Using a Spousal Lifetime Access Trust for Flexible Estate Tax Planning

Wealth Planning | Estate and Tax Planning

Due to uncertainty surrounding the future of the federal estate and gift tax framework, many wealthy couples hope to take full advantage of the current exemption ($12.92 million per individual in 2023) before it's too late. A spousal lifetime access trust (SLAT) may help couples achieve this objective without the loss of flexibility and access typically associated with estate tax planning strategies.

How Does a SLAT Work?

A SLAT is an irrevocable trust established by one spouse (the grantor) for the benefit of the other spouse. The grantor makes a gift of assets to the SLAT and utilizes his or her gift tax exemption to shield the gift from gift taxes.

Typically, the SLAT terms provide that the trustee may make discretionary distributions to the grantor's spouse and descendants. An independent party usually serves as trustee. However, the grantor's spouse may serve as trustee so long as distributions for the spouse's benefit are subject to an "ascertainable standard" (e.g., health, education, maintenance, and support). These and other SLAT terms are designed to remove the SLAT assets from the grantor's gross estate for estate tax purposes. Often, each spouse will create a SLAT with the other spouse as a beneficiary (subject to the "reciprocal trust doctrine" mentioned below) in order to use the gift tax exemption of each spouse.

Who Should Consider a SLAT?

A SLAT is often preferable for married couples who wish to minimize estate tax exposure while maintaining the ability to access the trust assets if necessary due to changes in their wealth or changes in the estate tax laws.

Can a SLAT Own Life Insurance?

Yes, a SLAT often holds life insurance on the grantor's life. This removes the life insurance death proceeds from the grantor's gross estate, but it allows the grantor's spouse to access the policy's cash value. Thus, a SLAT is often a preferable alternative to a traditional irrevocable life insurance trust that names only the grantor's descendants as beneficiaries.

How Is a SLAT Treated for Income Tax Purposes?

A SLAT is often designed as a grantor trust. This means that all income tax consequences realized by the SLAT assets flow through to the grantor. If the SLAT was instead a separate taxpayer, it would be subject to the compressed income tax brackets applicable to trusts, often resulting in higher income taxes. Income tax payments by the grantor further reduce his or her estate while allowing the SLAT assets to grow without any reduction due to income taxes.

Assets owned by the SLAT upon the grantor's death will not receive a basis step-up for income tax purposes. Thus, the recipients of the SLAT assets after the grantor's death, upon selling such assets, may incur capital gains tax on appreciation that occurred before (as well as after) the grantor's death. However, any SLAT assets distributed to the grantor's spouse may be included in his or her gross estate, causing such assets to receive a basis step-up. The SLAT terms can also potentially incorporate certain "asset swap" powers that allow for the transfer of higher-basis assets into the trust during the grantor's lifetime in exchange for lower-basis assets. By incorporating and utilizing these powers, a grantor can facilitate a future basis step-up for any lower-basis assets he or she receives back from the trust.

Are There Any Additional Advantages?

Assets held by the SLAT will avoid probate. Also, a SLAT may be used to protect assets from creditor claims against the grantor or the beneficiaries.

What Are Some Common Pitfalls?

If the grantor outlives his or her spouse, the grantor will typically lose indirect access to the SLAT assets upon the spouse's death. To address this issue, the grantor may obtain a life insurance policy on the spouse's life. In addition, depending on state law, the SLAT terms may give the grantor an interest in the SLAT assets effective after the spouse's death.

If each spouse creates a SLAT and the terms of each SLAT are essentially identical, the IRS or a court may apply a rule called the "reciprocal trust doctrine." This means that each spouse would be treated as if he or she created a trust for the benefit of him or herself (rather than for the benefit of the other spouse), which would eliminate the estate tax advantages of a SLAT. To deal with this risk, the attorney who drafts the SLAT documents may include slightly different dispositive or fiduciary appointment provisions in one of the documents.

If you are interested in creating a SLAT, you should discuss the advantages and disadvantages of this strategy with your financial advisor, attorney, and tax professional.

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