Looking for a trust that can also act as a financial backup plan? Consider a SLAT

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Some of the most effective estate planning strategies involve setting up irrevocable trusts. For a trust to be deemed irrevocable, you, the grantor, lose all incidents of ownership of the trust's assets. In other words, you're effectively removing those assets from your taxable estate.

But what if you're uncomfortable placing your assets beyond your control? What happens if your financial fortunes take a turn for the worse after you've irrevocably transferred a sizable portion of your wealth? This may be an especially pertinent question in light of the current economic downturn resulting from the novel coronavirus (COVID-19) pandemic.

If you're married, and feel as though your marriage is strong, a spousal lifetime access trust ("SLAT") allows you to obtain the benefits of an irrevocable trust while creating a financial backup plan.

A SLAT in action

A SLAT is simply an irrevocable trust that authorizes the trustee to make distributions to your spouse if needs arise. Like other irrevocable trusts, a SLAT can be designed to benefit your children, grandchildren or future generations. You can use your lifetime gift tax and generation-skipping transfer tax exemptions (currently, $11.58 million each) to shield contributions to the trust, as well as future appreciation, from transfer taxes. And the trust assets also receive some protection against claims by your beneficiaries' creditors, including any former spouses.

The key benefit of a SLAT is that by naming your spouse as a lifetime beneficiary you retain indirect access to the trust assets. You can set up the trust to make distributions based on an "ascertainable standard" — such as your spouse's health, education, maintenance or support — or you can give the trustee full discretion to distribute income or principal to your spouse.

To keep the trust assets out of your taxable estate, you must not act as trustee. You can appoint your spouse as trustee, but only if distributions are limited to an ascertainable standard. If you desire greater flexibility over distributions to your spouse, appoint an independent trustee. In addition, the trust document must prohibit distributions in satisfaction of your legal support obligations.

Another critical requirement is to fund the trust with your separate property. If you use marital or community property, there's a risk that the trust assets will end up in your *spouse's* estate.

Understand the pitfalls

There's a significant risk inherent in the SLAT strategy: If your spouse predeceases you, or if you and your spouse divorce, you'll lose your indirect access to the trust assets.

One way to mitigate this risk is to use dual SLATs. In other words, you and your spouse each establish an irrevocable trust using your separate property and naming each other as lifetime beneficiaries. However, if that approach is to be used, it's necessary to avoid the "reciprocal trust" doctrine, which can cause the SLATs to become "uncrossed" and taxable in the original donor's estate. Some of the possible techniques to help keep the SLATs separate include the following: (1) different trustees or co-trustees; (2) different rights to the trust (e.g., one spouse might have access to income, but the other spouse only to principal); (3) different beneficiaries (e.g., one SLAT might be for just the spouse, while the other SLAT might be for spouse and children); (4) different powers (e.g., one SLAT might have a special power of appointment to change the distribution of assets to certain family members or charities); (5) fund with substantively different assets (e.g., one SLAT receives cash and securities, and the other SLAT receives a share of the family business or real estate). Another strategy to avoid the rule is simply to space out the SLATs in the first place (e.g., one SLAT is created now and the other SLAT is created in the future) - if one is created now, and the other isn't established until years from now, it's difficult for the IRS to claim they were purely reciprocal (obviously the caveat is that waiting too long may diminish the benefit of the strategy, but that "risk" is part of what substantiates the trusts aren't reciprocal).

If you're considering using a SLAT, or would like to learn about other estate planning strategies, please contact us to learn more about the benefits and risks.

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