Bloomberg Tax

Tax Management Estates, Gifts and Trusts Journal™

SLAT-OPEDIA: Considering All Options and a Client-Friendly Letter

By Alan S. Gassman, Christopher J. Denicolo, and Brandon Ketron[*]
Gassman, Crotty & Denicolo
Clearwater, FL

A Spousal Lifetime Access Trust (SLAT) is a trust established by one person that is held for the benefit of his or her spouse and others in a manner that will not be subject to the creditor claims of the spouse and other beneficiaries of the trust and also will not be subject to federal estate tax in the estates of such beneficiaries. The SLAT has its roots under the common law of all 50 states of the United States, and has been fine-tuned and augmented by creative planners over the years to comply with and take advantage of guidance set forth under applicable state statutes. Given the present uncertainty and possible changes with respect to the federal estate and gift tax laws, the SLAT offers clients flexibility while making use of what might be a vanishing lifetime gifting exclusion.

THE CURRENT STATUS OF THE FEDERAL ESTATE AND GIFT TAX SYSTEM

Under the federal estate and gift tax system, there is presently an $11.7 million dollar unified estate and gift tax exclusion amount.[1] This allows a person to make large gifts which reduce the exclusion amount for both estate and gift tax purposes without paying gift tax unless or until the entire exclusion amount is exhausted. Current law provides for the unified estate and gift tax exclusion amount to be reduced to $5 million, plus post 2011 increases for inflation as a result of the changes to the ''Chained Consumer Price Index'' since 2012 (which many estimate will be approximately $6.5 million) effective January 1, 2026.[2]

There has been much discussion and ink spilled regarding the possibility of decreases to the federal estate and gift tax exclusion amounts prior to 2026, most notably including Bernie Sanders' recently proposed ''For The 99.5% Act,''[3] which calls for a reduction in the estate tax exclusion to $3.5 million and in the lifetime gifting exclusion to $1 million. Under the Bernie Sanders Bill, any gifts made by an individual exceeding $1 million would result in a gift tax that would be based upon graduated rates beginning at 45% and increasing up to 65%, depending on the amount of the gift. Therefore, many wealthy clients are faced with the possibility of a vanishing exclusion amount, which has caused them to consider making gifts of assets to utilize the present gifting exclusion amount that may not be available in the near future. Nevertheless, while many clients recognize that they want to use their vanishing lifetime gifting exclusion, they may not be inclined to part with the dominion, control, and access to assets that would otherwise be used for gifting purposes.

---

[*] Alan S. Gassman, J.D., LL.M., is a partner in the law firm of Gassman, Crotty & Denicolo, P.A., of Clearwater Florida, which he founded in 1987. He is on the Board of Advisors for the annual Notre Dame Tax and Estate Planning Institute, is board certified in Trusts and Estates by the Florida Bar, and is listed in Best Lawyers in America.

Christopher Denicolo, J.D., LL.M. is a partner at the Clearwater, Florida law firm of Gassman, Crotty & Denicolo, P.A., where he practices in the areas of estate tax and trust planning, taxation, physician representation, and corporate and business law.

Brandon Ketron, CPA, JD, LL.M. is a partner at the law firm of Gassman, Crotty & Denicolo, P.A., in Clearwater, Florida and practices in the areas of estate planning, tax, and corporate and business law.

[1] §2010(c)(3). All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] §2010(c)(3)(C).

[3] S. 994, 117th Cong. (introduced Mar. 25, 2021).

ISSN 0886-3547

THE SLAT: A USEFUL SOLUTION

For married couples, the SLAT is an excellent tool to help achieve the balance between gifting assets to make use of lifetime gifting exclusion and retaining the possibility of access to such assets because it involves the ''grantor-spouse'' establishing a trust for the ''beneficiary-spouse'' whereby the beneficiary-spouse can receive distributions as needed for his or her health, education, maintenance, or support (HEMS). The beneficiary-spouse also can be the sole trustee or a co-trustee of the SLAT, and the assets of the SLAT should not be subject to the beneficiary-spouse's creditors or subject to estate tax in the beneficiary-spouse's estate.

This is based upon the federal estate tax law in this area, which was enacted to run parallel to a fundamental tenet of the common law with respect to ''third-party irrevocable trusts.'' If a ''third-party irrevocable trust'' is formed by one person for the benefit of another person who can only demand or effectuate withdrawals to the extent needed for HEMS, the assets of the trust will not be subject to federal estate tax in the estate of the beneficiary (which typically would not be subject to the creditors of the beneficiary), unless there are certain strings attached or arrangements in place.

It is very important that a beneficiary of a trust (such as the beneficiary-spouse) not have the right or power to demand payment or benefits that are more than what is needed for his or her HEMS (such as distributions determined to be for the ''best interest'' of the beneficiary). A trustee other than the beneficiary may have the power to distribute the assets of the trust to the beneficiary beyond what is needed for HEMS, and this will not cause the assets of the trust to be subject to federal estate tax in the beneficiary's estate or subject to the beneficiary's creditors, so long as there is not an understanding between the beneficiary and the trustee that the trustee will make such distributions in excess of what is needed for HEMS. Likewise, a SLAT can be an important planning technique for single wealthy individuals who may want to benefit a future spouse. The Trust can be drafted with a ''floating spouse'' provision whereby the definition of the ''grantor's spouse'' is defined as the individual to whom the grantor is married at any given time.

As with much of the tax law and estate planning techniques, it can be a challenge to explain complex topics such as the federal estate and gift tax law and the SLAT to the clients in an easily understandable format that allows them to make an informed decision in view of the salient benefits and limitations. It is the authors' experience that even sophisticated and business-savvy clients can have difficulty with abstract concepts if they are not explained in layman's terms in writing and in a format that can be referenced at a later time. Clients can be better educated and have many of their questions answered by a well-drafted letter explaining the mechanics of a SLAT, the planning opportunities associated therewith, and the implications and limitations of the technique. Such a letter can be invaluable in communicating the complex ideas associated with the federal estate and gift tax law and the SLAT in simple terms.

A Client Friendly Explanation Letter of the SLAT

The authors recently prepared such a letter to a sophisticated retired CPA client that was largely similar to the following, although without the authors' annotations in the footnotes, which provide considerations regarding the design of a SLAT to reader of this article:

> Dear Client:
>
> It was a pleasure to speak with you on Friday. I thought that it would be useful to reiterate much of what we discussed.
>
> Under the federal estate and gift tax system, there is presently an \$11.7 million dollar unified estate and gift tax exemption. Under this exemption, a person can make large gifts which reduce the exemption amount for both estate and gift tax purposes.
>
> In addition, the first \$15,000 of gifts per year given directly to any one person do not count against the exemption. For example, if you gave your brother-in-law and his wife \$30,000 in a given year, this would not count against your exemption. If you gave them \$1,030,000 in a particular year, then your exemption would go down from \$11. 7 million to \$10.7 million dollars.

POTENTIAL LEGISLATIVE CHANGES TO THE FEDERAL ESTATE AND GIFT TAX SYSTEM

Under the Bernie Sanders proposed Estate and Gift Tax Reform Bill, the gift tax exemption would come down to \$1 million dollars.

If you make a taxable gift of \$120,000 this year that does not qualify for the \$15,000, then your lifetime exemption would be \$880,000 after the Bernie Sanders Bill passes (if it passes). Therefore, if you thereafter gift over the \$15,000 per person per year amount, then the reduction would be from \$880,000, and the gift tax of at least 40% (and possibly up to 65%) would be owed to the extent that you give in excess of the \$880,000 during your lifetime.

In addition, the Bernie Sanders Bill would reduce the federal estate tax exemption to \$3.5 million per

ISSN 0886-3547

person, so your exemption would be $3.38 million if the reduction occurs before or after you make a $120,000 reportable gift.

Even though it seems to me that it is unlikely that these provisions of the Bernie Sanders Bill could pass, many clients are advancing their estate tax planning under the assumption that something will happen eventually.

For example, the estate tax exemption is scheduled to come down to half of its otherwise inflation-adjusted amount in 2026 (which is expected to be approximately $6.5 million), and Congress could be in gridlock from now until well after 2026 on this issue.

Alternatively, a Democratic sweep of the House and Senate in 2022 could yield drastic changes to the federal estate and gift tax law, similar to what has been proposed by Bernie Sanders.

USE OF A SLAT

As a result, many married clients are entering into an estate planning trust arrangement known as a ''Spousal Lifetime Access Trust'' (a ''SLAT'') where one spouse forms an irrevocable trust for the benefit of the other spouse and their descendants.

> A combination of estate tax planning techniques that can be very effective for most individuals in your situation involves the creation of a SLAT for your spouse and descendants, and also a strategy called the ''Installment Sale to a Defective Grantor Trust'' and involves the following principles:
>
> 1. You can establish one or more irrevocable trusts for the benefit of your spouse and descendants that will pass estate tax-free but would be disregarded for income tax purposes.
>
> 2. As a result of this, you can pay the income tax on the income of the trust, without such payments being considered to be gifts for gift tax measurement purposes. This means that your exemptions would not be reduced and no gift tax would result from payments of income tax on the trust.
>
> 3. In addition, you can exchange or sell assets to the trust in exchange for other assets or a long-term low-interest note income tax-free, without this being considered to be a gift. Further, the interest on the note (which can be at a low rate) will not be considered as income to you for income tax purposes as long as the trust is disregarded for income tax purposes.
>
> 4. In addition, if you are selling or transferring minority or non-voting ownership interests in an LLC or other entity, then a discount may be taken in determining the value of what is sold or transferred. For example, if an LLC has $1 million in underlying assets, and you transfer a 70% non-voting interest to the trust, then the value of the 70% non-voting LLC interest is probably worth something like $490,000 after accounting for a 30% valuation discount.
>
> Please keep in mind that the Bernie Sanders Bill would grandfather arrangements put into place using the above four advantages before the Bill passes, but would essentially take away the right to use these four features in the future, or to make substantial changes to arrangements in place on the day that the bill passes.

Example of Use of SLAT

An example of an appropriate SLAT arrangement might be as follows:

> Howard has $1,500,000 worth of investments in an LLC that he has owned for three or four years.
>
> He would like to have the investments available to benefit his wife, Wilma, for her lifetime, and then to pass to be held for the lifetime benefit of their children, and later their grandchildren, without being subject to federal estate tax.
>
> Howard forms an irrevocable SLAT for Wilma and the children, and names Wilma and their friend, Frieda, as the co-trustees. Howard will have the right to replace the trustee of the trust at any time and for any reason with an individual who is not related to Howard or employed by him.
>
> The trust provides that Wilma can make distributions to herself based upon what is reasonably needed for her health, education, maintenance, and support.[4] Frieda, as an independent trustee who is not a beneficiary of the trust, will have the power to distribute to Wilma any or all of the trust assets at any time and for any reason as Frieda determines

[4] One question is whether the beneficiary/spouse is considered to be making a gift by not withdrawing amounts as needed for health, education, maintenance, or support when he or she has the right to do so. This is a possible issue, although, to the authors' knowledge, it has not been successfully argued by the IRS. Nevertheless, the adverse effects of the spouse being considered as having made a gift to the trust could be catastrophic because if the spouse makes a contribution to the Trust that benefits him or her, then the value of the Trust attributable to such gifts will be subject to estate tax upon his or her death and may be subject to his or her creditor claims. The authors have a savings clause in the SLATs that they draft which provides that any portion of the trust that is considered to have been funded by the beneficiary-spouse may not be used for the benefit of the beneficiary-spouse.

ISSN 0886-3547

in her sole and absolute discretion, with no duty whatsoever to make any such distribution.[5]

The trust also gives Wilma the right to redirect how the trust assets will pass upon her death as long as they are used solely for their descendants. This is known as a ''limited power of appointment.''[6]

In the example, Howard retains the right to replace trust assets with assets of equal value, which makes the trust ''disregarded'' during Howard's lifetime for federal income tax purposes. Additionally, Wilma's status as the trustee of the trust and as a beneficiary of the trust also causes the trust to be ''disregarded'' for federal income tax purposes during Howard's lifetime.[7]

This results in all income and deductions of the trust being reported on the income tax return of the grantor, or the joint income tax return of the grantor and the beneficiary-spouse, if the spouses file a joint Form 1040, *U.S. Individual Income Tax Return*.

The trustee of the SLAT should file a blank Form 1041, *U.S. Income Tax Return for Estates and Trusts*, for the trust with the IRS, along with a statement indicating that the trust has been established and that all income and deductions will be reported on Howard's tax returns. It is also prudent to include a list of the income and deductions of the trust on the statement.

Additionally, the trust provides for Howard and Wilma's trusted accountant, Alex, and Howard's cousin, Charles, to serve as independent Trust Protectors who can amend the trust (but only with Wilma's consent, or the consent of Howard and Wilma's common adult children) under certain circumstances, such as to modify the trusteeship or

---

[5] It should be possible for the beneficiary-spouse to choose an independent trustee who can give the spouse unlimited amounts based upon the HEMS standard, but might be best to limit the scope of potential Trustees that the beneficiary-spouse can appoint to any one or more listed individuals or trust companies. In any event, it is advisable that no such independent trustee should be a relative or employee of the grantor or the grantor's spouse, and that there be no pre-existing understanding that the independent trustee would give the beneficiary-spouse ''whatever he or she wants.'' By the same token, it is common not to have an independent trustee who could give the assets of the trust to the beneficiary-spouse in case some undue influence on both the beneficiary-spouse and the independent trustee were to apply. Notwithstanding the above, it is common to have ''Trust Protectors'' appointed to be able to amend a trust, and they may be given the power to direct the assets to the spouse.

[6] It is important to assure that the power of appointment be structured as a ''limited'' or ''special'' power of appointment, and not as a general power of appointment. A limited or special power of appointment is a power of appointment which is exercisable in any manner other than in favor of: (1) the powerholder herself; (2) the powerholder's creditors; (3) the powerholder's estate; or (4) creditors of the powerholder's estate. If a power of appointment allows the powerholder to exercise the power in favor of any one or more of the four above potential appointees, then the power will be considered to be a general power of appointment, and the assets subject to the power will be included in the powerholder's gross estate for federal estate tax purposes and probably would be subject to the powerholder's creditors under estate law.

Another consideration is whether the exercise of the limited power of appointment should be exercisable solely with the consent of one or more parties so as to prevent unwise or improper exercise. This approach is less common, as typically the class of appointees would be restricted so as to limit the possibility of undue influence or improper exercise of the power of appointment.

[7] An exception to grantor trust status applies if any and all distributions to the beneficiary-spouse must be approved by an ''adverse party,'' (a party with a substantial economic interest in the trust that would be adversely affected distributions to the beneficiary-spouse) and the spouse is not a trustee of the Trust. If the beneficiary-spouse is the Trustee and beneficiary of a SLAT, then it generally will be considered to be a grantor trust with assets of the trust being considered to be owned by the grantor for income tax purposes, unless distributions to the beneficiary-spouse require the approval of an adverse party and the beneficiary-spouse resigns from being the Trustee. In that event, the trust may not be considered as owned by the grantor for income tax purposes unless the grantor has another ''grantor trust power'' over the Trust, such as the right to replace trust assets with assets of equal value. There are some exceptions to the rule that the beneficiary-spouse serving as Trustee would cause grantor trust status to apply, but this requires careful drafting and it is generally advisable to have the beneficiary-spouse resign as trustee if grantor trust status is not desired.

For this reason, most well-drafted SLATs provide that no distributions will be made to the beneficiary-spouse without the approval of at least one other beneficiary of the Trust.

Families having several children and grandchildren typically have no problem with this standard because if no child or grandchild will approve a distribution, they can simply be disinherited under the exercise of the beneficiary-spouse's power of appointment.

This is a good reason to let the spouse's power of appointment be exercisable to charity or other non-descendants in case there is family squabbles or the spouses wish to disinherit members of the family for actions taken after the grantor-spouse's death.

With the repeal of §682, it may difficult, if not impossible, to toggle off grantor trust status. Specifically, the repeal of §682 causes the determination of whether a beneficiary is the ''grantor's spouse'' to be made at the time of establishment of the trust, and does not change as a result of the later divorce of the grantor and the grantor's spouse. This therefore causes the rights and powers of such spouse to be imputed to the grantor for the purposes of determining whether the trust is a grantor trust, regardless of whether the parties later divorce. In essence, the repeal of §682 causes a trust established for the benefit of the grantor's spouse to continue to be a grantor trust for federal income tax purposes notwithstanding a divorce between the spouses. Most authorities believe that, if the power of the trustee to make distributions to the beneficiary-spouse must be approved by ''an adverse party'', then grantor trust status may be toggled off even if the beneficiary-spouse remains as a beneficiary of the trust. However, this is not exactly clear following the repeal of §682.

ISSN 0886-3547

change the distribution standards applicable to the trust.[8]

Howard makes a gift of $100,000 to the trust and provides that his four children each have the right to withdraw up to $15,000 from the trust within 60 days of when he makes the contribution. This will cause $60,000 of the contribution not to count against Howard's $11.7 million estate and gift tax exemption if he makes no other gifts to the children during the year.

Howard also provides Wilma with a right to withdraw up to $5,000 from the trust within 60 days of his contribution. This allows for another $5,000 of the $100,000 contribution to not be considered to be a gift that will reduce Howard's lifetime exclusion. None of Wilma or the children exercise their withdrawal rights.

Howard will, therefore, file a gift tax return in the following calendar year showing use of only $35,000 of his $11.7 million dollar estate tax exemption, so it will be $11.665 million or will go to $965,000 if the Bernie Sanders Bill passes.[9]

Howard recapitalizes the ownership of his LLC so that he owns 1% of the LLC as the sole voting member and 99% as a non-voting member.

Howard then sells his 99% non-voting member interest to Wilma and Frieda, as co-trustees of the trust, in exchange for a long-term low-interest promissory note.[10]

[8] Another common strategy is to give the Trust Protectors the power to give the surviving spouse the right to direct trust assets to creditors of his or her estate, which should be a general power of appointment. This approach might be attractive where the estate tax is not as much as a consideration as the income tax because giving the beneficiary-spouse a general power of appointment will cause the assets to be considered as owned by him or her for federal estate and income tax purposes to allow for the assets of the trust to receive a new income tax basis equal to fair market value upon her death.

Trust Protectors may also be given the power to install a general power of appointment that can be exercised by an older or infirm relative in order to have the trust assets receive a new income tax basis on the death of the powerholder.

Under the present law, it does not appear that the powerholder needs to be a beneficiary of the trust in order to cause this to happen.

This result seems too good to be true and may, therefore, be eliminated in future tax law changes.

[9] It might be possible for the grantor/spouse and beneficiary-spouse to split the gift made to the SLAT under the ''gift-splitting rule'' notwithstanding that the beneficiary-spouse is a beneficiary of the trust. The effect of the split gift is that the gift is treated as having been made one-half by each spouse for federal estate and gift tax purposes, therefore reducing each spouse's exclusion amount by one-half of the value of the gift.

The IRS has taken the position that a spouse cannot split a gift to a trust of which he or she is a beneficiary where the beneficiary-spouse's interest was not terminable or severable from the other beneficiaries' interests, but the courts have limited this to situations where it is reasonably expected that the spouse will benefit from the trust, or that the amount that can be split will be reduced by whatever portion of the trust that would be expected to benefit the spouse. *See* Steiner, Bruce *Gift-Splitting Where the Spouse is a Beneficiary,* 37 Est., Gifts & Tr. J. No. 6, 320 (Nov. 8, 2012) (citing e.g. *Robertson v. Commissioner,* 26 T.C. 246 (1956).

If Mr. and Mrs. Smith have $100,000,000 in joint assets, and the trust provides that Mrs. Smith can only access the trust if and when needed for health, education, and maintenance after taking into account other sources of income and resources, then it appears the gift can be split.

If this is an issue and the trust indicates that Mrs. Smith's cumulative benefits from the trust cannot exceed $4 million then she should be able to split the gift to the extent of at least $5 million ($9 million minus $4 million) in the above example.

[10] The authors have found that the most effective use of a SLAT for a married couple with a high net worth is to facilitate an installment sale using discounts and low-interest rates that are presently available, especially after the Bernie Sanders ''For the 99.5% Act'' has indicated that the possibility that discounts for non-business entities and grantor trusts status (whereby the income of the trust can be reported and paid under the grantor's Form 1040 income tax return) may not be available once further tax legislation has occurred. The Bernie Sanders proposed legislation would grandfather those arrangements in place before it is passed.

Clients can be informed that most tax legislation becomes effective back to the date that it is proposed by the Ways and Means Committee of the House of Representatives, which is where tax legislation formally and technically comes into existence.

Getting defective grantor trusts and installment sales into place can take a number of weeks because of the step transaction doctrine, and it is difficult to predict when legislation may come out of the House Ways and Means Committee.

It is noteworthy that the installment sale to the SLAT should usually come only from the grantor for two primary reasons: (1) if the sale is considered to be a bargain sale by the IRS, then the grantor would be considered to be the contributor to the trust. If the beneficiary-spouse is considered to be a contributor to the trust, then a portion of the trust will be subject to federal estate tax upon such spouse's death, as discussed above; and (2) interest paid by one spouse to another spouse results in interest income, even if they file a joint Form 1040 income tax return.

The death of the grantor-spouse who has sold appreciated assets to a SLAT may cause an income tax event, according to some authorities. *See* Mulligan, Michael, *A ''Reality of Sale'' Analysis of Installment Sales to Grantor Trusts: Properly Structured, the Best Transfer Tax Strategy* , Lewis Rice (Aug. 2015) (citing *Mandorin v. Commissioner* 84 T.C. 667 (1985). Many authorities appear to agree that the promissory note held by grantor-spouse would receive a step-up in income tax basis upon the death of the grantor, therefore causing any payments of principal owed under the promissory note to be income tax free. Mulligan, Michael, (citing Blattmachr, Gans, and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. Tax No. 3, 149 (2002) (citing *Crane v. Commissioner* 331 U.S. 1 (1947)).

On the other hand, toggling off grantor trust status during the

ISSN 0886-3547

If this occurs in May of 2021, then Howard and Wilma can use the lowest interest rate that applies under the ''Applicable Federal Rates'' that are issued by the IRS for March, April, and May of 2021. Howard's life expectancy is 20 years, so his lawyer recommends a 20-year promissory note so that if interest rates go up, the note will be locked into the low rate now available for 20 years, which requires a minimum interest rate of 1.61% per year based upon the March 2021 Applicable Federal Rate for ''long-term'' debt obligations (i.e., loans with a term of longer than 9 years).

Howard hires a valuation expert recommended by his certified public accountant who reviews the information about the LLC and its investments, and the valuation expert determines that a 30% valuation discount should apply to the value of a non-voting interest in the LLC.

Therefore, the promissory note will be for just under $1,039,500, and the annual interest payable will be approximately $16,735 per year based upon an annual interest rate of 1.61%. The trustee will also be able to prepay the note without penalty.

One variation to the above is for the promissory note to be ''self-canceling,'' at least to some extent. This variation requires that the higher interest rate be used on the promissory note in exchange for the promissory note ''canceling'' if the ''grantor'' (i.e., Howard) dies during the promissory note term. The benefit of this technique is that the value of the note will not be included in Howard's estate if he were to die during the note term. The downside is that a higher interest rate must be used, which would require additional amounts of payments to be made annually and which would therefore increase Howard's gross estate for federal estate tax purposes.

The additional interest rate charged under a self-canceling installment note (SCIN) is known as a ''risk premium'' and generally is based upon the actuarial life expectancy if the grantor/spouse is of reasonable health when the note is entered into. It is usually appropriate that the grantor/spouse has at least a 50% chance of living to his or her actuarial life expectancy. Normally, the note will need to balloon based upon the life expectancy of the person when it is entered into.

For example, a 60-year-old has a life expectancy of 21.54 years under the current actuarial tables, and said actuarial tables provide that the applicable annual interest rate for a 21-year SCIN that would cancel if the grantor died during the 21-year term should be 3.578%. Therefore, if the 60-year-old dies before the end of the 21-year promissory note term, then the promissory note should not be considered as a taxable asset for federal estate tax purposes.

For a 50-year-old, the life expectancy under the actuarial tables is 29.88 years, and the interest rate for a 29-year interest only SCIN would be 2.63%.

For many younger clients, it therefore makes sense to use a SCIN rather than a conventional promissory note because the risk premium is low given the relatively small likelihood that the person would die during his or her actuarial life expectancy.

CREATION AND OPERATION OF THE SLAT

There are several guidelines that must be followed with respect to the creation and operation of the SLAT, in order to help assure that the trust functions as intended and that unintended adverse estate or gift tax consequences do not result. These guidelines laid out below are as follows.

First, The trust must be funded solely by the grantor-spouse, and not by the beneficiary-spouse.

If the spouse who is the beneficiary of the trust is shown to have made contributions to it and is a beneficiary of assets so contributed, then that portion of the trust that has been contributed by the beneficiary-spouse will be considered to be owned by the beneficiary-spouse upon his or her death. This can have adverse tax and creditor protection consequences because the portion of the trust that is considered to be owned by the beneficiary-spouse will be subject to estate tax upon his or her death, and also will be subject to any creditor claims against the beneficiary-spouse.

For this reason, we normally have the grantor-spouse as the sole seller and contributor of assets to the trust because if the IRS were to determine that a sale to the trust by the beneficiary-spouse was a ''bargain sale/part gift,'' then the gift element would be considered to be a contribution in part by the beneficiary-spouse, causing the assets to be subject to estate tax to that extent.

As a protective measure, we have a provision in our trusts which provides that any contribution considered as having been made by the beneficiary's spouse will go into a separate sub-trust to benefit only descendants. Nevertheless, the IRS may not respect such a ''safety clause,'' especially if the addition to the trust's

grantor's lifetime with an installment note in place may cause income tax to be incurred as if the sale occurred when the toggle off is completed. This may be avoided by swapping assets with the trust so that the trust does not own assets that have a fair market value exceeding the basis at the time that the trust is toggled off.

ISSN 0886-3547

net value by the beneficiary spouse is intended, or the result of highly aggressive conduct.

For example, if the grantor/spouse makes an $800,000 gift to the trust and the beneficiary-spouse sells an asset to the trust for $1.1 million (that is later determined to be worth $1.3 million) in exchange for a $1.1 million note, then the beneficiary-spouse may be considered to be the owner of 20% of the trust assets for estate tax purposes. The provision in our trust agreements should cause 20% of trust assets to be considered as held in a separate sub-trust for the sole benefit of the descendants of the spouses and not for the benefit of the beneficiary-spouse.

It is noteworthy that when a trust is considered to be created by one spouse for income tax purposes (for example, because that spouse funded the trust with a gift and retained the right to replace trust assets with assets of equal value), then monies owed by the trust to the other spouse will cause interest income to the other spouse and may cause an interest deduction to the grantor/spouse depending on the circumstances (such as whether the spouses itemize their deductions, and if the interest relates to a personal residence or business or investment assets).

Second, one potential issue is where assets contemplated for transfer are owned jointly or in part by the beneficiary/spouse. As described above, it is important that the beneficiary/spouse not be considered as a contributor to the trust because of the adverse estate tax and creditor protection consequences that could result.

When the beneficiary/spouse has an ownership interest in assets that the couple would like to have go into the SLAT, the grantor/spouse may purchase those assets from the beneficiary/spouse by trading assets of equal value or giving the beneficiary/spouse a bona fide promissory note that is enforceable under state law.

For example, Howard and Wilma would like for Howard to donate $ 100,000 to a trust for Wilma and descendants and sell an investment property that Howard and Wilma own jointly that is worth $400,000 to the trust.

Howard may give Wilma $200,000 from his checking account in exchange for Wilma transferring her 50% ownership in the property to Howard. Howard may then sell the property to the SLAT in exchange for a note.

As described above, if Wilma makes a sale or loans money to a trust considered as owned by Howard for income tax purposes, then Wilma will have taxable income that must be reported on her Form 1040 income tax return or the return that she and Howard file jointly, and Howard may or may not have a corresponding deduction, depending on the circumstances (such as whether Howard and Wilma itemized their deductions, and if the interest relates to a personal residence or business or investment assets).

Third, it is important to have a valuation report prepared by a qualified and reputable valuation expert to support the sale price of the asset being sold. This can help assure that the sale price is based upon the fair market value of the asset being sold and that such sale price might withstand IRS scrutiny. Nevertheless, the IRS may challenge the sale price and argue that the transaction was a ''bargain sale'' whereby the excess in the value of the asset over the sale price is considered to have been a gift made by the grantor/spouse.

One way to reduce the risk of a bargain sale characterization by the IRS would be to have the grantor/ spouse who is selling the asset do so with ''valuation adjustment clauses,'' which would cause a change in the sale amount if it turns out that the value of the assets transferred is more than the note received in exchange for it.

It is very important that precise language be used under these types of clauses which specifically refers to if and when a court would make a determination of a value other than what is used in a gift or sale transaction for federal gift tax purposes. A recent court case reached an unintended result when interpreting a valuation adjustment clause because the language did not contain the necessary wording.

There are three different kinds of valuation adjustment clauses:

1. A commonly used valuation adjustment clause is a ''Wandry'' clause, which is named after a recent court case in which a court upheld use of this type of provision.[11] The Wandry valuation adjustment clause involves stating the assets being transferred in terms of a specified dollar amount, rather than in terms of a percentage of ownership in an entity. The goal is that the percentage of ownership of an entity or asset transferred will be reduced if the IRS takes the taxpayer to court and proves that the interest was worth more than agreed. An example of the language used in this type of clause is as follows: ''I hereby give to the Trustee of ABC Trust an amount of non-voting ownership interests in ABC, LLC worth $1 million in exchange for a $ 1 million promissory note.''

We typically would have a valuation report showing that $1 million of non-voting LLC interests are equivalent to a specified percentage of ownership in the LLC (such as 65%). The result of the above

[11] *Wandry v. Commissioner*, T.C. Memo 2012-88.

ISSN 0886-3547

language is that, if it turns out that 65% of ABC, LLC is worth more than $1 million, then the percentage given will be reduced to whatever is worth $1 million.

2. A second type of valuation adjustment clause is known as a ''King'' clause, which also is named after a court case that approved this type of provision.[12] The King clause defines the assets transferred in terms of a percentage of ownership as is typically done under a conventional assignment document, but provides for the sale price and/or outstanding balance of the promissory note to be adjusted based upon whether the value of the assets transferred is determined to be greater than what is contemplated under the documents.

An example of the language used in a King valuation adjustment clause is as follows: ''I accept a $1 million promissory note for 65% of ABC, LLC, but if it turns out that 65% of ABC, LLC is worth more than $1 million then the promissory note, with retroactive interest, will be for the appropriate greater amount.''

3. The third type of adjustment clause, known as a ''McCord/Petter'' clause, or charitable overflow clause, involves transferring a specified number of shares, with shares equal to a defined dollar amount going to the trust with any excess passing to a charity. If the IRS takes the taxpayer to court and proves that the interest was worth more than agreed, then the number of shares exceeding the specified dollar amount would pass to charity and qualify for the charitable gift tax deduction so that no taxable gift would be made to the trust.

An overly simplified example of the language used in a McCord/Petter clause is as follows: I hereby sale transfer and assign $8 million worth of stock to the Trustee of the ABC Trust, and hereby gift $900,000 worth of stock to the Foundation, provided that if a court determines that the value of the amount of stock sold to the trust as finally determined for federal gift tax purposes exceeds $8 million, then the excess stock above the amount of $8 million will instead pass to the Foundation as a charitable gift.

Fourth, from an operational standpoint, the SLAT should be kept separate and apart from the assets of the couple, and have its own separate checking or brokerage account, and be considered a separate fiscal entity.

The SLAT does not need to file an income tax return or pay any income tax, but it is best for the SLAT to have a separate taxpayer identification number to help establish that it is a separate entity, and to facilitate it having its own bank or brokerage account. The SLAT does need to file a blank Form 1041 income tax return with a statement that basically lets the IRS know that the income and deductions of the SLAT are going onto the tax return of the donor, or the married couple if they file jointly.

As mentioned above, there is no income tax on the sale of assets to a trust that is disregarded for income tax purposes, and no interest considered to be received or paid for income tax purposes when the trust owes money and pays interest to the grantor.

It is important that the interest payments be made at least annually and that the terms of the documents are complied with to help assure that the trust and the installment sale will be respected by the IRS.

USE OF RECIPROCAL SLATS

Finally, a common question asked by clients is whether spouses can establish trusts for each other and descendants. There is something known as the ''reciprocal trust doctrine'' where the IRS has argued that each spouse would be considered as a beneficiary of the trust that they have established, which could lead to the assets in both trusts being included in the estate of the applicable grantor and subject to the creditor claims of the grantor/spouse.[13]

There are tax court cases and a few IRS rulings which have permitted ''reciprocal SLATs,''[14] but our law firm does not recommend them or feel comfortable installing these in the way that some estate planners might.

Our concern is that the Tax Court and IRS pronouncements do not mention the creditor protection implications of reciprocal trusts. Specifically, if under state law, a creditor can reach into a reciprocal trust that spouses establish for each other (which would be based upon a ''state law reciprocal trust doctrine''), then the IRS likely would take the position that the

[12] *King v. United States*, 545 F.2d 700 (10th Cir. 1976).

[13] One question is whether a trust formed in an APT jurisdiction will be considered to be ''creditor proof'' if the jurisdiction allows family support claims, such as alimony and child support, to be paid by the trust. For this reason, the authors prefer to use jurisdictions that do not allow for the payment of any family support obligations, such as Nevada and South Dakota. Delaware permits the claims of the spouse presently married to the grantor of the trust to be paid from the trust, but does not allow such claims of a ''future spouse.''

[14] *See, e.g., Estate of Levy v. Commissioner*, T.C. Memo 1983-453; *Lueders' Estate v. Commissioner*, 164 F.2d 128 (3d Cir. 1947); PLR 200426008, *but see also United States v. Grace*, 395 U.S. 316 (1969). For an excellent summary of the Reciprocal Trust Doctrine and planning to avoid its application see Bruce D. Steiner & Martin M. Shenkman, *Beware of the Reciprocal Trust Doctrine*, Trusts & Estates (Apr. 2012).

ISSN 0886-3547

assets in each trust are therefore subject to estate tax in the applicable grantor's state.

There is a ''common law'' reciprocal trust doctrine that goes back to England, which provides that if two people form trusts for each other at approximately the same time and the trusts benefit each other, then creditors of each person may reach into the trust established for them by their spouse as if they had established the trust for themselves. Florida, like many other states, has adopted the common law of England as it existed on July 4, 1776.

Therefore, our concern is that the trust would be subject to estate tax if creditors can reach into the trust as a matter of state law.

For this reason, clients who would like to consider ''reciprocal trusts'' should establish one or both trusts in an asset protection jurisdiction that does not allow creditors into a trust even if it is formed and funded by a beneficiary, such as Nevada, South Dakota, Alaska, and Delaware. Nevertheless, individuals residing in non-asset protection jurisdictions, such as Florida, Texas, and California, cannot be sure that the law of an asset protection jurisdiction where a trust is formed would be applicable if the debtor/grantor of the trust, the beneficiary, and the creditor are all in a state like Florida, Texas, or California that does not recognize the asset protection trust (APT) laws.

Therefore, the vast majority of our clients form one trust as a SLAT, with the beneficiary spouse forming a trust solely for descendants that may be situated in Nevada, South Dakota, Alaska, or Delaware but may allow one or both spouses to become beneficiaries only if unexpected circumstances arise, and individuals named as Trust Protectors have the discretion to add one or both spouses as a beneficiary if and when such unexpected circumstances may arise.

Nevertheless, it may be of interest that trusts that provide only for the health, education, maintenance and support of one or more beneficiaries may be moved to Nevada, South Dakota, Delaware, or another APT jurisdiction in order to provide for independent Trust Protectors to have the ability to add the grantor/spouse as a beneficiary of the trust if and when certain circumstances occur.[15] This approach can add additional flexibility, while likely avoiding any adverse estate tax or creditor issues based upon the laws of the above-referenced jurisdictions providing that the creditors of a grantor of an irrevocable trust cannot reach into a trust established for the grantor's benefit.[16]

Unexpected circumstances may include divorce and significant financial misfortune (such as the grantor's net worth dropping below a certain threshold which is far lower than the grantor's net worth as of creation of the trust).

Given that Trust Protectors may be neutral or may favor one spouse over another, the trust instrument may provide that there will be specific Trust Protectors of each separated trust in the event of divorce. Some clients are skeptical or concerned that Trust Protectors may not act in the way intended when the time comes for a potential Trust Protector action. The authors commonly give the beneficiary-spouse a right to veto actions taken by the Trust Protectors.

As a practical matter, most couples who have estate tax issues should be able to live comfortably on the assets not going into the SLAT, promissory notes that the SLAT may owe the grantor/spouse, and promis-

[15] The vast majority of SLATs are prepared and implemented by individuals who reside in states that would allow creditors to reach into a trust where the grantor is a beneficiary. This follows the English common law and was the law of all 50 states until the 1997 when Alaska, with the assistance of Jonathan Blattmachr, passed a trust law which basically provides that a grantor's creditors cannot reach into an irrevocable trust where the Trustee has the discretion to make distributions to the grantor.

As the result of this, it appears that a SLAT formed by a couple who resides in an APT Trust jurisdiction may provide that the grantor will be a beneficiary of the trust, although the IRS has not heartily endorsed this.

Therefore, individuals who reside in APT jurisdictions may want to provide that Trust Protectors can add the grantor to the trust in their discretion so that the grantor is not considered to be a beneficiary of the trust. This assumes that the Trust Protectors are not ''fiduciaries'' and have full discretion as to whether to add the grantor or not.

Families residing outside of APT jurisdictions need to be even more careful because we do not yet have many court cases on the question of whether the law of a non-APT jurisdiction will apply to a trust where the grantor, beneficiaries, and creditors involved in the situation are in a state that does not recognize the APT rules.

As an additional safeguard, the authors commonly recommend that the grantor cannot be added as a beneficiary by the Trust Protectors unless an unexpected ''event of independent significance'' occurs, such as in the event of a divorce or if the grantor's assets and earnings become insufficient to support him, or his net worth drops below a certain level.

In addition, such trust agreements should specifically provide that the grantor is not a beneficiary that could become a discretionary beneficiary of a trust established in an APT jurisdiction.

[16] PLR 200944002 ruled that an irrevocable trust established by a grantor which he is the beneficiary would not be subject to estate tax in the grantor's estate if the grantor's creditors cannot reach into the trust under state law, so long as the grantor is not the trustee and there is not an understanding or pre-existing arrangement between the grantor and trustee that trustee's exercise his discretion to make distributions to or for the benefit of the grantor.

It is noteworthy that the laws of Nevada and South Dakota (and other states) permit a trust to be decanted or reformed to allow an independent trustee to have the power to make discretionary distributions to a beneficiary under a trust that only permitted distributions as needed for HEMS, notwithstanding whether this was consistent with the intentions of the grantor.

ISSN 0886-3547

sory notes that may be due from an irrevocable trust established solely from descendants (a ''Descendants' Trust''), without ever having to worry about whether they might need to invade a Descendants' Trust.

As a worst-case scenario, the Descendants' Trust might make distributions to descendants who might then loan money or provide financial assistance for parents, although there cannot be an agreement or understanding that this would ever occur when a Descendants' Trust is formed and funded.

CONCLUSION

As described above, the SLAT is a versatile and flexible planning tool that can be a great fit for many clients' situations. The SLAT can provide both advantages and be subject to limitations or potential issues. It is therefore important to assure that the clients are aware of potential restrictions and implications of establishing and funding a SLAT and to program in as much flexibility as possible.

ISSN 0886-3547