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## MBL Advisors

### **Summer/Fall 2022 Gift Tax Series:** **Volume 2: Spousal Lifetime Access Trusts** **(with apologies to Ben Franklin)**

Benjamin Franklin's famous observation "in this world nothing can be said to be certain, except death and taxes" is an often-quoted opening remark when discussing the estate tax, so please forgive the quip. And yet, while death and taxes remain certain, the nature of the tax associated with death is less so. The federal estate and gift tax regime (often referred to jointly as the transfer tax regime) is a political football that gets tossed around with predictable regularity. While our clients carefully prepare for the future, changing winds in Washington can and often do result in uncertainty.

A recent example occurred when President Trump signed the Tax Cuts and Jobs Act of 2017, which roughly doubled the applicable exclusion value for the combined estate and gift tax. Indexed for inflation, the exemption has increased for 2022 to \$12,060,000 in 2022 (\$24,120,000 for a married couple's combined exemption). The longevity of this applicable exclusion is unknown; if Congress does what it has typically done best (i.e., nothing), then the new heightened exemption will sunset in 2025. However, the Biden administration and the Democratic majority 117<sup>th</sup> US Congress flirted with significantly impacting transfer tax consequences before the Build Back Better Bill died at the hands of Senator Manchin in late 2021.

The point is that while the current exemption level may persuade some individuals whose net worth is less than \$24 million to ignore their estate plan, that approach would ignore the potential for changes in the estate tax (not to mention improperly assuming that transfer tax mitigation is the sole or most important aspect of estate planning).

Given the uncertainty of the transfer tax exemption amounts looking forward, many high net worth couples are trying to make hay while the sun is shining. As a gross oversimplification, the Spousal Lifetime Access Trust (often referred to as a "SLAT") is a transfer tax technique that attempts to allow a taxpayer (i) to take full advantage of the entire exemption now while it remains at its historic high, (ii) to freeze the value of assets now so that future appreciation occurs outside of the estate, and (iii) to do all of this without losing control of or access to the gifted assets. Sound too good to be true? The devil, as they say, is in the details. There are many ways to spoil the structure by not understanding the rules of the game.

**The Basics of a Spousal Lifetime Access Trust** or *"Tell me and I forget, teach me and I may remember, involve me and I learn."*

A SLAT is an irrevocable trust created by one spouse for the benefit of the other spouse and also for the benefit of additional family members, (i.e., children and/or grandchildren).

The Grantor (the “Donor Spouse”) uses a portion of his or her gift tax applicable exclusion to make a gift to the SLAT, and the “Beneficiary Spouse” is named as a current beneficiary. The SLAT can name other beneficiaries as current beneficiaries as well but is not required to do so. While the Donor Spouse gives up his or her right to the property transferred into the trust, the Beneficiary Spouse maintains access to that same property, effectively creating an escape hatch at the Grantor’s generational level as long as the spouses remain alive and married.

The trust can be structured as appropriate for each family. Some families allow only the Beneficiary Spouse to access funds during his or her lifetime while children and grandchildren only benefit after the Beneficiary Spouse’s death. Other families may choose to structure SLATs to permit distributions to the Beneficiary Spouse and children simultaneously. Additional components to the dispositive scheme may be incorporated as appropriate.

**Tax Aspects** or “*When you’re testing to see how deep the water is, never use two feet*”

**Transfer Taxes.** The 2022 estate and gift tax applicable exclusion of \$12,060,000 per individual can be used during life or at death, and it does not need to be used all at once. Completed gifts using the applicable exclusion, along with their growth, are sheltered from future transfer taxes. Though the applicable exclusion may be used to transfer a variety of different assets (for example, cash, securities, real estate, life insurance, and closely held business interests), practitioners generally recommend gifting assets that are expected to appreciate significantly over time, thereby potentially increasing the tax-advantaged wealth transfer. Any assets that are not distributed to the beneficiary spouse remain in the trust and may continue to grow free of estate and gift taxes while remaining available for the next generation.

Despite the allowance for distributions to the Beneficiary Spouse, practitioners generally advise the family to consider other available resources before making a distribution from the SLAT. If the SLAT does make a distribution of trust assets to the Beneficiary Spouse, the transfer tax exemption used by the Grantor in donating assets to the SLAT are “wasted” to the extent a portion of the assets come back to the Grantor’s generational level.

**Income Taxes.** SLATs are taxed as grantor trusts for income tax purposes, which means the grantor bears the income tax burden on any trust earnings. This can be advantageous as it gives the trust the potential to grow without the encumbrance of income taxes, and the payment of those taxes by the grantor is not considered an additional gift. From a transfer tax perspective, this is generally considered a benefit. However, some grantors may weary of continuing to bear a tax burden without directly enjoying a corresponding benefit!

**Structural Considerations** or “*An ounce of prevention is worth a pound of cure*”

Typically, for a gift to be considered a completed gift for federal gift tax purposes, the donor of the gift must not retain any interest in the gifted property or control over it. The combined nature of the federal gift and estate taxes and the current high exemption level with an anticipated short window of opportunity mean that many wealthy individuals would like to “strike now while the iron is hot” so as not to miss the opportunity to transfer substantial wealth in the event the exemption goes back down before they die. Most people would agree that if the cost of taking advantage of the exemption now is dying prematurely, the juice isn’t

worth the squeeze. Hence the appeal of a SLAT for married individuals with substantial wealth.

SLATs present a unique opportunity to use the Donor Spouse's transfer tax exclusion amount while maintaining indirect access to the contributed funds. Constructing a SLAT requires thought to help ensure it is appropriate given someone's unique financial and family goals. Considerations when contemplating a SLAT should include:

- Can the trust be revocable? The trust must be irrevocable, and the grantor **cannot** retain any beneficial interest in the trust. As an irrevocable trust, the SLAT will not be included in the grantor's estate.
- What happens in the event of a divorce? Because the trust must be irrevocable, divorce poses considerable risk to the functionality of a SLAT. Part of the benefit of the SLAT is the indirect access afforded by the Beneficiary Spouse, so divorce has the effect of cutting off that indirect access. If not carefully drafted, the trust can also result in the continued support of an estranged spouse. A common safeguard would be to draft the SLAT so it is available only for any current spouse (and not former or estranged spouses). The SLAT can also be drafted to eliminate a spousal beneficiary completely in the event of divorce and/or remove the beneficiary spouse as trustee. While that doesn't help the Donor Spouse retain indirect access to or control of the assets of the SLAT, at least the Donor Spouse can be confident that the divorcing Beneficiary Spouse cannot access or control them.
- What happens in the event of the premature death of the Beneficiary Spouse? Similar to a divorce, a premature death of a Beneficiary Spouse would have the effect of cutting off indirect access for the Donor Spouse. A common workaround would be to incorporate a 10 year term policy on the life of the Beneficiary Spouse to "compensate" the Donor Spouse for this loss.
- Who can be a trustee? The Donor Spouse should **not** serve as trustee. But the Beneficiary Spouse may, so long as the power to make distributions to himself or herself is subject to an "ascertainable standard." A typical example for such language might include an allowance for the trustee to exercise discretion for trust distributions for the health, education, support, and maintenance of the Beneficiary Spouse. Either or both spouses (and current or future beneficiaries) can be given the ability to remove and replace a trustee.
- Who are the beneficiaries? The primary beneficiary is typically the Beneficiary Spouse. Children, grandchildren, more remote descendants and/or even unrelated individuals and charities may also be named as either current or remainder beneficiaries. (Note: in the event that a SLAT is intended to remain intact beyond the lifetime of the Grantor's children, there are additional tax considerations that should be taken into account.)
- What assets should be used to fund a SLAT? As previously discussed, a SLAT can be funded with a variety of assets. However, it is important for the Donor Spouse to fund the SLAT with **separate** property only *and not assets jointly owned with the beneficiary spouse*. The risk of funding with a jointly owned asset is that the Beneficiary Spouse could be perceived as making a gift to the SLAT, which may result

in the trust assets being includable in his or her estate, thereby, in effect, wasting the applicable exclusion allocated by the Donor Spouse.

- What else can a SLAT own once funded? A SLAT can own any liquid or illiquid asset that an individual can own. One viable consideration is that life insurance purchased by a SLAT can provide a powerful combination of income tax and transfer tax benefits. A portion of the assets given to the SLAT can fund a life insurance policy and relieve the donor from worrying about making annual gifts to fund current or future premium payments. Life insurance cash value grows without recognition of current income taxes, which can be a significant benefit when the Grantor is responsible for the income tax liabilities within the SLAT. Finally, life insurance death benefits within the SLAT are not subject to estate taxes and can be used to fund any estate tax liability of the Grantor at their death.
- What if it seems too early to know what my children can handle? The Beneficiary Spouse can be given a limited power of appointment within a SLAT that can be exercised at any point during the window of time between the creation of the SLAT and the death of the Beneficiary Spouse. This power provides flexibility by giving the Beneficiary Spouse the ability to allocate trust assets in any manner to a limited class of recipients, generally the children in equal or unequal shares and with similar or different parameters. This is especially helpful in cases where children are too young for the parents to determine what their future needs will entail. With a limited power of appointment, the manner in which children will benefit can be outlined sometime after the trust is created.

## **Death and Taxes**

Benjamin Franklin has coined a phrase or two, none more famous or frequently cited than “a penny saved is a penny earned.” A SLAT affords an estate plan the flexibility to adapt throughout one’s lifetime while potentially maximizing gifting opportunities with the ability to transform in future financial and tax climates. While the SLAT is by no means an estate planning panacea, in our uncertain times it is often a technique worth discussing in a variety of circumstances. Let us know how we can be of service to you and your family. And remember Ben Franklin’s warning that “You may delay, but time will not.”

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