC 2036.

Background: Admittedly the impetus to create and fund a spousal lifetime access trust (SLAT) before the end of 2025 has ceased with a Republican controlled federal government. That said, there are still good reasons to consider a SLAT for creditor protection purposes and to remove future appreciation from the settlor's taxable estate.

Perhaps one asset to consider holding in a SLAT is a vacation home, one that is likely to be passed down to heirs. Often vacation homes are 'family legacy' assets where the carry-over basis of the vacation home is not a concern to their heirs, since they plan to hold onto it for decades and 'keep it in the family.' Also, a beneficiary's use of a trust asset will not impute income to the SLAT beneficiary nor will it carry out distributable net income (DNI) of the trust to that beneficiary.

- QPRT: Often a qualified personal residence trust (QPRT) is initially considered as the device to hold a vacation or second home. A QPRT is a viable option, but if the settlor dies during the exclusive use term of the QPRT, the value of the home is *clawed back* into the settlor's gross estate. [IRC 2702.] Accordingly, if the goal using a QPRT was to shift the value of the home and all future appreciation of that home out of the settlor's taxable estate, the QPRT may not accomplish that objective.

Risks of a Vacation Home Held in a SLAT: While holding a vacation home in a SLAT sounds like a good idea, as with any transfers to a trust, there are some risks to consider.

- IRC 2036: If the settlor gifts the vacation home to a SLAT and then proceeds to use/reside in the home with his/her spouse, the IRS could argue that IRC 2036(a)(1) applies to include the value of the vacation home in the settlor's gross estate, since the settlor transferred title during the settlor's lifetime but he/she *retained* the enjoyment of the transferred home merely by living with the SLAT's beneficiary. This might not be as big a problem if the settlor transferred an

investment portfolio to the SLAT and the SLAT then purchased the vacation home. There would be no *retained* interest to implicate IRC 2036 with the SLAT making the purchase.

- Use of SLAT Asset-Lease: Akin to the IRC 2036 problem, if a husband created a SLAT for his wife and funded the SLAT with a vacation home, if the wife had been on the title to the vacation home with her husband, she should probably sign a Lease to use the vacation home. Otherwise, she would face the same IRC 2036 estate inclusion problem that her husband might face. If the wife was never on the title to the vacation home, then that would not present an IRC 2036 problem since the wife was never on the title to the home, and consequently, there would be no *retention* of a previously held interest in the real estate. Unfortunately, with some unique vacation homes, which may be isolated, it may be difficult to determine a comparable rent to be charged to the spouse-beneficiary. Adding to this problem is the fact that the use of a corporate trustee for the SLAT would not assure the spouse-beneficiary his/her right to rent the vacation home. Additionally, many SLATs (in order to make the spousal SLATs appear dissimilar as possible) include other beneficiaries along with the settlor's spouse. This then implicates the trustee's duty of impartiality towards all trust beneficiaries, not to favor just the settlor's spouse.

- Rent: An interesting case that dealt with the rent of a QPRT is *Estate or Riese v. Commissioner, Tax Court Memo, 2011-60 (2011)* which might provide some level of comfort when dealing with rent paid to a SLAT. In that case the settlor of a QPRT failed to pay rent following the QPRT's exclusive use term for a period of six months after the term ended. Her attorney had advised her to pay rent, how to determine fair rental aloe, and to document the settlor's continued use of the residence with a lease. After the settlor's death her Personal Representative calculated the unpaid rent and paid it to the continuing trust. The estate prevailed in the Tax Court. When comparing *Riese* to a SLAT, the spouse beneficiary should have the right to live in the vacation home; if the SLAT's settlor uses the vacation home, it is not because of a reserved right but because of the marital relationship with the spouse beneficiary. By analogy, if the spouses later divorce and the spouse beneficiary remarries, presumably the new spouse would have the right to reside in the residence absent the use of a *floating spouse* provision in the SLAT.

- Reciprocal Trust Doctrine: As we have covered multiple times in previous missives, if the spouses each owned a 50% tenant-in-common interest in the vacation home, and each used his/her 50% tenant-in-common interest to fund a SLAT for their spouse, this could prompt the IRS to unwind or 'uncross' the two trusts, again triggering IRC 2036. The fact that each of the two SLATs held identical property interests, despite different SLAT terms, might be enough to

invite IRS's scrutiny, since arguably the spouses' economic positions were not actually changed by their lifetime gifts into the SLATs.

- Step-Transaction Doctrine: If the spouses owned the vacation residence jointly, and they then divide the residence into tenants-in-common, before each contributes his/her 50% share to the SLAT that they form for their spouse, that again invites the IRS to apply the step-transaction doctrine, which increases the risk that IRC 2036 should apply to cause the value of the SLAT asset to be included in the settlor's gross estate.

- Implied Agreement: Many SLATs are set up with the spouse-beneficiary acting as the trustee of the SLAT for their own benefit, subject to an ascertainable standard when it comes to principal distributions. That arrangement increases the risk that the IRS will look for an implied agreement between the settlor and the trustee, given the obvious fact that they are married, again implicating IRC 2036. With this potential risk in mind, that may prompt the settlor to name a corporate trustee of the SLAT, since with an institutional trustee it is less likely that the IRS will search for an implied agreement that the settlor may use and enjoy the vacation home that he/she transferred to their spouse's SLAT. Yet the use of a professional trustee brings with it the reality (or risk) that the corporate trustee has control over the vacation home, including the ability to make decisions like who can use the home (and when), whether rent should be charged, and how much rent should be charged.

Conclusion: There are several good reasons to consider creating a SLAT for a spouse, beyond the impetus to use the *bonus* applicable exclusion amount before it disappears. Funding a SLAT with a vacation home also may make some sense, especially if it is a heirloom asset that is to be maintained in the family for multiple generations, since the settlor's large GST exemption can be assigned to the SLAT when it is funded. With those positives in mind, it also important to think through some of the risks associated with a SLAT which might be *used* by its settlor.