

Living for today, planning for tomorrow: Utilizing a spousal lifetime access trust



When implemented correctly, a Spousal Lifetime Access Trust can potentially mitigate gift and estate taxes in the future, while significantly increasing the value heirs receive. If used in multi-generational planning, the current spouse can benefit today while allowing the assets to be protected long after the client has passed away. This article will review the key aspects of the strategy and who may benefit from implementation.

Why this is important

- The estate and gift tax exemption in 2022 currently stands at \$12,060,000 per person but is set to sunset and will be reduced by roughly half on January 1, 2026, if it isn't repealed before then.
- A flexible estate planning tool such as a Spousal Lifetime Access Trust (SLAT) is an opportunity to utilize the currently elevated exemption.
- Any potential growth from a SLAT is intended to be outside of the donor and beneficiary spouse's gross estate, and not subject to any additional estate taxes when either the beneficiary or donor spouse passes away.

Why you should care

- Every dollar that an individual owns above \$12,060,000* is taxed at 40% when that individual passes away, unless assets are passed to the spouse with the marital deduction or unless the assets qualify for the charitable deduction. If the exemption is allowed to sunset (expire) on December 31, 2025, this will translate to an additional \$6,030,000* of wealth being taxed at 40% or an additional \$2,412,000* in transfer costs. This is a rare time to use the exemption—or risk losing it.

* Indexed annually for inflation

Times, they are a changing

Bob Dylan said it best when he wrote the words to this iconic 1964 American folk song to reflect the challenges being faced by the US government as a result of the burgeoning civil rights movement and escalating Vietnam conflict. As was the case then, the planning community has found itself in its own period of unrest in more recent times, as Congress wrangles to find solutions that support a growing economy while promoting tax fairness within our system. Over the last decade alone, we have seen increases and decreases, as well as the decoupling and subsequent recoupling of the gift and estate tax exemptions. And in 2010 we even experienced the complete repeal of the estate tax. While political partisanship has continued to increase, past administrations have contoured the planning landscape with uncertainty as planners attempt to guide their clients and navigate these changes to meet family legacy and charitable goals. Fortunately though, current gift and estate laws

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have provided us a window of opportunity for those with large, growing estates—the Spousal Lifetime Access Trust is one such example for married couples to shift more wealth from their estates while still retaining some limited access over these previously transferred assets.

What is a Spousal Lifetime Access Trust?

A Spousal Lifetime Access Trust (“SLAT”) is an appealing technique for individuals hoping to use a portion or all of their lifetime gift tax exemptions. A SLAT is an irrevocable trust that one spouse creates for the benefit of the other spouse. One spouse is the grantor or donor, and he or she uses their gift tax exemption to make a gift to the SLAT, therefore giving up their access and control of the property. The other spouse is the beneficiary, so he or she maintains access to the assets according to the provisions in the trust document.

SLATs have an incredible amount of flexibility. Some families allow only the beneficiary spouse to access funds during his or her lifetime, while others allow children and grandchildren to benefit during the beneficiary spouse’s lifetime as well. SLATs can be drafted to fit each individual family’s needs. Typically, once the beneficiary spouse passes away, the assets are maintained in trust for the next generation.

What about taxes?

The 2022 estate and gift tax exemption of \$12,060,000 per individual (\$24,120,000 per married couple) can be used during life or at death and does not need to be used all at once. Any estates that are worth more than the exemption at death, or gifts made during life that are larger than the exemption, will be subject to the estate and gift tax. While the exemption can be used to transfer a multitude of different assets, assets that have a high chance of growth would be the best candidates to transfer to a SLAT. Once a gift has been made,

any additional growth will be outside of that individual’s taxable estate. For instance, if an asset that is transferred to a SLAT is worth \$2 million today, and in 10 years grows to \$5 million, the entire \$5 million remains outside of the individual’s taxable estate, not just the initial \$2 million gift. These assets can continue to grow estate-tax free for the next generation if the beneficiary spouse does not use them.

Keep in mind, under current law, that an asset transferred to a SLAT will not receive a “step-up” in basis which occurs when individuals pass away holding an asset in their own name. There may be a capital gain recognized when a trust sells an asset, which could have been avoided if the asset had not been transferred to a trust. With careful drafting, there is the potential to substitute assets in and out of the SLAT after it has been created. This can help mitigate some of the risk of losing the “step-up” in basis. Please talk to your tax and legal advisors when considering this alternative.

Lastly, SLATs are taxed as grantor trusts for income tax purposes. This means that the grantor or donor spouse is obligated to pay income taxes on any trust earnings from their personal funds. This can be advantageous since it gives the trust potential to grow without payment of income taxes, while further reducing the grantor or donor spouse’s estate during their lifetime by the payment of the income taxes during the grantor or donor spouse’s lifetime.

Who should consider a SLAT?

In the current estate planning environment, SLATs are a great option for many married couples. SLATs allow married couples the opportunity to lock in the current exemption, while the donor spouse can still maintain indirect access to the funds through the beneficiary spouse. That access allows for security in case of a worst-case scenario, such as a market crash or unforeseen hardship.

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Private Equity

Individuals that have exposure to private equity could be a great candidate for a SLAT. Those funds are already committed to an investment; therefore, it is easier to transfer to a SLAT since the individual isn't counting on it for current cashflow. The SLAT also allows for growth to be outside of the individual's estate, which is advantageous for the potential high growth of Private Equity.

Business Owner

Special consideration should be given for business owners who look to transition their businesses to the next generation while improving the overall efficiency of their estates consistent with their stated goals. Concurrently, one common issue among business owners is that much of their net worth is tied directly to their business, as income retained by the business is utilized to foster future growth. This creates two potential dilemmas—a growing estate fueled by a successful business, which is also likely to be highly illiquid. This makes the future payment of estate taxes a real challenge and may result in the forced sale of the business or other assets to pay this eventual tax bill. A SLAT can help address both issues through the gift and/or sale of the business interests.

Business ownership interests can be divided into two basic groups—those with control versus those without it. Under current IRS rules, special valuation discounts are available and permitted if the transferred business interests:

- 1) Represent either a minority or non-voting interest, which does not permit the recipient to control or act on behalf of the business.
- 2) Lack a ready and available “market” to sell what are typically privately held business shares.

Now, if a non-controlling business interest is gifted into a SLAT, then the owner can move more value out of their estate using a lesser amount of gift tax exemption. Similarly, if the same business owner further or instead decides to sell a business interest to a SLAT, the value on the interest sold can also be discounted for the same reasons noted. Under the sale scenario, the business owner will typically take back a promissory note between themselves and the SLAT. The business will then be required to make an annual distribution to the SLAT since it now has been assigned ownership in the business. In turn, the SLAT will make a note payment back to the owner-grantor. As a result of the gift and sale scenario, the owner's current liquidity position is improved while concurrently reducing the size of the grantor's estate.

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It is critical to note here that the setup and structure of transferring business interests should also include your estate planning attorney as well as a certified valuation appraiser to properly document the business's value, as well as substantiating any discounts being applied, as they will be critical when filing a gift or estate tax return. Lastly, valuation discounts have been highly scrutinized by the IRS and Congress as there have been many attempts to limit or even eliminate their use.

Things to think about

To help ensure optimal efficiency, there are many considerations when deciding if a SLAT is the right tool for a given client. Below are a list of factors and variables to consider when structuring a SLAT, to ensure it is appropriate given a couple's estate planning goals.

Irrevocability

A SLAT must be an irrevocable trust and is drafted to be excluded from the grantor's estate. The grantor cannot retain any interest in the trust, and the trust cannot be substantially changed once it has been signed.

Flexibility

SLATs allow the donor to take advantage of their current estate and gift tax exemption, while still allowing for future flexibility. The beneficiary spouse can be given a limited power of appointment, which provides the ability to allocate trust assets to a limited class of people, normally the children, in equal or unequal shares. This is very helpful if the SLAT was set up when the children were minors, and too soon to know what the future needs of the child will entail.

The beneficiaries

The beneficiary spouse may be a primary beneficiary of a SLAT. Children and grandchildren may also be named as beneficiaries, either current or after the beneficiary spouse passes away. A SLAT can be a great place to hold wealth for the benefit of the children and grandchildren, once the beneficiary spouse has passed away.

The Trustee

The Trustee directs the distributions of the SLAT. The beneficiary spouse may serve as trustee, but the distributions to themselves must be restricted by an “ascertainable standard.” An ascertainable standard includes a beneficiary's need for health, education, maintenance and support. Both spouses, and other beneficiaries, can be given the ability to remove and replace a trustee. A bank can also serve as trustee. For business owners, a special investment advisor can be named so that business-related decisions can be made by someone with the appropriate experience and familiarity and may be someone other than the named trustee.



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Separate property

A SLAT can be funded with any assets, but it is important for the donor spouse to fund the SLAT with their separate property. If the donor spouse is perceived as making a gift with the beneficiary spouse's assets, then the SLAT could be includable in his or her estate, essentially wasting the exemption. Make sure to talk to your legal and tax advisors when considering funding a SLAT.

Divorce

Divorce is a major risk to the success of a SLAT. The trust can be drafted so the funds are only available for a current spouse (and not a previous spouse), but the donor spouse then loses indirect access to the assets.

Interest rates

Interest rates today are at historical lows. Selling an asset to a SLAT, and receiving a promissory note in return, can be better for individuals with larger estates, or those wanting to build more flexibility in their plan. As of January 2022, the Long-term annual AFR rate is just 1.82%.

Changes in legislation

Always keep an eye on the potential changes in legislation. There are a couple of proposals that would dramatically change the estate tax planning landscape. One potential new law is to tax capital gains when assets are transferred to or from an irrevocable trust. This can be a major hindrance when transferring highly appreciated assets.

There has been a significant amount of discussion in Washington about changes to the current estate tax exemption. The current law is for the exemption to sunset, or be cut approximately in half, effective January 1, 2026. If you think a SLAT would be right for you, it may be beneficial to act quickly.

Reciprocal Trust Doctrine

We have outlined the benefits of a SLAT, and how they can be optimal for married couples. When drafting two SLATs, both spouses creating one for the other, it is important that they be substantially different. The SLATs cannot leave the couple in the "same economic position" as they would have been if they had created trusts naming themselves as beneficiaries. Differences in the choice of trustee, distribution provisions, timing, and powers of appointment are major factors that the courts have looked at in determining economic position and helps preserve compliance with the Reciprocal Trust Doctrine, which is the legal doctrine that looks to avoid a couple from creating identical trusts to simply benefit themselves. Violation of this doctrine may result in having the transaction undone, therefore bringing previously transferred assets back into the grantor's estate.

Conclusion

Times, they are a changing, and the current estate tax landscape is constantly evolving. Now could be a great opportunity to lock in the higher exemption with the use of a SLAT. A SLAT isn't right for everyone, but your BMO Private Wealth Advisor, along with our team of Wealth Planning Consultants and your tax and legal advisors, can help determine if this could be an appropriate strategy for you.

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