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Spousal Lifetime Access Trusts – A Fleeting Opportunity

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Charles A. Redd is a partner in the St. Louis, Missouri, office of the law firm of STINSON LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now Bank of America Private Bank).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

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Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Past Chair of Communications Committee; Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as a member of the Advisory Committee for the Heckerling Institute on Estate Planning and is Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils. In 2023, he was recognized by the Estate Planning Council of St. Louis as Distinguished Estate Planner of the Year. Mr. Redd is listed in The Best Lawyers in America and is "Band 1" ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

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I. INTRODUCTION

A spousal lifetime access trust ("SLAT")[1] is, at its essence, nothing more than an irrevocable trust to which the Settlor makes a completed gift and of which the Settlor's spouse is a current beneficiary. SLATs have been in the estate planner's arsenal for as long as anyone can remember, although, admittedly, their popularity has increased in recent years.

II. PURPOSES OF A SPOUSAL LIFETIME ACCESS TRUST

A. Use It or Lose It

The 2017 Tax Act[2] increased the gift and estate tax basic exclusion amount under Internal Revenue Code ("IRC") § 2010(c)(3) to $10 million as adjusted for inflation with a 2010 base year (the same base year under prior law). Thus, the basic exclusion amount for 2024 for gift and estate tax purposes, and the generation-skipping transfer ("GST") exemption amount under IRC § 2631(c),[3] is $13.61 million (an historically high amount). Under the 2017 Tax Act, inflation adjustments each year will continue to increase the basic exclusion amount through 2025.[4] Under the 2017 Tax Act, on January 1, 2026, the basic exclusion amount will revert to pre-2017 Tax Act levels.[5] Of course, federal tax legislation could reduce the basic exclusion amount before January 1, 2026.

In response to IRC § 2001(g)(2), enacted as part of the 2017 Tax Act, in which the Secretary of the Treasury was directed to prescribe regulations to carry out IRC § 2001(g) with respect to the difference between the basic exclusion amount applicable at the time of a decedent's death and the basic exclusion amount applicable with respect to any gifts made by the decedent, the Secretary issued Treas. Reg. § 20.2010-1(c).[6] This provision (the so-called "anti-clawback" rule) ensures that, if an individual uses the increased basic exclusion amount for gifts made while

[1] These materials discuss spousal lifetime access trusts ("SLATs") that are designed to accomplish the purposes described in part II below. SLATs that have no tax planning objectives but, rather, are intended to serve solely as asset protection vehicles are beyond the scope of these materials.
[2] An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, Enacted December 22, 2017.
[3] Using a SLAT for generation-skipping dispositions, and allocating GST exemption to a SLAT, may be seen as generally inefficient because of the expected distributions to or for the Settlor's spouse, a non-skip person. *See* Internal Revenue Code ("IRC") § 2613(b). However, a typical SLAT Settlor doesn't contemplate making large generation-skipping transfers outside the SLAT, so allocating GST exemption to the SLAT may well be appropriate.
[4] IRC § 2010(c)(3)(C).
[5] *Ibid*.
[6] Treas. Reg. § 20.2010-1(c), REG-106706-18, 84 Fed. Reg. 64995 (November 26, 2019).

the 2017 Tax Act's basic exclusion amount provisions are in effect and dies when they are no longer in effect, such individual's estate won't be treated, for estate tax purposes, solely because the increase in the basic exclusion amount effectuated by the 2017 Tax Act was eliminated, as if such individual made adjusted taxable gifts.

B. Have Your Cake and Eat It Too

Some married couples have enough net worth to cause them to be concerned about the possibility that the estate of the survivor of them will be subject to federal estate tax if the 2017 Tax Act's basic exclusion amount isn't in effect at the death of the first of them to die and/or at the death of the survivor. However, they are not so wealthy that they would be comfortable in making lifetime gifts sufficient to enable use of the currently elevated basic exclusion amount that would result in their losing the economic benefits of the assets to be gifted. A SLAT may be an ideal estate planning strategy for such a couple whose marriage is solid.

C. Alternative Techniques are Limited

On April 27, 2022, the Secretary issued Prop. Treas. Reg. § 20.2010-1(c)(3), which, as and when finalized, would generally foreclose application of the "anti-clawback" rule to completed gifts that aren't adjusted taxable gifts but, rather, are gifts whose value is includable in the donor's gross estate under IRC §§ 2035, 2036, 2037, 2038 or 2042. A properly designed SLAT would not be implicated by any of those provisions of the Internal Revenue Code but, as a practical matter, would provide many of the same advantages, albeit indirectly, of a transfer with retained beneficial interests.

III. DESIGNING A SPOUSAL LIFETIME ACCESS TRUST

A. Income Tax Status of a SLAT

Practically speaking, a SLAT is almost always a grantor trust for income tax purposes. No special drafting technique or approach is need to achieve grantor trust status for a SLAT. IRC § 677(a) provides, in pertinent part that "[t]he grantor shall be treated as the owner of any portion of a trust…whose income without the approval or consent of any adverse party[7] is, or, in the discretion of the grantor or a nonadverse party,[8] or both, may be…distributed to…the grantor's spouse." It will be a rare case, indeed, in which a married couple considering a SLAT strategy would want to involve an adverse party (even a child of theirs who would be an additional current beneficiary and/or a remainder beneficiary of the SLAT) in making discretionary distribution decisions.

B. Funding Options When Using Difficult-to-Value Property to Fund a SLAT

As discussed, the sole tax-related objective of a SLAT is to take advantage of as yet unused basic exclusion amount before it declines. There is virtually no circumstance in which a SLAT

[7] IRC § 672(a) defines "adverse party" as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."
[8] IRC § 672(b) defines "nonadverse party" as "any person who is not an adverse party."

Settlor seeks to expose him or herself to gift tax liability because of funding the SLAT. Such exposure could, however, occur accidentally if the SLAT is funded with assets that don't have a readily discernable fair market value at the time of funding. In such a case, the fair market value of such assets, as finally determined for federal gift tax purposes, could materially exceed their fair market value as asserted by the Settlor on his or her gift tax return, and the excess value could trigger gift tax liability. There are ways to minimize this possibility.

1. *Defined Value Provisions*

The documents used to effectuate the transfer to the SLAT could incorporate defined value provisions. Such provisions could take a variety of forms.[9] One approach could direct the transfer of the subject property in two segments. The first segment, to be allocated to the SLAT, would be in the amount of $X.XX (the amount of the donor's basic exclusion amount he or she wishes to utilize). The second segment, to be allocated to a tax-exempt charity (which could be the donor's private foundation), would be in the amount that's equal to the difference between $X.XX and the fair market value, as finally determined for federal gift tax purposes, of the subject property. Thus, any excess value in the subject property arrived at in an examination of the donor's gift tax return would automatically pass to the charity – thereby resulting in no gift tax.[10] Another approach could involve the use of language saying that the donor is transferring to the SLAT a number of shares or units equal in value, as finally determined for federal gift tax purposes, to $X.XX (the amount of the donor's basic exclusion amount he or she wishes to utilize) and no more.[11]

2. *Potential QTIP Trust*

The SLAT could be designed as a QTIP trust.[12] To the extent the election described in IRC § 2523(f)(4) isn't made, property transferred to the SLAT wouldn't qualify for the gift tax marital deduction and would constitute a completed gift absorbing the donor's basic exclusion amount – as a transfer to a SLAT is intended to do. To the extent the election is made, property transferred to the SLAT would qualify for the gift tax marital deduction – thereby resulting in no gift tax. A formula election could be made on the donor's gift tax return stating that the election is being made with respect to the smallest amount that will result in no gift tax being payable.

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[9] One technique that shouldn't be emulated is that which was shot down by the Tax Court in *Nelson v. Commissioner*, T.C. Memo. 2020-81. In *Nelson*, the value to be established was "fair market value," and such value was to be determined by "a qualified appraiser."

[10] This strategy succeeded in *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011), and has the advantage of having been sanctioned in a United States Court of Appeals decision. *See*, *also*, *Hendrix v. Commissioner*, T.C. Memo. 2011-133.

[11] This strategy succeeded in *Wandry v. Commissioner*, T.C. Memo. 2012-88. Although *Wandry* isn't a U.S. Court of Appeals decision, it has the advantage of not requiring the involvement, however theoretical, of a charity.

[12] "QTIP" is an acronym for "qualified terminable interest property." A QTIP trust is a trust in which the beneficiary spouse has a "qualifying income interest for life." *See* IRC § 2523(f). The spouse must have a mandatory income interest for life (in which income is distributed at least annually), and no person may have a power during the spouse's life to appoint trust property to anyone other than the spouse.

3. *Disclaimed SLAT Property to Pass to Beneficiary Spouse or to QTIP Trust*

The SLAT could be designed as a non-QTIP trust, but the SLAT's governing instrument could provide that any property transferred to the SLAT that is disclaimed by the beneficiary spouse would pass to the spouse or, if the instrument contained alternative QTIP trust provisions, under those QTIP provisions[13] – in either case giving rise to the gift tax marital deduction. The spouse could disclaim an amount described by a formula stating that the disclaimer is being made with respect to the smallest amount that will result in no gift tax being payable by the donor spouse. Formula disclaimers are specifically approved by the regulations under IRC § 2518.[14]

C. Settlor's Spouse as Current Beneficiary

The distribution options that may be incorporated into a SLAT's governing instrument are almost endless and limited only by the Settlor's imagination – tempered, hopefully, by tax planning considerations and, perhaps, practical considerations relating to the Settlor's unique family situation and economic posture.

1. *Income, Unitrust Amount or Annuity Distributions*

The fairly obvious alternatives for arranging for distribution of trust accounting income, a unitrust amount[15] or an annuity are to provide that the spouse shall receive (or be entitled to withdraw) the entire net income or unitrust amount or an annuity on a periodic basis, *e.g.*, monthly, quarterly, annually, or that income or unitrust amount distributions shall be discretionary with the Trustee.

2. *Principal Distributions*

The SLAT's governing instrument may provide, with respect to SLAT property not consisting of trust accounting income, a unitrust amount or an annuity, (which could be loosely referred to as principal) that such property may be distributed to the spouse pursuant to the Trustee's discretion or that the spouse may have rights of withdrawal in specified amounts or circumstances.

3. *Other Beneficiaries*

Of considerable importance is the question of whether the spouse shall be the sole current beneficiary or one of multiple current beneficiaries. The most likely candidates to be additional current beneficiaries would be the Settlor's children and, perhaps, grandchildren and even more remote descendants. If the Settlor and the spouse do not have all the same descendants,

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[13] Consider, however, whether a ***donee*** spouse is to be treated the same as a ***surviving*** spouse for purposes of IRC § 2518(b) and Treas. Reg. § 25.2518-2(e)(2).
[14] Treas. Reg. § 25.2518-3(d), *Example 20*.
[15] Uniform Fiduciary Income and Principal Act, Article 3, Section 301(6).

deciding which descendants to name as additional current beneficiaries (who would potentially be competing with the spouse to receive discretionary distributions) could present difficulties.

4. *Lifetime Power of Withdrawal*

A SLAT instrument could give the spouse a power to withdraw trust property. Such a power could include reference to a pecuniary amount, a fractional share or particular trust property and could allow the spouse to exercise the power periodically or only once. In general, however, such a power should be quite narrow because, since the power will result in inclusion in the spouse's gross estate of the value of property subject to the power,[16] the tax-planning purpose of the SLAT is vitiated to that extent.

5. *Powers of Appointment*

The governing instrument of a SLAT instrument could confer a power (or powers) of appointment on the spouse. A "power of appointment" is a non-fiduciary dispositive power to decide who will take the trust property next, and the time, terms, shares and conditions under which the recipient(s) will receive it. A power of appointment may be exercisable currently (a "lifetime" or "presently exercisable" power of appointment), upon the occurrence of a specified event, upon the satisfaction of an ascertainable standard, upon the passage of a specified time or upon the powerholder's death (usually in that instance by will—a "testamentary" power of appointment). Any power of appointment to be given to a SLAT beneficiary should be carefully designed to be a non-general power. Note, however, that even a non-general power of appointment can give rise to gift tax consequences if such a power is held and exercised by the holder of a mandatory income interest.[17]

6. *"Floating Spouse" Provision*

A SLAT instrument could contain a provision explicitly defining the term "Settlor's spouse" as including, throughout the term of the SLAT's existence, only the individual to whom the Settlor is legally married and not including any individual whose marriage to the Settlor is dissolved (or from whom the Settlor is legally separated or who is living separate and apart from the Settlor for specified reasons and for a delineated period of time). The purpose of such a provision would be to eliminate the spouse's beneficial interests if and when the spouse no longer satisfies the definition and cause the SLAT thereafter to be administered as if the spouse had then died. If the lawyer seeking to represent the Settlor in the design and creation of the SLAT also represents the spouse (as would often be the case in an estate planning engagement), he or she would likely be foreclosed from discussing with the Settlor and including such a provision unless he or she reasonably believed he or she could provide competent and diligent representation to both the Settlor and the spouse and both the Settlor and the spouse gave informed consent, confirmed in writing.[18]

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[16] *See* IRC § 2041(a).
[17] *See Estate of Regester v. Commissioner*, 83 T.C. 1 (1984).
[18] *See* Model Rule 1.7. Model Rules of Professional Conduct, American Bar Association (adopted by ABA House of Delegates 1983).

D. Settlor as Future Beneficiary

In many cases, a SLAT Settlor will be apprehensive about the possibility that he or she will be alive and in need of funds from and after the time when his or her spouse is no longer a beneficiary (to occur in most cases at the spouse's death). To address such a concern, the Settlor may wish to have a direct beneficial interest in the SLAT from and after that time.

The same considerations outlined in part III.C. above are relevant when pondering if and how to design such a beneficial interest and incorporate it into the SLAT instrument, subject, however, to the very important fact that the Settlor must be concerned about having the value of the SLAT property included in his or her estate under IRC §§ 2036(a)(1) and/or 2038 (a concern that doesn't exist in relation to the spouse's being a beneficiary). The result of such inclusion would be to destroy the tax planning purpose of the SLAT. Such inclusion could occur in any one or more of the following circumstances:

- If the Settlor were the Trustee[19];
- If discretionary distributions were subject to an objective standard that the Settlor, as beneficiary, could enforce[20];
- If the Settlor's creditors could reach the trust property under applicable state law[21]; and/or
- If the Settlor, at the time the SLAT was created, had an understanding with the Trustee that the Settlor, on becoming a beneficiary, would receive distributions on request.[22]

Even if the Settlor and his or her advisors were confident that each of the above-recited circumstances weren't present or could be avoided, it may be possible further to reduce the odds that the value of SLAT property will be included in the Settlor's gross estate for the reason that the Settlor is a contingent beneficiary. The foundation of the approach would be to design the Settlor's contingent beneficial interest (to whatever extent it may exist) in the SLAT so as not to be "retained" by the Settlor upon establishment of the SLAT. Put another way, the SLAT instrument would not articulate any provisions establishing or providing for the administration of a contingent beneficial interest in the Settlor but would instead put in place a framework by which

[19] *See* IRC § 2036(a)(2).
[20] *See* IRC § 2036(a)(1); *United States v. Byrum*, 408 U.S. 125 (1972). If the Settlor's potential to receive discretionary distributions were subject to the Trustee's exercise of absolute discretion, and the Settlor's creditors couldn't reach the trust assets (*see*, *infra*, *note* 21), IRC § 2036(a) should not apply. Rev. Rul. 77-378, 1977-2 C.B. 348.
[21] *See* Rev. Rul. 76-103, 1976-1 C.B. 293; *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986); *Outwin v. Commissioner*, 76 T.C. 153 (1981), *acq*. 1981-2 C. B. 1; *Estate of Holtz v. Commissioner*, 38 T.C. 37 (1962), *acq*. 1962-2 C.B. 4; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), *acq*. 1962-2 C.B. 3.
[22] *See* Treas. Reg. § 20.2036-1(a); *Strangi v. Commissioner,* 417 F.3d 468 (5th Cir. 2005), *aff'g Estate of Albert Strangi et al. v. Commissioner*, T.C. Memo. 2003-145.

such an interest could be indirectly initiated. The methods by which this goal may be achieved are as follows:

- The spouse could be given a non-general power of appointment that either explicitly allows the spouse to appoint in further trust for the Settlor or (and this alternative is preferable) is broad enough that the Settlor would be included in the class of potential appointees;

- Provisions could be included designating a non-fiduciary, independent trust protector and granting the trust protector the power:

    - To designate the Settlor as a beneficiary and specify the terms and conditions of the Settlor's beneficial interest; or

    - To grant the spouse a non-general power of appointment of the type described above.

IV. SELECTION OF TRUSTEES

A. In General

One of the usual objectives of a SLAT is for the Settlor and the Settlor's spouse to maintain as much control over the SLAT property as possible while at the same time causing transfers to the SLAT to be completed gifts for gift tax purposes and not setting up the potential for inclusion of the value of SLAT assets in the gross estate of either the Settlor or the spouse. At the same time, it's important that the SLAT be administered competently[23] and by parties that don't have an irreconcilable conflict of interest with a current or future beneficiary.[24] Accordingly, it is challenging, and critical, carefully to identify who would be most suitable in the roles of initial and successor Trustees. A capable lawyer can prepare a SLAT instrument of otherwise superb technical quality, but, if the Trustees entrusted to implement the SLAT's directives are inappropriate, the client's intended goals will likely fail to be achieved, and they could blow up entirely.

[23] While it is true that a Trustee may usually engage agents and assistants to provide expertise in an area of trust administration in which the Trustee may be lacking in expertise, *e.g.*, investments, the Trustee is ultimately responsible for exercising prudence in selecting the agent, establishing the scope of the delegation and periodically reviewing the agent's actions. *See* Uniform Prudent Investor Act, Section 9.

[24] For an example of the results of seemingly horrible Trustee selection, *see Carter v. Carter*, 965 N.E.2d 1146 (Ill. App. 1st Dist. 2012), *appeal denied* 968 N.E.2d 1064 (2012), wherein the Trustee, who was also the sole income beneficiary of the trust as well as the stepmother of the remainder beneficiary, invested the entire trust property in tax-free municipal bonds and, amazingly, was held not to have breached her fiduciary duties to the remainder beneficiary.

B. Tax Issues Relating to Selection of Trustees

1. *Settlor as Trustee*

It is usually very unwise, from a tax planning perspective, for the Settlor to be a Trustee of the SLAT he or she established. Although the SLAT is very likely a grantor trust as to the Settlor for income tax purposes in any event,[25] the Settlor's serving as a Trustee will often trigger inclusion of the value of SLAT assets in his or her gross estate under IRC §§ 2036(a)(2) and/or 2038. The most useful way to analyze this issue is to identify those circumstances in which the Settlor's serving as a Trustee would not create an inclusion problem under IRC §§ 2036(a)(2) and/or 2038 and then to avoid all other circumstances. The Settlor's serving as a Trustee would not result in such inclusion if, under the SLAT's governing instrument:

- The Settlor weren't a beneficiary in any scenario; and
- Discretionary distributions weren't allowed at all or were allowed but only subject to a determinable, external standard.[26]

2. *Settlor's Spouse as Trustee*

Grantor trust issues are very unlikely to be relevant in relation to whether the Settlor's spouse should be a Trustee of a SLAT, but, to avoid potential estate and gift tax issues, the spouse should not have discretion to make discretionary distributions:

- To or for him or herself other than pursuant to an "ascertainable standard" relating to his or her health, education, maintenance and support[27];
- To or for any beneficiary with respect to whom he or she has a legal obligation of support[28]; and
- To or for any beneficiary other than him or herself other than pursuant to a "fixed or ascertainable standard which is set forth in the trust instrument."[29]

3. *Settlor's Child as Trustee*

To avoid potential estate and gift tax issues, a child of the Settlor should not have discretion to make discretionary distributions for the same reasons and in the same circumstances as the Settlor's spouse shouldn't have such discretion.

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[25] *See* part III.A. above.
[26] *See Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).
[27] *See* IRC § 2041; Treas. Reg. § 20.2041-1(c)(1) & (2).
[28] *See* Treas. Reg. § 20.2041-1(c)(1).
[29] *See* Treas. Reg. § 25.2511-1(g)(2).

V. PITFALLS TO AVOID

There are a number of landmines that that may be triggered in connection with the design of a SLAT's governing instrument and administration of the SLAT. Several are noted in the materials above, but they, along with a few others, are summarized here.

A. Inclusion in Settlor's Gross Estate

Creating a SLAT would be pointless if the value of its assets were to be included in the Settlor's gross estate. The methods by which to elude that result, in a case in which the Settlor will or may be a beneficiary after termination of the Settlor's spouse's beneficial interest, are set forth in part III.C. above. In addition, if there were no possibility that the Settlor would become a beneficiary of the SLAT, the Settlor's eventual gross estate would be further insulated from inclusion of the value of the SLAT's assets.

A particularly insidious indicator of gross estate inclusion would be if the Settlor, at the time the SLAT was created, had any understandings with the Trustee, a trust protector or the Settlor's spouse that, although perhaps not legally enforceable, would, as a practical matter, give the Settlor a beneficial interest and/or powers of disposition that fall within the reach of IRC §§ 2036(a) and/or 2038.[30] Such understandings should, obviously, be assiduously avoided. They include:

- An understanding that distributions to which the Settlor's spouse is entitled will be made to the Settlor or will be turned over by the spouse to the Settlor.
- An understanding that, on becoming a beneficiary, the Settlor would receive distributions on request.
- An understanding that the Settlor will be reimbursed, on request, for income taxes generated by transactions in the SLAT for which the Settlor is personally liable.
- An understanding that the Settlor's spouse will exercise a power of appointment in favor of the Settlor.
- An understanding that the non-fiduciary, independent trust protector (assuming there is one) will exercise a power (assuming the trust protector has such a power) to designate the Settlor as a beneficiary and specify the terms and conditions of the Settlor's beneficial interest.
- An understanding that the non-fiduciary, independent trust protector (assuming there is one) will exercise a power (assuming the trust protector has such a power) to grant the Settlor's spouse a power of appointment that can be exercised in favor of the Settlor.

[30] *Supra, note 22.*

Another way in which inclusion in the Settlor's gross estate of the value of SLAT property could result would be if it were possible for the Trustee to make discretionary distributions in a manner that would defray or satisfy a legal obligation of support owed by the Settlor. Beware of the potential impact on the tax posture of a SLAT of state laws (antiquated though they may be) that impose on a husband the legal duty to support his wife. Also potentially problematic would be a SLAT that's a discretionary trust whose concurrent beneficiaries are the Settlor's spouse and descendants, one or more of whom are the Settlor's minor children. A well-drafted SLAT instrument should include an overriding provision prohibiting in all circumstances the making of any distributions to or for any beneficiary in a manner that would reduce or discharge a legal obligation, including a support obligation, of the Settlor.

Finally, even if all other possible triggers for inclusion of the value of SLAT assets in the Settlor's gross estate have been addressed and resolved, such inclusion could still result if the Settlor's creditors could access such assets. The Settlor's creditors would have such a right if the Settlor's transfers of property to the SLAT could be deemed fraudulent or voidable transfers under applicable state law,[31] so care should be taken in connection with SLAT funding to minimize that possibility. The Settlor's creditors could also reach SLAT property in most jurisdictions if the Settlor is a SLAT beneficiary[32] (perhaps even if the Settlor isn't a beneficiary from and after establishment of the SLAT but becomes a beneficiary by means of post-SLAT creation steps taken by the Settlor's spouse and/or a trust protector). Accordingly, if the Settlor is to be a beneficiary, the SLAT should be established in a domestic asset protection trust ("DAPT") jurisdiction[33] and carefully designed to satisfy that jurisdiction's DAPT legislation's requirements.[34] In fact, if at all possible, the SLAT should be so designed and established even if the Settlor isn't a beneficiary at the outset but could become a beneficiary later.[35]

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[31] *See* the Uniform Fraudulent Transfers Act ("UFTA"), promulgated by the National Conference of Commissioners on Uniform State Laws (now known as the Uniform Law Commission) in 1984. During the ensuing thirty years, forty-three states, plus the District of Columbia and the U.S. Virgin Islands, adopted it. In 2014, the Uniform Law Commission amended the UFTA and renamed it the Uniform Voidable Transactions Act ("UVTA"). Twenty-three states have enacted the UVTA. All but two of the UVTA enacting states (New York and Vermont) had previously enacted the UFTA. *See* http://www.uniformlaws.org.

[32] The Settlor could be an accidental beneficiary. If the SLAT instrument contains a provision authorizing the Trustee to reimburse the Settlor for income taxes generated by transactions in the SLAT for which the Settlor is personally liable (*see* part III.A. above), the Settlor could be deemed to have a beneficial interest in the SLAT. That beneficial interest, even if subject to the Trustee's exercise of absolute discretion, could give rise to rights in the Settlor's creditors to gain access to the SLAT's property, in which case Rev. Rul. 2004-64, 2004-2 C.B. 7, would not prevent inclusion in the Settlor's gross estate under IRC § 2036(a).

[33] There are currently nineteen states that have some form of domestic asset protection trust legislation: Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

[34] Alternatively, the SLAT could be established in a jurisdiction having specific legislation deeming the Settlor of an irrevocable trust of which the Settlor's spouse is a beneficiary, if the Settlor is to become a beneficiary of the trust after the Settlor's spouse's death, not to be a "settlor" and not to be a person who contributed property to the trust. *See*, *e.g.*, Fla. Stat. § 736.0505; Miss. Code Ann. § 91-8-504(d).

[35] *See* the text immediately following after *note* 22.

B. Inclusion in Settlor's Spouse's Gross Estate

Similarly, the purpose of a SLAT would be eviscerated if the value of its assets were to be included in the Settlor's spouse's gross estate. Such inclusion would result if and to the extent the spouse holds a general power of appointment at his or her death.[36] Following are the ways by which to avoid that result:

- The SLAT's governing instrument shouldn't confer a power of withdrawal on the spouse.[37]

- The SLAT's governing instrument shouldn't confer on the spouse a power of appointment, exercisable during life, at death or in either circumstance, that would enable the spouse to direct distribution of trust property to or for the spouse, him or herself, the spouse's estate, the spouse's creditors or the creditors of the spouse's estate.[38]

- The SLAT's governing instrument shouldn't designate the spouse as a Trustee or, if the spouse is to be a Trustee, shouldn't confer on the spouse, as a Trustee, a power to make discretionary distributions to him or herself other than pursuant to an "ascertainable standard" relating to his or her health, education, maintenance and support or to or for any beneficiary with respect to whom he or she has a legal obligation of support.[39]

C. Creating Potential for Settlor's Spouse to Make Taxable Gifts

If the Settlor's spouse is to hold a lifetime non-general power of appointment, the spouse shouldn't be a mandatory income beneficiary. Upon exercise of the power, the spouse would be treated as having made a taxable gift of the portion of his or her then remaining income interest, at its present value, that's proportionately allocable to the value of the appointed property.[40]

Additionally, if the spouse is to be a Trustee, the SLAT's governing instrument shouldn't confer on the spouse, as a Trustee, a power to make discretionary distributions to or for any beneficiary other than him or herself other than pursuant to a "fixed or ascertainable standard which is set forth in the trust instrument."[41]

D. Reciprocal Trust Doctrine

In some cases, perhaps many, of the type described in part II.B. above, it may be desirable, from the interrelated perspectives of estate tax minimization and financial planning, for each spouse to create a SLAT for the current benefit of the other. Such a scenario may give rise to

[36] *Supra*, *note* 16.
[37] *See* part III.C.5. above.
[38] *See* part III.C.6. above.
[39] *See* part IV.B.2. above.
[40] *See* part III.C.6. above.
[41] *See* part IV.B.2. above.

application of the reciprocal trust doctrine, the results of which would render both SLATs useless as estate tax minimization devices.

1. *Definition and Development*

Reciprocal trusts may be defined as two trusts conceived within a common plan and establishing substantially identical property interests, one such trust being created by an individual (A) for the benefit of another party (B) and the other being created by B for the benefit of A.[42] Reciprocal trusts are problematic in estate planning because each trust may be re-characterized, for estate tax purposes, as having been created by the Settlor for his or her own benefit, thereby giving rise to inclusion of the value of the trust assets in the Settlor's gross estate under IRC § 2036(a).[43]

2. *Escaping its Application*

Both spouses can create SLATs and not trigger application of the reciprocal trust doctrine, but care and attention to detail must be observed in the design and funding of the SLATs. As many of the following guidelines as possible should be adopted:

- There should be a meaningful amount of time that elapses between the dates of establishment of the SLATs.
- The value of the assets contributed to each SLAT should be materially different.
- Different assets should be used to fund each SLAT.
- The Trustees of each SLAT (preferably, both the initial and successor Trustees but at least the successor Trustees) should be different.
- The beneficiaries of each SLAT should be different.
- The "core" dispositive provisions of each SLAT, both while the Settlor's spouse is a beneficiary and thereafter, should be different.[44] For example, the spouse could be a mandatory income beneficiary of one SLAT, and the other spouse could be a discretionary income beneficiary of the other SLAT. As another example, the terms of one SLAT could permit discretionary distributions in the Trustee's absolute discretion, and the terms of the other SLAT could allow discretionary distribution but only in accordance with an objective standard.

[42] *See Lehman v. Commissioner,* 109 F.2d 99 (2d Cir. 1939).
[43] The Supreme Court adopted and applied the reciprocal trust doctrine in *United States v. Estate of Grace,* 395 U.S. 316 (1969).
[44] *See* PLR 200426008 (release date June 25, 2004).

- The scope and character of powers of appointment, and the class of permissible appointees, could be different in each SLAT. An even better approach involving powers of appointment would be for one SLAT to confer a power of appointment on the spouse and the other SLAT not to confer such a power.[45]

E. Step Transaction Doctrine

Another problem can arise in a case in which for each spouse wants to create a SLAT for the current benefit of the other to facilitate both spouses' taking advantage of their historically high basic exclusion amounts[46] but only one of the spouses owns assets having a large aggregate value. If each donor were seeking to make a large gift to or for the benefit of individuals other than his or her spouse, gift-splitting[47] could achieve the spouses' tax-saving objective. However, in the case of a transfer to a SLAT in which the value of beneficial interests held by the beneficiaries other than the Settlor's spouse isn't mathematically ascertainable at the time of the gift (so that it can be separately identified from the part of the gift transferred to the spouse), gift-splitting isn't available.[48]

Without gift-splitting, the only option for spouses such as are described in the preceding paragraph would be for the spouse owning the assets with a large aggregate value to transfer assets to the other spouse and, then, for each spouse to create and fund a SLAT. There is a distinct danger in proceeding in this fashion, though. Transactions of the type described in the preceding sentence could be re-characterized as a step transaction.[49] The underlying theory would be that the spouse who received a gift of assets which he or she subsequently used to fund a SLAT (the "second SLAT") was a mere conduit and that the substantive reality was that other spouse (the "wealthy spouse") was the true Settlor of and contributor of property to the second SLAT. The results would be calamitous. First, if the structure of the second SLAT were such that the wealthy spouse's deemed transfer to the second SLAT were a completed gift, that gift, coupled with the wealthy spouse's transfer to the SLAT of which he was the nominal (and true) Settlor, could cause the wealthy spouse to have an unexpected, multi-million-dollar gift tax liability. Second, again, depending on the structure of the second SLAT, the value of the second SLAT's assets could be included in the wealthy spouse's gross estate.

The step transaction doctrine is a classic example of a trap for the unwary. In the context of both spouses establishing SLATs where only one spouse has assets of significant value, the following methods of steering clear of the trap should be considered:

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[45] *See Estate of Levy,* T.C. Memo. 1983-453.
[46] *See* part II. above.
[47] Generally, IRC § 2513 allows a spouse to consent to the other spouse's treating his or her gifts as having been made one-half by each spouse.
[48] *See* Treas. Reg. § 25.2513-1(a) & (b)(4).
[49] For a recent example of how the step transaction doctrine was applied in a very analogous situation, *see Smaldino v. Commissioner*, T.C. Memo. 2021-127.

- There should be a significant amount of time (at least a few months) between the wealthy spouse's gift to the other spouse and the other spouse's establishment of the second SLAT.

- Engineer the wealthy spouse's gift to the other spouse and the other spouse's gift to the second SLAT so they are not of the exact same assets and/or not in the exact same amount.

- Ensure (and document the fact that) the other spouse has a clear and unambiguous understanding that the wealthy spouse's impending gift to him or her is absolute and unrestricted and that he or she may retain the gifted property indefinitely or dispose of it at any time and in any manner whatsoever.

F. Dissolution of Marriage

As stated in part II.B. above, a SLAT can be a great estate planning tool for a couple whose marriage is solid. It can be a train wreck, however, in the event of divorce – particularly if it's an acrimonious parting. Thus, it must be acknowledged that SLAT planning generally shouldn't be considered except in cases involving what appear to be excellent, long-term marriages.

1. *Possible Results*

If a SLAT is in place and the spouses' marriage ends, the deleterious (at least from the Settlor's point of view) results would (or could) include the following:

- The Settlor's former spouse remains a SLAT beneficiary, and the Settlor remains not a beneficiary. Thus, the economic benefits generated by the SLAT are no longer indirectly available to the Settlor, but the Settlor remains personally liable for all income tax liability generated by transactions in the SLAT.[50]

- The likelihood of the former spouse's establishing a beneficial interest in the Settlor by means of exercising a power of appointment is reduced or eliminated.[51]

- Depending on the breadth of a power of appointment held by the former spouse, the power may be exercised in a manner inconsistent with, or even diametrically opposed to, the Settlor's wishes.[52]

[50] *See* part III.A. above and IRC § 672(e)(1)(A).
[51] *See* part III.C.6. above.
[52] *Ibid*.

- If the former spouse is the sole Trustee, the former spouse may vindictively sell trust assets in order to realize large capital gains generating substantial income tax that the Settlor would be legally obligated to pay.[53]

2. *Ways to Avert or Manage Such Results*

Discussed in part III.C.7. above is a "floating spouse" provision. Including such a provision in a SLAT instrument would likely enable circumvention of all the possible results outlined in part V.E.1. above, but getting such a provision incorporated into the instrument would be a dicey proposition – to put it mildly. How does the prospective Settlor broach the subject with his or her spouse without creating enormous marital problems in a marriage that, up to that point, was considered by both spouses to be unquestionably secure? And, as observed in part III.C.7. above, a lawyer representing both spouses would be in a very difficult and awkward position in discussing and recommending inclusion of such a provision.

Another possible avenue for avoiding the results outlined in part V.E.1. above would be for the SLAT's governing instrument to designate a non-fiduciary trust protector and confer on the trust protector powers to: (a) add, change or eliminate beneficial interests (which could explicitly include the power to insert a provision authorizing the Trustee to reimburse the Settlor for income taxes generated by transactions in the SLAT for which the Settlor is personally liable); (b) expend, reduce or eliminate any power of withdrawal or power of appointment; and (c) remove and replace Trustees. Challenges that could arise in effectuating this solution include identifying a party willing to serve as such a trust protector, the named trust protector's availability to act when called upon to do so and the trust protector's willingness in the moment to make one or more difficult decisions with life-changing ramifications in an emotionally charged context.

Finally, in connection with dissolution proceedings, it may be possible for the Settlor to convince his or her spouse to relinquish certain interests in, and/or powers over, the SLAT and/or to reimburse the Settlor for income taxes generated by transactions in the SLAT for which the Settlor is personally liable in exchange for concessions in connection with other matters. Of course, success in negotiations while embroiled in a divorce is anything but assured. Moreover, the spouse's exercise of a power of appointment in a particular manner in exchange for something of value from the Settlor would almost certainly be unenforceable.[54]

[53] *Supra, note* 50.

[54] Such an exercise would constitute a "fraud on the power." *See* Uniform Powers of Appointment Act, Section 307(b) and Comment.

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Location: Teleconference

Length of Presentation: 1.5 Hours

ELIGIBLE CALIFORNIA MCLE CREDIT:

TOTAL HOURS: 1.5

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Elimination of Bias in the Legal Profession:

Competence:

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1.5	0.0	0.0
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