Spousal Lifetime Access Trust (SLAT)

Concept

A Spousal Lifetime Access Trust (SLAT) is an irrevocable trust that can own permanent life insurance and/or other assets. A SLAT permits the non-insured spouse to have access to the trust for distributions of principal and income during the spouse's lifetime, while continuing to prevent inclusion of the death benefit in the grantor's estate.

Situations

An irrevocable trust can be an excellent vehicle for providing controlled distributions of assets to heirs, while at the same time keeping the trust proceeds outside the grantor's taxable estate. One major drawback, however, is that in order to accomplish these objectives, such a trust must be irrevocable and the grantor cannot directly receive any benefits from the trust, and at best can hold very constrained control over the trust. Many people are unwilling to create an irrevocable trust because they are hesitant to give up access to, and management of, a large portion of their wealth.

However, two trust designs exist that provide a grantor's spouse limited accessibility during the spouse's life, while keeping the assets within the trust out of both the grantor's and the spouse's taxable estates. One is the SLAT mentioned above; the other is the Survivorship Spousal Trust (or Survivor Life SLAT).

Requirements and Logistics

Spousal Lifetime Access Trust

In a SLAT, the trust must be irrevocable and the grantor/insured must not have any incidents of ownership in an insurance policy on the grantor owned by the trust. Someone other than the insured and/or grantor should serve as trustee of the trust. The spouse may serve as trustee; however, certain limitations must be placed on his or her powers to make distributions to him or herself, in order to avoid inclusion of the trust principal in his or her estate. A concern arises if an individual is both a trustee and a beneficiary, and the trustee has discretion to distribute assets to him or herself. Under Internal Revenue Code (Code) §2041, such discretion can amount to a general power of appointment, which causes inclusion in the power holder's estate. To avoid this result, the trustee's power to distribute assets to himself or herself should be limited to an "ascertainable standard" (one a court can enforce) related to health, education, maintenance and support.

A spouse can also have a right to withdraw assets from the trust in any one year up to the greater of $5,000 or 5% of trust assets (a so-called "5 or 5" power). Such a power does not create a general power of appointment in the trust that would result in estate inclusion, nor does the failure to exercise such a right create a taxable transfer on behalf of the spouse back to trust.

Frequently it is desirable to have the spousal beneficiary serve as trustee, a combination of the 5 or 5 power and the ascertainable standard can exclude the value of the trust property from both the grantor's and the spouse's estate, while at the same time provide substantial access to trust property.

A broader distribution standard can also be available to an independent trustee, an individual or institution that is neither a grantor nor beneficiary of the trust. Such a broad distribution power can offer a measure of additional flexibility should circumstances change. Care must be exercised in maintaining independence in the role, though. If a grantor or beneficiary appears to exert undue control or influence over the independent trustee (perhaps due to being related or subordinate), the independent trustee's powers could be imputed to such grantor or beneficiary.

One major drawback of the SLAT is that the ability to access the trust comes only through the spouse's interest as a beneficiary. If the spouse should die before the grantor or if there is a divorce, this access may be lost. If the grantor remarries, the trust may provide that his or her new spouse may become the trust beneficiary. If the grantor does not remarry, he or she may still have access to the trust assets if the trustee has the power to lend trust property to the grantor. Repayment would become an obligation of the grantor and/or the estate.

It should be stressed that access to the trust is not unlimited. If the spouse exercises a withdrawal right and consistently uses those distributions for the grantor's benefit, this could be considered a retained interest, thus triggering inclusion of the trust principal in the grantor's estate. To avoid this result, trust distributions should be used for the primary benefit of the uninsured spouse.

Funding the SLAT

Transfers to SLATs are generally completed gifts for gift tax purposes. A grantor may therefore utilize his or her lifetime gift tax exemption (currently $5.43 million per individual (in 2015)) to fund a SLAT without the actual payment of gift taxes. Additionally, gifts up to the annual gift tax exclusion (currently $14,000, subject to cost of living adjustments) may be made to each of an unlimited number of recipients annually. Such gifts are excluded from gift taxation only if they are "present interest" gifts, meaning that the recipient has current enjoyment of the gift. Gifts to trusts ordinarily would not convey immediate enjoyment to the trust beneficiaries, and thus are ordinarily be excluded from gift taxation. To convey immediate enjoyment, however, a beneficiary can be given a temporary right to withdraw the trust gift.

When funding a SLAT, it is important that the grantor use his or her own separate property. If any contributions to the trust are from property owned by the uninsured spouse, the uninsured spouse would be treated as a grantor of the trust, and his or her status as both grantor and beneficiary would cause inclusion of the trust property within the taxable estate at the uninsured spouse's death. It is particularly important to take preventative measures to avoid contributing assets of the uninsured spouse in community property states where both spouses are considered to own half of all community property. This may be accomplished by partitioning community assets into separate property and using the grantor's partitioned assets for contributions to the trust.

Also, if the grantor is considering the transfer of an existing life insurance policy to the trust, the uninsured spouse should gift any interest he or she owns in the policy to the grantor spouse before transferring the policy to a trust. (In community property states, partitioning of the policy may be required first.)

While it may appear that each spouse establishing a SLAT for the other's benefit could achieve additional leverage, couples must exercise caution. If two similar SLATs are created, particularly close in time, the Service could uncross the transactions and apply the reciprocal trust doctrine. This doctrine is applied when individuals make transfers that are deemed to be reciprocal in nature, resulting in each spouse's trust being deemed established for his or her own benefit, rather than the benefit of the named spousal beneficiary. In most situations, this results in estate inclusion of the trust property for each spouse.

Survivorship Spousal ILIT or Survivor Life SLAT

When utilizing survivorship life insurance in a SLAT, additional considerations are generally present. In order to avoid creating an incident of ownership (and thereby inclusion of the trust-owned life insurance policy within either spouse's estate), neither spouse should generally serve as a trustee of the Survivor Life SLAT. Instead, a family member or close friend is typically named trustee.

As in a single life SLAT, the non-grantor spouse is generally named as a beneficiary, and the grantor must be sure to use separate property to fund the trust. In addition, reciprocal trust issues are a concern if each spouse creates a trust.

When designing the permanent life insurance policy for a Survivor Life SLAT, if the policy is to be funded with annual exclusion gifts from the grantor (as described above), the clients also should consider one or more alternative funding strategies, in the event the grantor spouse dies before the premiums on the survivorship policy are fully paid. Otherwise, if the grantor is the first of the two insureds to die, the SLAT may lack the additional funds it will need to maintain the policy in force until the death of the second insured spouse.

One alternative funding strategy to consider is for the SLAT to purchase a first-to-die term rider on the life of the grantor for a death benefit amount equal to the scheduled premiums. If the grantor dies while the first-to-die term rider is in force, the SLAT could then use the death benefit proceeds it would receive upon the grantor's death to help it fund any remaining premiums on the survivorship policy. Alternatively, if the grantor lives long enough and completes the funding of the survivorship policy, the first-to-die coverage could be dropped. A second strategy to complete the funding of the SLAT in the event of the grantor's premature death would be for the grantor to bequeath to the SLAT the additional funds it would need to complete the funding of the survivorship policy. This strategy could easily be implemented pursuant to a formula clause in the grantor's will or living trust.

Tax Ramifications

The primary goal of creating an irrevocable trust is to remove the trust assets from the grantor's gross estate for estate tax purposes. However, there are several ways an irrevocable trust can be includible in the grantor's estate. First, §2036 of the Code provides that a decedent's taxable estate includes any property transferred by the decedent in which the decedent retained a beneficial interest (including the right to income), or the right to control who owns or enjoys the use of the property. Section 2036 may apply indirectly if the trustee has the ability to control the ownership or use of the property and the grantor can replace the trustee with him or herself.

A second basis for inclusion is §2038 of the Code which requires inclusion of assets transferred if the decedent retained the right to alter, amend, revoke or terminate the terms of the recipient's enjoyment of the property. Section 2038 may apply indirectly if the trustee has the ability to change the terms of the beneficiaries' enjoyment of the property, and the grantor can replace the trustee with him or herself.

If the trust owns permanent life insurance policies on the grantor's life, §2042 of the Code could require inclusion of the proceeds of the policies in the grantor's estate if the grantor/insured has any incidents of ownership over the policies. An example might be the right to borrow against the policy's cash surrender value. Similarly, if the grantor/insured transferred existing policies on his or her life to the trust and died within three years of the transfer, §2035 of the Code would cause inclusion of the policies in his or her taxable estate.

Therefore, a properly drafted SLAT will not:

- Grant any beneficial interest to the grantor,
- Give the grantor any power to replace the trustee with himself or herself, or
- Give the grantor any incidents of ownership in the policy.