Are We Still Recommending SLATs?

Take-Away: Married individuals might want to think twice before they adopt spousal lifetime access trusts to use their *bonus* applicable exemption amount before it expires at the end of 2025.

Background: For the past, several years now, spousal lifetime access trusts, or SLATs, have been pitched by advisors to their married clients to exploit their *bonus* applicable exemption amount before it disappears on December 31, 2025. That *bonus* transfer tax exemption is currently about $7.0 million- the total applicable exemption amount for an individual is almost $14 million. Now, with a Republican controlled Congress, it is looking much more likely that a spouse's *bonus* applicable exemption amount will be extended, perhaps for another 9+ years, before we again must worry that it will disappear. [Congress is also looking at completely abolishing the federal estate tax but keeping the federal gift tax.] Consequently, if the 2017 Tax Act is extended by Congress for another ten years, there will be far less pressure to recommend, or adopt, a SLAT at this time, to avoid its complications and a few of its hidden tax *traps*. A short review of some of the problems associated with a SLAT follow.

Reciprocal Trust Doctrine: If each spouse creates and funds an irrevocable trust for the other's benefit, the danger exists that the IRS will seek to 'uncross' the two SLATs and treat the settlor as the beneficiary of the SLAT that he/she created for their spouse. With that 'uncrossing' the SLAT assets will then be included in the settlor's taxable estate for federal estate tax purposes at their date of death values. [IRC 2036(a)(1).] To avoid the reciprocal trust doctrine the two SLATs, need to be differentiated as much as possible using different terms, different assets, different trustees, and created at different times. Making the two SLATs as *mirror images* will lead to the application of the reciprocal trust doctrine. However, by making the two SLATs as dissimilar as possible will often lead to confusion in the trusts' administrations. A client's directive to 'keep it simple' will not be achieved when adopting a SLAT.

***Grantor* Trust Classification:** Creating an irrevocable trust for a spouse will cause that SLAT to be classified as a *grantor* trust for federal income tax purposes. [IRC 677(a)(1).] While the settlor may have indirect access to the SLAT's income (through his/her spouse) the settlor will have direct liability for the SLAT's income tax obligation. Thus, there can result in a mismatch between the settlor's access to the SLAT's income and the burden of paying taxes on that income, e.g., the spouse-beneficiary is only a discretionary income beneficiary of the SLAT. The most obvious example is if the spouses later divorce; that *grantor* trust classification will continue, even after the spouses' divorce.

Spouse's Death: If the settlor's spouse dies, then usually other trust beneficiaries are then entitled to receive the SLAT's income. Accordingly, with the spouse's death, the settlor loses indirect access to the SLAT's income, yet he/she continues to be liable to pay the SLAT's income tax liability. Some potential solutions have been identified to address this potential problem, like giving a trust director the power to add the settlor as a trust beneficiary after the spouse's death, or to give the spouse-beneficiary a testamentary special power of appointment to add the settlor to the trust as a beneficiary, but again those 'backdoor solutions' may not be totally reliable, and the IRS might argue that there was a prearrangement that the settlor would be added as a beneficiary to the trust at a later date, again exposing the settlor's estate to claims that the SLAT's assets should be included in the settlor's gross estate for federal estate tax purposes under IRC 2036(a)(1).

Divorce: If the spouses later divorce, the settlor loses his/her indirect access to the SLAT's income. Yet his/her income tax burden continues. Nothing could be a greater aggravation than losing all access to the SLAT's income that your former spouse continues to enjoy, while having to pay the income taxes on that income. This scenario has led to interesting 'solutions' like a *floating spouse* provision, (where the spouse is not named but the lifetime beneficiary is identified as '*the person to whom I am married'*) but it is an awkward solution, at best, to a major irritant.

Buyer's Remorse: As with any irrevocable trust, the settlor may later have second thoughts on how much was irrevocably gifted to the SLAT created for their spouse. Depending on the SLAT's terms, neither the settlor nor the settlor's spouse may have the ability to easily access the assets held in the trust. If the settlor later has liquidity needs, the inability to access SLAT assets could force the settlor to liquidate other 'outside' assets, incurring capital gains, while the SLAT remains funded. [Example: The SLAT is a true dynasty-type of trust with an independent trustee and the settlor's spouse, children, and grandchildren are all named as discretionary beneficiaries, where the trustee is reluctant to make any principal distributions to the settlor's spouse due to the trustee's fiduciary duty of impartiality.] The loss of control and access associated with any trust is something that the settlor needs to be fully aware of when considering a funded SLAT.

Implied Understanding: Some individuals are tempted to aggressively fund their respective SLATs using their full *bonus* applicable exemption amounts, to the point that they have retained few remaining assets ‘outside’ the two SLATs. The IRS has successfully argued in the past in the Tax Court that if there are not enough assets retained ‘outside’ the SLATs to maintain the spouses’ lifestyle, there must then have been an implied understanding with the SLAT trustee that the settlor and/or the settlor’s spouse will readily have access to the SLAT’s income and assets to meet their lifestyle needs. This implied understanding then leads, again, to the application of IRC 2036(a)(1) which will cause the value of the assets held in each SLAT to be included in the settlor’s gross estate for federal estate tax purposes. If the settlor faces a liquidity crisis and must still pay the income taxes for the SLAT, that will quickly erode the settlor’s remaining ‘outside’ assets.

Alternative? A spouse might consider instead of a SLAT adopting a qualified dispositions in trust, i.e., a Michigan domestic asset protection trust (DAPT.) Rather than immediately name the settlor’s spouse as a beneficiary, the spouse could be added later as a beneficiary by a trust director. For example, the DAPT could be a dynasty-type of trust where a class of beneficiaries is identifies as any descendant of the settlor and the settlor’s spouse’s antecedent. Thus, the DAPT would not start out as a *grantor* trust since the settlor’s spouse had no immediate rights to the trust’s income or principal. Moreover, the settlor could also be added to the trust as a beneficiary later by the trust director. Similarly, a DAPT could also function as what is known as a special power of appointment trust, or SPAT, which would give the powerholder, serving in a non-fiduciary capacity, the power to appoint assets held in the trust to the settlor.

Conclusion: With Congress about to extend the 2017 Tax Act provisions, there is less of a pressing need to explore, or adopt, a SLAT. SLATs are still effective estate planning devices, but they do present challenges in their drafting, administration, and continuing risks of estate inclusion that must be constantly monitored.

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