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Worth It Episode 3: Having Your Cake and Eating It Too - How to Use SLATs to Use Your Lifetime Gift Tax Exemption?

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In this episode of Worth It, associate Daniel W. Hatten, and partner Andrew M. Katzenstein, discuss whether clients should consider creating spousal lifetime access trusts (SLATs) to use their federal lifetime gift tax exemption before the end of 2020. Tune in as Dan and Andy describe in more detail what a SLAT is, why it is particularly beneficial this year and why it may be appropriate for clients to create SLATs.

Dan Hatten: Hello and welcome to Worth It, a podcast brought to you by Proskauer's Private Client Services Group covering a wide range of topics concerning estate planning, wealth transfers and important legal developments and other issues our clients frequently face when organizing their estates. My name is Dan Hatten, associate in Proskauer's New York office. In this episode, we'll be discussing whether clients should consider creating SLATs to use their federal lifetime gift tax exemption for the end of 2020. We will describe a SLAT and some of the risks associated with creating a SLAT. Joining me for this episode is Andrew Katzenstein, partner in Proskauer's Los Angeles office. Welcome, Andy.

Andrew Katzenstein: Hi, Dan. Thanks for having me on today.

Dan Hatten: Thanks for joining. Andy, I said the acronym a lot in my introduction, but could you please explain what exactly is a SLAT?

Andrew Katzenstein: I'll be happy to. A SLAT is a spousal lifetime access trust. And what it is, is an irrevocable trust that one spouse creates for the benefit of their spouse or their spouse and children. It's a technique that we recommend to clients who want to make gifts to use up their lifetime gifting exemptions but might not feel comfortable with transferring that many assets to their kids. So, it’s a trust that we create, where they can create and transfer assets to a trust for each other, which gets it outside their taxable estates for state tax purposes, and uses their exemptions, but if they run out of money from other sources and they need to tap into it later on, they can get back at those assets that they've given away.

Dan Hatten: So, I think you answered this a little bit, but maybe you could talk a little more. Could only one spouse create a SLAT for the other or could both spouses create separate SLATs for each other?

Andrew Katzenstein: It depends. As a technical matter, a husband can create a SLAT for a wife, the wife can create a SLAT for a husband, and I talk about these as husbands and wives, but of course same sex couples can do it for each other as well. The problem with creating SLATs for each other is that the SLATs have to be different enough so that the government doesn't uncross them to defeat the estate plan. If you create a trust for yourself and your spouse creates a trust for herself, then none of those assets would be outside either spouses’ taxable estate; but, if a husband creates a trust for his wife, and his wife creates for her husband, then the trusts are pretty much the same. The government can then uncross them and say “well, each of you really created a trust for yourself and therefore the tax plan doesn't work”. So, if each spouse is going to create a SLAT for the other, you want to make sure that the SLATs are different enough that the government can't uncross them to defeat the estate plan.

So then of course, the question is: how do you make one trust different enough from the other to avoid that problem and then unfortunately there is no code section or regulation or case which tells us exactly what needs to be done. You know, you can make different ages that people get distributions, you can make grandchildren the beneficiary of one trust along with a spouse and the other trust just being for a spouse. You can give powers of appointment and some documents as opposed to others, but you really can't be sure. And you want to make them different enough so that you can defeat an IRS attack that tries to uncross these things and defeat the estate plan.

Dan Hatten: Thanks for that. So a lot of that begs the inevitable question that I get a lot which is what happens when one of the spouses dies or if the couple goes through a divorce?

Andrew Katzenstein: If a spouse dies the trust ends and the assets go to the children. Each spouse creates a SLAT for the other and when one of them dies that means 50% of the assets are no longer available to provide for the lifestyle of the surviving spouse. If the couples' expenses that are in their marriage are pretty equal, then it probably doesn't matter because if half the assets go to the kids since they only have half of the expenses of living, the remaining half of the assets ought to be enough. But if half of those assets going to the kids would mean that the surviving spouse was in need of other funds, additional planning should be considered like establishing a life insurance trust to replace those assets for the survivor that passed to the kids out of the first [SLAT] when the first spouse dies. Divorce is a stickier problem, especially if each spouse doesn't create a SLAT for the other. If only one spouse creates a SLAT and then they divorce the spouse who's not the beneficiary of the SLAT isn't particularly happy. Because for example, if husband created a SLAT for his wife with the idea that as they grew older, if they needed money, wife could pull money out of the SLAT, and then spend it to support her lifestyle, along with her husband's. If they get divorced, the husband who created the trust doesn't have access to those funds; and so this is an important part of the discussion, making sure that the couple understands that in the context of divorce this is going to be an issue that has to be resolved.

Dan Hatten: Another question that I think comes up frequently is, how do you suggest clients proceed if only one spouse has more than the exemption, which for now is $11.58 million?

Andrew Katzenstein: The good news is that spouses who are married can generally transfer assets between each other without any gift tax consequence. Let's say that one spouse had $22 million dollars and the other spouse had none. The one spouse could give $11 million of assets to the other spouse; and using the marital deduction there would be no gift tax. Then each spouse would have $11 million that they could use to create a SLAT for the other. So the marital deduction really allows you to accomplish that end.

Dan Hatten: As we get ready to wrap this up -- I think you've explained a lot about SLATs -- we've talked a little about the reciprocal trust doctrine and that issue and some of the problems that could come up in just the risks of a potential divorce or one spouse predeceasing. Are there any other risks that clients should be aware of when considering creating a SLAT?

Andrew Katzenstein: The only other thing to consider is that many times when we create a trust for estate planning purposes, we create them as grantor trusts, which means that the person that creates the trust, pays the income tax on the earnings inside the trust. There is an opportunity in almost every grant or trust context in estate planning to turn the grantor power off. So if you get tired of paying the tax, you don't have to pay the tax anymore if you just flip the switch and make the trust into a non-grantor trust. The problem with a SLAT is you cannot convert it from a grantor trust to a non-grantor trust. So long as the spouse for whom the trust is created is alive, the trust will be a grantor trust. Think about what might happen in the context of a divorce. Husband creates a trust for his wife; it's a grantor trust, then they divorce. The question is, is that trust still a grantor trust or not a grantor trust? There are two ways to read the law and no one is sure how it will come out, but the income tax consequences of having a grantor trust should be considered. The good news is so long as the couple stays together, if there is tax that needs to be paid, the spouse that's the beneficiary of the SLAT can pull money out and give that to the creating spouse so that that spouse can pay the tax on their grantor income. But the income tax consequence is something to think about in the context of a SLAT.

Dan Hatten: That is certainly helpful and I think it is an underrated piece of planning with SLATs. Andy, I want to thank you for joining today and explaining so much about SLATs to us. Sounds like with some careful planning, SLATs really allow clients to potentially have their cake and eat it too by using the remaining exemption, making a gift, but retaining some degree of access to those gifted assets -- especially while so much is uncertain it will really maybe be a great time by the end of 2020 to implement SLAT planning for a lot of clients.

Andrew Katzenstein: I think that's right. Thanks a lot for talking to me about this today.

Dan Hatten: With that, we will wrap up this episode of Worth It. We hope you enjoyed this podcast, and please join us for future episodes. If you would like to receive notifications when new episodes are available, please visit our website, Proskauer.com, and click the subscribe button to our publications link at the bottom of any page. Thank you for listening.