SPOUSAL LIFETIME ACCESS TRUSTS: TAKING ADVANTAGE OF HIGH EXEMPTION AMOUNTS

By John Welsh

As Director of Commerce Family Office, John Welsh specializes in counseling very high net worth individuals and families on the development and implementation of estate, wealth transfer, philanthropic, family education and fiduciary planning activities, as well as a variety of other related wealth planning matters. In his commentary here, John discusses how the Spousal Lifetime Access Trust (SLAT) might become particularly valuable as a wealth transfer planning technique with estate tax exemption amounts potentially trending downward. With the upcoming presidential election and the potential for major tax changes, including the lowering of the estate tax exemption amount from $11.58 million to as low as $3.5 million per individual, the ability to retain indirect access to gifted assets throughout a couple's lifetime, and the potential to possibly continue benefiting from the asset following the death of a beneficiary spouse, make this an option worth considering for appropriate clients.

The amount by which individuals can gift to others free of gift or estate tax, commonly referred to as the estate tax exemption amount, is the highest it has ever been, currently $11.58 million per individual ($23.16 million per couple). That amount is scheduled to automatically decrease to below $7 million in 2026. However, given a potential change in presidential administrations in the upcoming 2020 election and the budgetary holes that the coronavirus has created or exacerbated across the country, it is possible this amount will be decreased even further and/or sooner than 2026.

That's the bad news.

The good news is that the IRS and the U.S. Treasury have already stated that any exemption used under the increased exemption amounts will not be "clawed back" if exemption amounts do, in fact, decrease. In other words, if you use it, you won't be penalized at a later date, but if you don't use it, you lose it.

The reality is that simplifying this concept down to an oft-used term of "use it or lose it" is easier said than done. In order to use your exemption, one must irrevocably relinquish control of and access to an asset. This means that the individual making the gift cannot receive income from that asset, proceeds from the sale of the asset or many other benefits that an owner may receive. This is often a major hurdle for many.

For couples with a net worth between $15-50 million who want to take advantage of these increased exemptions, they are often left between a rock and a hard place: do they forgo the benefits of owning that asset by using the increased exemption now, or do they retain control and benefit of the asset but lose out on the increased exemption amount should it decrease in the future, resulting in a higher estate tax bill for their family at their death.

Luckily, there is a way to have your cake and eat it, too. It's called a Spousal Lifetime Access Trust, or SLAT (sometimes referred to as Spousal Limited Access Trust). A typical SLAT is like most other trusts created for future generations. The main difference is that in addition to naming children, grandchildren and/or future descendants as beneficiaries, the spouse of the grantor of the SLAT is also a beneficiary. While the goal of most SLATs is to not make any distributions to the beneficiary spouse, naming the spouse as a beneficiary allows the grantor spouse to "indirectly" benefit from the trust without being a beneficiary if needed. The grantor is able to use his/her exemption amount, remove the asset and any future appreciation from his/her taxable estate and retain the flexibility of indirectly benefiting from the assets should there come a time when he/she needs to.

HOW SLATS CAN BE UTILIZED

Consider this scenario: Henry and Bernice Jones have a net worth of $25 million, including $11 million in rapidly appreciating assets. They decide they would like to take advantage of their increased exemption, but are not comfortable gifting more than the $11 million in appreciable assets. To accomplish this, Henry establishes a SLAT and transfers the entire $11 million in rapidly appreciating assets to the SLAT. Henry has never made a gift before, so he was able to use $11 million of his remaining lifetime gift and generation-skipping tax exemption.

The beneficiaries of the SLAT are Henry and Bernice's children and grandchildren, as well as Bernice. Bernice is also the trustee of the trust and is allowed to make distributions to the beneficiaries, including herself, for each beneficiary's health, education, maintenance and support. Unfortunately, Henry cannot be a beneficiary of the SLAT. However, if there comes a time when the $14 million that was not gifted to the SLAT was no longer sufficient to support Henry and Bernice, Bernice may receive distributions under the trust terms and use those assets for their joint benefit. The hope however is that Henry and Bernice never receive a distribution from the SLAT so that the assets can grow and benefit their descendants.

Should the assets in the SLAT double in value between now and Henry's death, he and his family will have avoided paying estate taxes for this asset. As shown below, if Henry and Bernice live off the income of their $14 million, the $11 million asset doubles in value and they pass away when the estate tax exemption is $3.5 million, their combined estates would save over $7 million in estate taxes by having used Henry's $11 million of exemption for the SLAT.

	SLAT CREATED	NO SLAT CREATED
SLAT ASSETS	**$ 11,000,000**	**$ -**
NON-SLAT ASSETS	**$ 14,000,000**	**$ 25,000,000**
EXEMPTION USED	**$ 11,000,000**	**$ -**
GROSS ESTATE AT DEATH	**$ 14,000,000**	**$ 36,000,000**
EXEMPTION REMAINING	**$ (3,500,000)**	**$ (7,000,000)**
TAXABLE ESTATE AT DEATH	**$ 10,500,000**	**$ 29,000,000**
ESTATE TAX RATE	**40%**	**40%**
ESTATE TAX DUE	**$ 4,200,000**	**$ 11,600,000**
TOTAL AMOUNT TO BENEFICIARIES	**$ 31,800,000**	**$ 24,400,000**

DRAWBACK WITH A POTENTIAL SOLUTION

One major drawback of SLATs is that the grantor's ties to the SLAT and the ability to indirectly benefit from it are tied to one's spouse. The potential for losing this ability and being cut off from the SLAT can be realized when the beneficiary/trustee spouse dies or in the event of divorce.

This potential may be mitigated by giving the beneficiary spouse a limited power of appointment at death that allows an appointment of property back in trust in favor of the grantor spouse, thus making the grantor a beneficiary of the trust. This power should be permissible, not required. This approach would allow the surviving spouse to access the assets in the SLAT for his/her remaining lifetime while ensuring the assets and their growth are excluded from the taxable estates of both spouses. Because of varying state laws, one should consult with a qualified tax advisor and estate planner before including such a power to ensure there are no adverse tax or creditor protection issues.

OTHER CAVEATS

For couples willing to gift up to the current exemption amount, it might be appropriate for one of the spouses to create a SLAT while using only his/her exemption amount. If both spouses were to make a $5.5 million gift, using that amount of exemption each and the exemption amount later decreases to $5.5 million or less per individual, the couple now has no exemption left between them. If they utilize the strategy of one spouse using their entire $11.58 million exemption amount now and the exemption amount decreases to $5.5 million or less, the couple will still have the other spouse's entire exemption amount remaining.

For couples that want to each create a SLAT, it is important that they not violate the Reciprocal Trust Doctrine, which states that if two people create similar trusts for the other of them, the IRS and the courts can swap the beneficiary of the trusts and treat each trust as having been created for the grantor of the trust. This would result in that trust being included in the grantor's estate, thus defeating the purpose of creating the trust. To avoid this unfortunate mishap, the couple's estate planning attorney must make sure the SLATs differ from each other, possibly through different distribution provisions, different beneficiaries, different vesting provisions for their descendants and/or different trustee selection and succession provisions.

Commerce Trust clients are welcome to contact their Private Client Advisor with any questions about these strategies, or contact John Welsh at john.welsh@commercebank.com.

*Always consult with your CPA and professional advisor on matters involving taxes.

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