TRENDS 360

Parallel SLATs: Which Way Are the Winds Blowing?

By: Jonathan M. Forster, Partner, and Hillary Hammond Cook, Associate, Baker & Hostetler, LLP

The Conversation

Many married couples are interested in estate-tax mitigation, but still want (or require) access to their assets for lifestyle needs. A popular strategy to this problem involves implementing parallel spousal lifetime access trusts (SLATs).

Parallel SLATs offer tax mitigation, plus asset access, with the only apparent risks being the death of a spouse or divorce. This technique involves a loose understanding between the spouses to establish two SLATs, each generally including the other spouse as trustee, tax reimbursement provisions, and designating the spouse and descendants as beneficiaries.

TAILWINDS

Various factors have influenced the proliferation of parallel SLATs, but predominantly:

- **Historically high federal estate tax exemptions:** Increased federal estate tax exemptions provide opportunities for spouses to capitalize on tax-efficient gifts to their SLATs. Assets gifted to SLATs and their future appreciation are outside of each spouse's estate, thus reducing estate-tax liability.
- **Income tax benefits:** A SLAT's taxable income is usually reportable on the grantor's (creator's) personal income tax return, allowing the assets of the SLAT to grow income tax-free for its beneficiaries.
- **Lifetime spousal access:** During the beneficiary spouse's lifetime, he or she can access a SLAT's assets through trust distributions. Such distributions may (and likely will) indirectly benefit the grantor.
- **Flexibility:** SLATs may be drafted to include:

  a) The power to remove and replace the trustee.

  b) The beneficiary spouse holding a power of appointment to redirect trust assets upon their death.

  c) Income tax reimbursements to the grantor.

With virtually no public criticism from the IRS to date (possibly short of the *Smaldino* case), parallel SLATs continue to gain momentum.

HEADWINDS

Parallel SLATs may face significant risks beyond divorce and mortality, such as reciprocal trust treatment and IRS scrutiny because of so-called retained interest prohibitions:

- **Divorce:** Because SLATs are intended to benefit the opposite spouse, a divorce will leave the grantor paying the tax associated with his or her trust while their ex-spouse continues benefitting from the trust assets.
- **Mortality:** When a beneficiary spouse predeceases the grantor, a SLAT will usually pass to the grantor's children or other beneficiaries. If there is tension in the family relationships or the grantor's resources outside the SLAT are limited, it can leave the grantor facing financial hardship.
- **Reciprocal trusts:** In drafting parallel SLATs, estate planners must beware of the reciprocal trust doctrine, which applies to interrelated trusts that have substantially identical terms and are part of the same transaction or plan. Drafters must diligently incorporate varying factors in creating the trust agreements to reduce the risk of reciprocal trust treatment.
- **IRS scrutiny:** The IRS may begin devoting more attention to parallel SLATs as the prevalence of this technique grows and consequently, may attack trust nuances, on the basis of form over substance.

FORECAST

The proliferation of parallel SLATs may be strengthening, but spouses and advisors should consider more conservative posturing in their approach, such as:

1. Avoiding the reciprocal trust risks of parallel SLATs altogether by implementing a single SLAT. A single SLAT could be paired with a descendants' trust, which would not include the other spouse as a beneficiary.
2. Undergoing a financial review with a competent investment team to ensure lifestyle needs can be met after gifting to a SLAT without issue.
3. If using two parallel SLATs, avoid maximum funding levels especially if the economic consequences will be too severe.
4. Omitting income tax reimbursement clauses, which deplete trust assets available to the beneficiaries for the sole benefit of the grantor and are largely in conflict with the trustee's duty to the beneficiaries.

Conclusion

Ultimately, spouses must be able to show that they're not still in the same economic position before and after a parallel SLAT transaction. Expert guidance is crucial in achieving this objective.

