COMMITTEE REPORT:
DOMESTIC RELATIONS

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The SLAT Trap

Beware of income tax consequences of divorce

Spousal lifetime access trusts (SLATs) are an increasingly common estate-planning tool and can serve a variety of important objectives for married clients. However, a grantor may not anticipate, much less welcome, the income tax consequences of a SLAT in the event of divorce. It's important for estate-planning attorneys to take these issues into account in drafting SLATs or, if that's not possible, for matrimonial attorneys to address them in divorce negotiations.

Under current law, an individual can pass an unprecedented $11.7 million (indexed for inflation) (the applicable exclusion amount) free of federal estate and gift tax to anyone, either during life or, to the extent not previously used, at death.[1] On Dec. 31, 2025, the current law will sunset, and the applicable exclusion amount will revert in 2026 to $5 million, indexed for inflation.[2]

In light of that possibility, many clients are seeking ways to use their applicable exclusion amount now, even if they aren't in a position to give away assets with no strings attached, and many married clients are turning to the SLAT. A SLAT is generally structured for the benefit of the grantor's spouse and descendants (and any other beneficiaries a grantor may wish to include) and can be funded with as much of the grantor's applicable exclusion amount as the grantor chooses. The provisions of these trusts vary from one family to another, but at the death of the survivor of the grantor and the beneficiary spouse, the remaining trust property typically passes to the grantor's children (or is held in further trust for their benefit). To the extent the grantor's exclusion from generation-skipping transfer (GST) tax was also allocated to the SLAT on its funding, the property can continue in trust for children, grandchildren and more remote descendants without the imposition of any additional transfer taxes.

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Like many trusts, a SLAT is a beneficial estate-planning tool to pass property to descendants, but it also affords the distinct benefit of providing access to trust property by the beneficiary spouse, who can then use SLAT distributions for the couple (assuming a trustee determines to make a distribution). While, of course, the most tax-efficient option is to keep the property in trust for descendants rather than distribute it to the beneficiary spouse, a SLAT provides a safety valve for a couple who fears giving too much away in case they need access to the assets later, while using as much of the grantor's applicable exclusion amount as possible.

It's also common for each spouse to create a separate SLAT for the other spouse and the children of the marriage to use both spouses' applicable exclusion amounts. With other types of transfers that don't include spouses, it's not usually necessary to create separate trusts, because a grantor may elect to split gifts to a third party with their spouse—meaning that, even if the transfer is made by one spouse alone, the gift will be deemed for tax purposes to have been transferred one-half by the grantor and one-half by the other spouse, allowing the spouses to

apply both applicable exclusion amounts to the gift.[3] However, grantors who make transfers to SLATs generally can't take advantage of gift splitting or may only be able to split a portion of the gift, because the spouse is a beneficiary of the trust.[4] In light of this, married couples will often create reciprocal SLATs for each other (taking into account the reciprocal trust doctrine[5]) so that each spouse can use their applicable exclusion amount.

Income Tax Consequences

Clearly, SLATs serve important estate-planning objectives, but it's important for planners to consider that SLATs have income tax consequences as well. Because the grantor's spouse is a beneficiary of the SLAT, the SLAT is a so-called "grantor trust" for income tax purposes. Under Internal Revenue Code Section 677(a)(1), the grantor is treated as the owner of any portion of a trust they create if income from the trust may be distributed to the grantor or the grantor's spouse. The result of grantor trust status is that the grantor is responsible for paying the SLAT's income and capital gains taxes under IRC Section 671, even though the SLAT's assets have been transferred out of the grantor's estate for estate tax purposes. As such, these income tax payments by the grantor are effectively additional gifts to the SLAT that aren't subject to federal gift tax and allow the SLAT's assets to grow without being depleted by the payment of income taxes.[6]

However, the spousal access benefit of a SLAT can backfire when the grantor and the beneficiary spouse divorce. Not only does the grantor lose access to the assets in the SLAT (other than potentially by means of a loan, which accrues interest over time and must be repaid), but also the SLAT remains a grantor trust so the grantor remains liable for its income taxes. Under IRC Section 672(e)(1) (the spousal unity rule), the grantor is treated as holding any power or interest held by an individual who was the grantor's spouse at the time the power or interest was created, even after that individual ceases to be the grantor's spouse. Accordingly, if a trust was created while the parties were married and trust income could have been distributed to the grantor's spouse at that time, that trust likely will remain a grantor trust even if the grantor and the beneficiary spouse subsequently divorce. After the divorce, the grantor will remain liable to pay the taxes attributable to trust income that's distributed to their former spouse, and the former spouse will receive the property free of income taxes.[7]

There are a variety of strategies that can be implemented to mitigate this tax problem, both in drafting a SLAT and in the divorce negotiations.

Drafting Tips for SLATs

The most effective solution to this income tax problem is to draft the trust to avoid the problem in all cases, even if a divorce seems entirely unlikely. Estate planners should consider including language in the SLAT providing that, in the case of divorce, the beneficiary spouse ceases to be a beneficiary or directing that the trust terminate on divorce. Of these two options, termination usually isn't preferable, as it doesn't serve the grantor's estate-planning objectives in creating the SLAT and wastes the gift tax exclusion amount allocated to the SLAT (and exclusion from GST tax, if applicable). Accordingly, removing the spouse as a beneficiary in the case of divorce will often be the best approach. While this can be a delicate conversation in a joint representation, it can be very beneficial to address this issue proactively.

> Rather than changing the SLAT, the parties can address the future income tax payments in the separation agreement.

It can also be helpful to include reimbursement authority in the SLAT so the trustees can reimburse the grantor for income taxes paid on behalf of the trust, if reimbursement is permissible under the applicable governing law. While this authority is helpful and can be used by the trustees for the benefit of the grantor, particularly in a year when there's a large income tax obligation, it shouldn't be relied on too extensively, as a pattern or practice of reimbursement could cause the trust property to be included in the grantor's estate.[8]

Divorce Negotiations

For existing SLATs that don't include these provisions, the issue should be addressed in the divorce negotiations. In addition, for a grantor contemplating creating trusts during the course of an impending marriage, these issues can be addressed in the prenuptial agreement (prenup).[9]

One option is for the trustees of the SLAT to change the trust's terms to remove the former spouse as a beneficiary. Depending on local law, this might be accomplished by decanting to a new trust in which the former spouse isn't a beneficiary,[10] modifying the existing SLAT to remove the former spouse as a beneficiary[11] or otherwise altering the former spouse's rights under the SLAT. Because reciprocal SLATs are common, the trustees of each spouse's SLAT can use this option to extricate the spouses from each other's trusts. If only one spouse created a SLAT for the other, the grantor's other assets can be used to make the former spouse whole when they're removed as a beneficiary. This allows the grantor to use assets that will otherwise be subject to estate tax at their death for the former spouse and to preserve the tax-protected status of the assets in the SLAT. It's helpful to address the resolution in the separation agreement (or in a prenup) and to provide that the former spouse will release the trustees of the SLAT for their actions. However, attorneys and clients must exercise caution due to the risk that the actions of the spouse in agreeing to be removed from the trust may possibly be deemed to be a gift.[12]

Another option is that, rather than changing the SLAT, the parties can address the future income tax payments in the separation agreement. Through the division of other assets, the agreement can provide a means to equalize the grantor for any future income tax payments that are expected to be due by reason of distributions from the SLAT to the former spouse. This will require making assumptions about what those future income tax payments will be and the life expectancy of the spouse, and so likely either won't make the grantor completely whole or alternatively may penalize the former spouse because the trustees can minimize the income taxes due by investing for that purpose. However, it can be rough justice to extricate the spouses financially. A final alternative is to include a reimbursement provision from the former spouse beneficiary to the grantor to cover such tax payments, if and when they're made.[13]

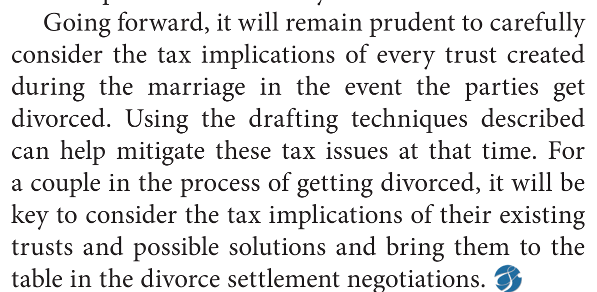
Assuming the SLAT allows for discretionary distributions of principal to the beneficiary spouse, it may be possible for the trustees to terminate the SLAT by paying out all the assets to the beneficiary spouse and equalizing the grantor with other assets or, alternatively, paying out the assets to the children. Note that while paying the assets to the spouse is an option that the grantor may prefer if they don't want to give other assets to the beneficiary spouse, it doesn't serve the grantor's estate-planning objectives in creating the SLAT and results in the waste of the grantor's applicable exclusion amount (and exclusion from GST tax, if applicable) allocated to the SLAT.

Finally, if the SLAT is purely discretionary, the trustees may address the issue at the trust level. Assuming this meets their fiduciary duties, they can simply elect not to make distributions to the beneficiary spouse after divorce, or they can invest to minimize trust income, so less income tax will be carried out to the grantor for distributions made from the SLAT to the former spouse. Of course, these options take the control out of the hands of the grantor, so they may be less attractive than the other remedies discussed above.

Consider Tax Implications

A SLAT is a useful estate-planning tool in an uncertain time, allowing a married client to use their applicable exclusion amount while it remains at unprecedented highs without giving up access to the assets in case they're needed by the couple. However, the tax implications of this tool can result in the grantor remaining liable to pay the income taxes attributable to trust income distributed to their former spouse well after they divorce.

Going forward, it will remain prudent to carefully consider the tax implications of every trust created during the marriage in the event the parties get divorced. Using the drafting techniques described can help mitigate these tax issues at that time. For a couple in the process of getting divorced, it will be key to consider the tax implications of their existing trusts and possible solutions and bring them to the table in the divorce settlement negotiations.



Endnotes

1. Internal Revenue Code Section 2010(c)(3)(C); Revenue Procedure 2020-45.
2. IRC Section 2010(c)(3)(C). While recent proposed legislation suggested that the applicable exclusion amount could be decreased even sooner and possibly to as little as $3.5 million, it's unclear at press time that Congress will pass any of these provisions. *See* For the 99.5 Percent Act, S. 994, 117th Congress Section 2(b)(1); Build Better Act, released on Sept. 13, 2021 by the House Ways and Means Committee.
3. IRC Section 2513(a); Treasury Regulations Section 25.2513-1(b). Note that if spouses elect to split gifts in a particular year, they must split all gifts made in that year that are able to be split. Treas. Regs. Section 25.2513-1(b).
4. A transfer in part to or for the benefit of the spouse and in part to or for the benefit of a third party may only be split to the extent the interest to or for the benefit of the third party is ascertainable at the time of the gift and is severable from the spouse's interest. Treas. Regs. Section 25.2513-1(b)(4). Accordingly, a gift to a typical spousal lifetime access trust (SLAT) that's for the benefit of the grantor's spouse and issue at the discretion of the trustees wouldn't be subject to being split. But if, for example, the SLAT provided that the spouse was the sole income beneficiary and the children were the sole principal beneficiaries, the spouses would split the portion of the gift allocable to principal if they elected to split gifts in that year.
5. The reciprocal trust doctrine provides that if spouses each create trusts for the other that are nearly identical, the trusts will be unwound and the assets treated as if each spouse had made a transfer to a trust for themself. *See, e.g., United States v. Estate of Grace,* 395 U.S. 316 (1969); *Estate of Bischoff,* 69 T.C. 32 (1977); *Estate of Levy,* T.C.M. 1983-453.
6. The Build Better Act includes provisions that would make drastic changes to the grantor trust rules for grantor trusts created or funded on or after the Act's date of enactment. While at press time, it's unclear whether Congress will pass these provisions, it's impossible to know whether these grantor trust benefits will remain available to SLATs and other grantor trusts going forward. If changes to the grantor trust rules are enacted, whether now or in the future, planning with non-grantor trusts will likely become key. Because SLATs typically will be grantor trusts due to IRC Section 677, it will be very challenging to create a non-grantor SLAT. One possibility for achieving non-grantor status is to require an adverse party (who would typically be a child of the grantor who's a trust beneficiary) to consent before distributions can be made to the spouse beneficiary (Section 677(a)(1)). However, that structure can be problematic from a practical standpoint—many parents will be uncomfortable requiring the consent of their children before they're able to receive a distribution—and consent itself may have gift tax consequences.
7. Until Dec. 31, 2018, IRC Section 682 prevented this result by providing that the income distributed to a spouse after a divorce is taxable to the recipient and not the grantor. The 2017 Tax Cuts and Jobs Act (TCJA) repealed this IRC section in respect of divorce agreements executed or modified after Dec. 31, 2018. *See* Sharon L. Klein, "Warn Clients About Change in Taxation of Trust Income After Divorce," *www.wealthmanagement.com/estate-planning/warn-clients-about-change-taxation-trust-income-after-divorce* (June 17, 2019). In 2018, the Department of the Treasury and the Internal Revenue Service requested comments regarding the application of certain grantor trust rules to the taxation of trusts for the benefit of a spouse following a divorce or separation in light of the repeal of Section 682. *See ibid.* No guidance has been issued.
8. In Revenue Ruling 2004-64, the IRS held that when a trustee merely uses their discretion to reimburse a grantor for the payment of income taxes, such reimbursement alone doesn't cause the trust property to be included in the grantor's gross estate under IRC Section 2036(a)(1). However, in reaching that conclusion, the IRS implied that inclusion would occur if there were an understanding, express or implied, between the grantor and the trustee regarding the trustee's exercise of such discretion. Rev. Rul. 2004-64. A pattern or practice of reimbursement could be viewed as an implied understanding between the grantor and trustee.
9. In reviewing all options, advisors should carefully consider the income tax consequences that may be triggered if the proposed changes to the grantor trust rules under the Build Better Act, or other similar changes, are enacted.
10. *See, e.g.,* N.Y. Est. Pow. & Trusts L. Section 10-6.6 and 12 Del. C. Section 3528, the decanting statutes of New York and Delaware, respectively.
11. *See, e.g.,* Delaware's statute authorizing modification, 12 Del. C. Section 3342.
12. Note that the IRS has previously ruled that beneficiaries who were entitled only to discretionary distributions of trust income and principal, but who relinquished their interests in favor of remainder beneficiaries, made taxable gifts of such interests. *See* Private Letter Ruling 201122007 (Feb. 24, 2011); PLR 8905035 (Nov. 4, 1988) and PLR 9802031 (Oct. 14, 1997). Perhaps the former spouse's consenting to their removal as a beneficiary of the SLAT and agreeing to release the trustees from liability for doing so would also be treated as a taxable gift to the other beneficiaries.
13. Prior to the enactment of the TCJA, the payor spouse could have deducted such payments as spousal support payments from their income, and the payee spouse would have been required to include such payments in their income. Now, under divorce agreements executed or modified after Dec. 31, 2018, spousal support payments are no longer deductible from the income of the paying spouse and aren't includible in the income of the receiving spouse. TCJA Section 11051(c) (2017). Such payments made pursuant to a written agreement that resolves divorcing spouses' marital and property rights or provides for the support of minor children won't trigger gift tax consequences, as they're deemed to be made for full and adequate consideration. IRC Section 2516.