



DON'T TAX YOURSELF

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When to Take Advantage of a Spousal Lifetime Access Trust (SLAT)

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Under the Tax Cuts and Jobs Act, in 2020 each person may transfer up to \$11,580,000 without incurring a gift or estate tax. This generous exemption amount will sunset at the end of 2025, which means that in 2026, the exemption amount will expire and it will revert to \$5,000,000 indexed for inflation. Many clients are concerned that under the new political climate, this gift and estate tax exemption amount will be reduced sooner and further.

Spousal Lifetime Access Trusts (SLATs) are an irrevocable trust created by a donor spouse during life, for the benefit of a beneficiary spouse. Although the donor spouse gives up access to the gifted assets, the beneficiary spouse enjoys access to the trust assets. While the donor spouse and beneficiary spouse are married, the donor spouse continues to have indirect access to the trust assets. The trust is designed to utilize the donor spouse's exemption amount, while it is still available.

There are many considerations that should be discussed before creating a SLAT, such as the following:

GIFT AND ESTATE TAXES

Completed gifts along with any future appreciation are sheltered in the trust from future gift and estate taxes. The IRS issued regulations which were intended to eliminate a potential claw back by allowing the estate of the donor spouse to use the greater of the estate tax exemption credit at the time of the death of the donor spouse or the estate tax exemption amount at the time of the gift.

However, in the examples in the regulations, the estate tax exemption amount is only applied to the amount gifted, so if the donor spouse gifts a portion of the exemption amount, instead of the full exemption amount, depending on the value of the estate and the then exemption at the death of the donor spouse, there may be estate taxes due.

A gift tax return must be filed reporting the gift and electing to utilize the estate tax exemption amount for the gift value.

Assets gifted to the trust retain the carryover basis from the donor spouse and will not receive a step up in basis at the death of the donor spouse.

The donor spouse may have a power to substitute property for equal value, which would allow the donor spouse to substitute cash into the trust in exchange for low basis assets. Upon the death of the donor spouse, the assets held in the name of the donor spouse would receive the step-up in basis.

GENERATION SKIPPING TAXES

The SLAT can be designed to hold trust assets for future generations and the generation skipping tax exemption amount may be allocated to the completed gifts. The GST exemption should be allocated on the gift tax return reflecting the gift to the trust for future generations.

INCOME TAXES

Before creating and funding a SLAT, the accountant should be consulted to review the income tax effects of the proposed transfers.

During the lifetime of the donor spouse, any income produced by the trust assets, such as dividends, interest, and capital gains, are taxed to the donor

spouse (the grantor of the trust). While the donor spouse pays the income taxes, the trust assets are essentially growing tax-free.

The transfer of assets to the trust does not incur income taxes. However, a sale of those assets by the trust at a later date will incur income taxes to the donor spouse under the grantor trust rules.

Each year, the estate of the donor spouse is further reduced without incurring a gift tax because the donor spouse is responsible for paying the income taxes for the trust.

The trust may state that the Trustee has sole discretion to reimburse the donor spouse for the payment of income taxes.

Upon the death of the donor spouse, the trust will cease to be taxed as a grantor trust, and will be taxed as separate entity.

BENEFICIARIES

The primary beneficiary is the spouse of the donor spouse. Upon the divorce or death of the beneficiary spouse, the donor spouse no longer has indirect access to the trust funds and income.

Other family members, such as children and grandchildren, may be named as current or remainder beneficiaries.

When descendants are named as current beneficiaries, the distributions to the descendants from the trust are not gifts, and thus no gift tax would incur upon the transfer.

ASSET PROTECTION

Assets gifted by the donor spouse cannot be reached by most creditors of the donor spouse. If an independent trustee is serving with a sole discretion standard, then the trust assets cannot be reached by most creditors of the beneficiaries.

However, under the Uniform Fraudulent Transfer Act, the assets may be reached by a creditor of the donor spouse if the donor knew or should have known of the creditor claim and transferred the assets to avoid payment.

TRUSTEES

The donor spouse cannot serve as trustee. The donor spouse cannot exercise dominion or control over the assets. The beneficiary spouse may serve as trustee, provided the distributions are restricted to an ascertainable standard of health, education, maintenance, or support. An independent trustee may distribute assets for any reason.

The donor spouse, beneficiary spouse, or remainder beneficiaries may remove and replace a trustee, so long as the replacement trustee is independent.

FINANCIAL FORECASTS

Before creating and funding a SLAT, the financial advisor should create forecasts modeling various gifting scenarios to identify how much can be transferred to the trust and how much should be retained by the donor spouse to ensure that the donor spouse has retained adequate assets to live comfortably after making the gift.

The donor spouse should consider purchasing life insurance on the beneficiary spouse to make up any shortfall in income. An insurance agent should be consulted regarding life insurance, disability insurance, and long-term care insurance.

If the donor spouse is concerned that they may need access to the trust funds in the future, then the trust may provide someone with a limited power of appointment which could be exercised in favor of the donor spouse. However, once exercised, the assets would be in the donor spouse's taxable estate without the estate tax exemption amount to shelter it at death.

TRUST FUNDING

The trust may hold any asset, but careful consideration should be given regarding which assets it should hold. The donor spouse should fund the trust only with assets in his or her individual name. The donor spouse may give assets that will rapidly appreciate, removing the value from his or her estate.

The gifted assets retain the donor's carryover basis, and will not receive the step up in basis at the death of the donor. Therefore, a donor spouse should not gift assets which were the replacement property under a like-kind exchange, or other such assets with a very low basis.

The trust may hold life insurance policies. Existing policies that are transferred to the trust are subject to the estate tax claw back rule if the donor spouse dies within three years of the transfer. Trust provisions creating a marital deduction for any insurance policies subject to the claw back rules will defer the estate tax until the death of the surviving spouse. Each year, the donor spouse will make contributions to the trust for the trustee to pay

the premium payments. In order to qualify the premium payments for the annual present interest gift tax exclusion amount, the trust must provide for a right of withdrawal to the beneficiaries, commonly known as Crummey notices. Instead, if the trust has adequate assets to pay the life insurance premiums, there would be no need for an annual contribution to the trust by the donor spouse or to send Crummey notices.

The trust may hold real estate. In order to hold real estate, the trust must be adequately funded to pay for the expenses and maintenance of the property. If the donor spouse resides in the property, then the donor spouse must pay fair market value rent. Upon the sale of the property, the donor spouse may not qualify for the residential exclusion amount for the sale of a primary residence. If the property is mortgaged, then the transfer to the trust will trigger the due on sale clause and the promissory note will be due and payable in full. Most lenders will not loan to a trust, so it is unlikely that the trust would qualify for refinancing.

RECIPROCAL TRUST DOCTRINE

When two people create trusts for the benefit of each other, the court may treat each party as though he or she created the trust for their own benefit, and therefore include the trust assets in the estate of the donor spouse. To avoid this undesirable estate tax result, if a couple decides to create trusts for each other, then the trusts must be different. The trusts may have varying trustees, beneficiaries, distribution standards, timing of distributions, timing of creation, or assets held by the trusts.

DIVORCE

Only clients with strong marriages should consider utilizing a SLAT. If a couple divorces, the donor spouse will lose indirect access to the trust assets through the beneficiary spouse.

Please contact us if you would like to discuss how a Spousal Lifetime Access Trust may benefit you.