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SLATs: The Non-Marital Trust for Spouses

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"slat"[1]
transitive verb
1 : STRIKE, PUMMEL
2 : to hurl or throw smartly
noun
1 : a thin narrow flat strip especially of wood or metal
2 : an auxiliary airfoil at the leading edge of the wing of an airplane

SLAT[2]
"Slime Love All the Time"
("Slime" is another word for "homie" or good friend.)

1 https://www.merriam-webster.com/dictionary/slat?utm_campaign=sd&utm_medium=serp&utm_source=jsonld

2 https://www.urbandictionary.com/define.php?term=SLAT

I. What's In a Name?

In the estate planning world, a "SLAT" is a "Spousal Lifetime Access Trust" and generally refers to an irrevocable trust created by one spouse (the "Settlor") of which the Settlor's spouse (the "Spouse"), along with others (typically the Settlor's and Spouse's descendants), are beneficiaries, to which the Settlor makes gifts and/or other forms of wealth transfers. Many estate planners have been helping clients create SLATs for years (or dare I say, even decades), before there was even such a nifty name for them. But, their popularity grew dramatically in the wake of the Tax Cuts and Jobs Act, which doubled the estate and gift tax exemption amount.

II. Just Another ILIT?

Irrevocable life insurance trusts (ILITs) are probably the original form of SLAT. The insured-Settlor transfers the policy on his or her own life to an irrevocable trust of which the Spouse and descendants are the beneficiaries. The trust becomes not only the owner but also the beneficiary of the policy, entitled to receive the proceeds of the policy at Settlor's death. This ensures the policy proceeds are available to Spouse if needed while removing the proceeds from both Settlor's and Spouse's estates for estate tax purposes.

However, SLATs can be used for wealth transfers other than life insurance:

A. Gifts Using Exemption: A SLAT can be used to receive a gift of any type of property using Settlor's gift tax exemption. The gifted property and all income and appreciation after the gift is transferred free of gift and estate tax.

B. Additional Annual Exclusions: Gifts to a SLAT can be used to make annual exclusion gifts for the benefit of Spouse, just like any other beneficiary. Only gifts made directly to a spouse or to a "marital trust" qualify for the marital deduction. By granting Spouse a Crummey withdrawal right, an additional $17,000 can be added to a trust for the Spouse and children. Once Spouse's withdrawal right lapses, the $17,000 is excluded from Spouse's estate.

C. Loans from Settlor: A SLAT could borrow funds from Settlor for a note, which funds could be invested by the SLAT, or the SLAT could purchase assets from Settlor for a note. The loan need only bear interest at the published "applicable federal rate" (AFR) to be sufficient interest to avoid a deemed gift. (The AFR for April 2024 is 4.45% for a loan with a term longer than 9 years and 4.30% for a loan with a 3-9 year term.) Income and appreciation on the property purchased by the SLAT with the borrowed funds in excess of the interest paid on the loan is transferred free of gift and estate tax.

D. GRATs: A SLAT could be the remainder beneficiary of a "grantor retained annuity trust," or "GRAT." A GRAT is a trust to which the

Settlor transfers property and retains the right to receive a fixed payment (i.e., an “annuity”), payable at least annually, for a term of years. After the annuity term ends, the remaining property (if any) is distributed to remainder beneficiaries (which could be a SLAT), free of gift and estate tax. In order for a GRAT to be successful, the GRAT’s rate of return on its investments must exceed the rate under Section 7520 of the Code,[3] which is 5.2% for April 2024.

III. What’s the Appeal?

A. Not So Limited Access: The fundamental feature of a SLAT is that Spouse is a beneficiary. The trustee is permitted distribute trust property to Spouse for his or her health, education, maintenance and support (HEMS), and/or for any purpose in the discretion of the trustee (although if Spouse is a trustee, he or she can only make distributions for HEMS), or whatever the terms the trust sets forth. In theory, the trustee could distribute all of the trust assets to Spouse. And, as long as Settlor and Spouse are on good terms, Settlor can indirectly benefit from SLAT property through Spouse.

B. Can “Undo” a Wealth Transfer: Clients may be hesitant to make substantial lifetime wealth transfers for fear that they may end up needing the money later in life. Or, they may be concerned that their descendants will end up with “too much” if the transferred assets appreciate substantially post-transfer. A SLAT provides a “back door” allowing Spouse (and Settlor via Spouse) to “take back” previously transferred property (and income and appreciation) through distributions to Spouse.

C. Grantor Trusts (For Now): SLATs have traditionally been structured as grantor trusts (but see section VII below). The very fact that Spouse is a beneficiary generally makes it a grantor trust. As such, Settlor reports and pays the income tax attributable to the SLAT’s assets, which simultaneously allows the SLAT’s assets to grow tax-free and reduces Settlor’s estate. Settlor may also engage in transactions with the SLAT without income tax consequences (e.g., Settlor will not recognize gain when he or she sells appreciated property to the SLAT and will have no income as a result of interest paid to him or her from the SLAT on loaned funds).

D. Receptacle for Gifts for Non-Citizen Spouses: The unlimited gift tax marital deduction is not available for gifts to a spouse who is not a U.S. citizen.[4] A SLAT can receive gifts to benefit a non-citizen spouse and others (e.g., the couple’s descendants).

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[3] As used herein, the “Code” shall mean the Internal Revenue Code.

[4] IRC § 2523(i).

IV. Slats by Both Spouses

A. Funding. In many cases, both spouses want to use their gift tax exemptions (perhaps within a short time, such as before the gift exemption amount is reduced in 2026 or sooner) but aren't comfortable parting with the full amount immediately, or don't have enough assets capable of being transferred. A solution is for Settlor to gift assets to a SLAT which he or she then borrows (or purchases) back in exchange for a promissory note. Settlor could then give the same assets to Spouse which Spouse then gives to a trust he or she creates. In other words, the same assets are used twice to make separate gifts to SLATs by both spouses.

B. Reciprocal Trust Doctrine: Having each spouse create a SLAT for the benefit of the other seems like a near-perfect plan. The full gift exemptions are transferred to trusts out of their estates but each is a beneficiary of one-half of the assets. Not so fast: Care must be taken in choosing the trust provisions and structuring the gifts to the trusts to avoid estate inclusion under the "reciprocal trust doctrine."

The reciprocal trust doctrine was first articulated in *Lehman v. Commissioner.*[5] In that case, two brothers established trusts for one another, giving the beneficiary-brother a life estate and a power to withdraw $150,000 from the trust, with the remainder passing to the beneficiary-brother's issue. The court held that each trust was established in consideration for the establishment of the other trust, and therefore the brothers were deemed to have created trusts for themselves. The basis for such holding was that each brother had received a quid pro quo for creating a trust for the other.

In applying the reciprocal trust doctrine, courts following *Lehman* focused on whether the trusts at issue were created in consideration for one another, which generally required a subjective determination as to the settlors' intent in creating the trusts. However, in *United States v. Estate of Grace,*[6] the U.S. Supreme Court held that application of the reciprocal trust doctrine is not dependent upon finding that each trust was created as a quid pro quo for the other, and that the subjective intent of the settlors need not be determined. Rather, the Court held that the application of the doctrine required only that: (i) the trusts be interrelated and (ii) the arrangement leave the settlors in approximately the same economic position as they would have been in if they had created the trusts naming themselves as life beneficiaries.

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5 109 F.2d 99 (2nd Cir.1940).

6 395 U.S. 316 (1969).

The scope of the reciprocal trust doctrine was later expanded by the Tax Court in *Estate of Bischoff v. Commissioner.*[7] In that case, the Tax Court applied the doctrine to "uncross trusts" in which the settlors, husband and wife, each created a trust for the benefit of their grandchildren. The settlors themselves did not have an economic interest in the trusts, but the husband designated the wife as trustee of the trust he created and the wife designated the husband as trustee of the trust she created. The Tax Court uncrossed the trusts to change the settlors of the respective trusts, with the result that each settlor was the trustee of the trust he or she created. Then, applying Code Section 2036(a)(2), the trusts were included in their estates. In so doing, the Tax Court stated: "The purpose of the doctrine is merely to identify the transferor of property … The doctrine's application is only part of a two-part process of taxation, i.e., it is not enough merely to "uncross trusts," there must also exist a basis for their taxation."

However, in *Estate of Green v. United States,*[8] the Sixth Circuit Court of Appeals was critical of the Tax Court's decision in *Bischoff*. The Sixth Circuit held that a retained fiduciary power was not enough to invoke the reciprocal trust doctrine unless such power was coupled with a retained economic benefit. In *Green*, husband created an irrevocable trust for one of his grandchildren and his wife created an identical trust for another grandchild. Each named the other as trustee. The trustee had the power to make income and principal distributions to the grandchild until the grandchild's 21st birthday. The Sixth Circuit Court held that although the trusts may have been interrelated, the trusts were not includable under Code Section 2036 because the settlors did not retain enough of an economic benefit to invoke the reciprocal trust doctrine under the Supreme Court's decision in *Grace*.

The factors used by courts to determine whether trusts are "interrelated" are: (i) the proximity in time in establishing the trusts, (ii) the similarity of assets transferred to the trusts and (iii) the similarity of the terms of the trusts. In *Estate of Levy v. Commissioner,*[9] the Tax Court emphasized the third of these factors. In *Levy*, the decedent and his wife had created trusts for each other on the same day. The trusts were identical, except that the decedent's wife was given a special power of appointment, while the decedent was not. The Tax Court held that because a power of appointment was created in one trust but not in the other, the decedent and his wife had

[7] 69 T.C. 32 (1977); *see, also, Exchange Bank & Trust v. United States,* 694 F.2d 1261 (Fed. Cir. 1982) and *Schultz v. United States,* 493 F.2d 1225 (4th Cir. 1974).

[8] 68 F.3d 151 (6th Cir. 1995).

[9] T.C.M. 1983-453.

substantially different interests in the trusts and, consequently, the trusts were not interrelated.

On the other hand, the similarity (or dissimilarity) of the terms of the trusts is irrelevant for purposes of applying the reciprocal trust doctrine to annual exclusion gifts to the trusts. In *Sather v. Commissioner*,[10] three brothers, each married with three children, made gifts of closely-held stock intended to qualify for the gift tax annual exclusion to trusts for the benefit of their own children. In addition, each brother made gifts of the stock to the trusts established by his siblings in order to take advantage of his annual exclusion gifts for his nieces and nephews. Citing *Grace*, the Eighth Circuit concluded that the gifts were interrelated since the transfers to the trusts were made on the same days and were for the same amounts of stock. And, although the brothers received no direct economic value in the exchange, the benefits to their children were an indirect economic benefit. After the gifts, the brothers were in the same economic position as they would have been in had they made all of their gifts only to their own children. As such, the portion of the gifts that exceeded their gift tax annual exclusions for their own children were taxable gifts.

The point of interest in *Sather* is that the court did not compare (or even discuss) the terms of the trusts to which the gifts were made. Presumably, this is because the brothers' children could withdraw the stock gifted to the trusts for a limited time, thus rendering the other provisions of the trusts moot during this period. Thus, all of the factors cited above to determine interrelatedness were satisfied: close proximity of the timing of the gifts, identical property and (in effect) identical trust provisions.

It is difficult to reconcile the *Bischoff* case with the *Green* and *Levy* cases. It is not clear whether reciprocal trusts need to be identical in order to be interrelated. It is equally unclear whether, and to what extent, the settlors must have a direct economic interest in the reciprocal trusts. But here are some general guidelines to follow to avoid the application of the reciprocal trust doctrine when each spouse is creating a trust:

1. Avoid having each spouse as a beneficiary of the other's trust, particularly if the trusts are being created closely in time. But perhaps one spouse ("Spouse A") could be a beneficiary of the trust created by the other spouse ("Spouse B") from the outset and, while Spouse B would not initially be a beneficiary of the trust created by Spouse A, the trust created by Spouse A could give an independent trustee or trust protector the power to add Spouse B as a beneficiary (which power could be exercised when, if ever, it becomes desirable

[10] 251 F.3d 1168 (8th Cir. 2001).

or necessary). Perhaps the power can only be exercised if Spouse A dies or they divorce.

2. Avoid reciprocal powers of appointment. If Spouse A is given a limited power of appointment over the trust created by Spouse B, ideally Spouse B would have no power of appointment over the trust created by Spouse A.

3. Avoid having each spouse as the sole trustee of the other's trust. If Spouse B is the sole trustee of the trust created by Spouse A, then Spouse A should not be a trustee (or at least not the sole trustee) of the trust created by Spouse B.

4. Avoid having the spouses make identical gifts to their respective trusts that are close in time. Ideally, Spouse A's gift to his or her trust would be of a different asset type and value than Spouse B's gift to his or her trust, and the gifts would be separated in time.

5. Avoid having the spouses make "reciprocal" annual exclusion gifts to trusts regardless of the differences in the terms of the trusts. If each spouse is a beneficiary of the trust created by the other, only one of them should have *Crummey* withdrawal rights over the trust of which he or she is a beneficiary.

V. Technicalities

A. <u>Gift Splitting</u>: Generally, an individual is subject to gift tax only on those gifts he or she makes out of his or her own personal assets. However, an individual's spouse may elect to be treated, solely for gift and GST tax purposes, as the donor of one-half of the value of the gifts the individual makes from his or her separate funds.[11] Three basic requirements must be met in order to elect to split a gift:

1. The parties electing to split the gift must be *married to each other* at the time the gift is made, and if they later divorce, the gift may not be split if either of them marries another person during the same calendar year;

2. The parties must both be *U.S. citizens or residents*; and

3. The non-transferring spouse must *consent* to split the gift on the transferring spouse's gift tax return.

[11] IRC §§ 2513, 2652(a)(2).

The election to split gifts applies to *all* gifts made to third parties by both spouses during the calendar year for which the election is made, except with respect to any gifts that are not permitted to be split.[12]

If a person transfers property to a trust for the benefit of his or her spouse and children (and/or other beneficiaries), the gift may be eligible, in whole or in part, for gift-splitting treatment. The rule is as follows: an election to split such a gift is effective only with respect to the interest transferred to persons other than the spouse, and only inasmuch as that interest is ascertainable at the time of the gift (and hence severable from the interest transferred to the spouse).[13]

If a trust provides that the spouse receives an annuity, life estate, remainder, or other *determinable interest,* the spouse's and children's interests would be ascertainable and the value of the children's interest would be eligible for gift splitting. Similarly, if the spouse and children each have the right to withdraw a portion of the gift to the trust (i.e., "*Crummey*" rights), the amount subject to withdrawal by the children would be ascertainable and thus eligible for gift splitting.[14] On the other hand, if a donor makes a gift to a single trust of which the donor's spouse and others are discretionary beneficiaries, the value of the spouse's and the other beneficiaries' interests cannot be ascertained and thus the gift cannot be split (except with respect to any portion of such gift that is subject to withdrawal rights of the non-spouse beneficiaries).

The non-donor spouse of a split gift is treated as the transferor of one-half of the transferred property for GST tax purposes.[15] Regulations Section 26.2652-1(a)(4) makes clear that each spouse is treated as having transferred one-half of the *entire* transferred amount for GST tax purposes — regardless of the actual amount deemed transferred by the consenting spouse for gift tax purposes. Thus, even if only a portion of the property transferred is capable of being split with a spouse for gift tax purposes, the spouse nonetheless will be treated as the transferor of one-half of the entire amount transferred for GST tax purposes. As a result, if the trust is to be GST exempt, each spouse must allocate GST exemption sufficient to cover one-half of the property transferred.

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12 Treas. Reg. § 25.2513-1(b)(5).

13 Treas. Reg. § 25.2513-1(b)(4).

14 Ltr. Ruls. 8044080 (Aug. 11, 1980), 8112087 (Dec. 29, 1980), 8138102 (Jan. 25, 1981), 200130030 (July 27, 2001).

15 IRC § 2652(a).

Settlor and Spouse will generally not be able to split a gift to a SLAT except for annual exclusion gifts for the non-Spouse beneficiaries of the SLAT over which such beneficiaries have *Crummey* rights of withdrawal. To illustrate, assume Settlor gives $1 million to a GST exempt SLAT of which Spouse and their two children are the current beneficiaries. The trust gives Spouse the right to withdraw $17,000 of such gift (to use Settlor's annual exclusion gift for Spouse) and each of the children the right to withdraw $34,000 of such gift (to use Settlor's and Spouse's annual exclusion gifts for their children). If Settlor and Spouse elect to split gifts for the year in which such gift was made, the election will only be effective with respect to $68,000 of Settlor's gift to the SLAT (the amount attributable to the annual exclusion gifts for their two children). So, for gift tax purposes, Settlor will be treated as having made a gift of $966,000 ($51,000 of annual exclusions plus $915,000 in excess of annual exclusions) to which Settlor will need to use $915,000 of his or her gift tax exemption and Spouse will be treated as having made $34,000 of annual exclusion gifts for their children. However, Settlor and Spouse will each be treated as having made a gift of $500,000 for GST tax purposes and they will each need to allocate $500,000 of their respective GST exemptions in order for the trust to remain wholly GST exempt. As such, split gift elections in years when significant gifts to the SLAT are made will lead to Settlor using far more of his or her gift tax exemption than his or her GST exemption and vice versa for Spouse.

B. <u>ETIP</u>: If the intent is for a SLAT to be GST exempt, consideration must be given to the "ETIP" rules if Spouse will have *Crummey* rights of withdrawal (or any other rights or powers over the SLAT that would cause any portion of the SLAT to be included in Spouse's gross estate). GST exemption may not be allocated to transferred property the value of which would be includible in the gross estate of the transferor or the transferor's spouse (other than by reason of Code Section 2035) if either were to die immediately after the transfer until the "estate tax inclusion period" (i.e., the period during which the property would be included in transferor's or his or her spouse's estate if he or she were to die), or "ETIP," ends.[16] If any part of a trust is subject to an ETIP, the entire trust is subject to the ETIP.[17] So, as a general rule, GST exemption may not be allocated to property transferred to a SLAT when Spouse has any right or power immediately after the transfer that would cause any part of the SLAT to be includible in his or her gross estate until such time as the ETIP ends. However, if Spouse's only such right is a *Crummey* right of withdrawal, no ETIP will arise (and GST exemption can be allocated effective as of the date of the transfer) provided the withdrawal right is limited to the greater of $5,000 or

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16 IRC § 2642(f).

17 Treas. Reg. § 26.2632-1(c)(1)(iii).

5% of the trust property and lapses within 60 days of the transfer.[18] As such, if a SLAT is to be GST exempt, it is advisable to limit Spouse's withdrawal rights (if any) accordingly.

C. Timing: If one spouse does not have enough assets to fund a SLAT, be careful on the timing of the transfer by the other spouse to the donor spouse. In *Smaldino v. Commissioner*, T.C. Memo 2021-127, the Tax Court agreed with the IRS that the taxpayer's gift to his wife, followed by her gift to an irrevocable trust the next day, was a gift by the taxpayer to the trust for federal gift tax purposes "as part of a prearranged plan between all parties involved to effectuate the transfer of the ownership of the LLC" from the taxpayer to the trust. It didn't help that the wife testified that, before the purported transfer in question she had already made "a commitment, promise" to her husband and family that she would transfer the LLC units to the Dynasty Trust, and that she could not have changed her mind if she had wanted to "because I believe in fairness." There were other unfavorable facts, such as that the LLC agreement was never amended to show the wife was a member or to admit her as a member, in contravention of the agreement, and that a subsequent amendment referred to the taxpayer as the sole member. So put time between the transfer to the spouse and from the spouse to the trust. Enough time that the spouse has the opportunity to use the funds or change his/her mind about making the gift. One might even have the spouse retain part of the assets transferred to help demonstrate that he or she had dominion and control over the assets.

VI. Death and Divorce

As discussed above, SLATs are often appealing to married clients because they allow the couple to "undo" previous wealth transfers to the SLAT and retain access to the SLAT's assets. However, this is only the case for both spouses so long as the marriage continues. If Spouse predeceases Settlor, Settlor will lose Settlor's indirect access to the SLAT's property. If Spouse and Settlor divorce and Spouse remains a beneficiary of the SLAT, surely Spouse will not willingly share any distributions he or she receives from the SLAT with Settlor. And, to potentially add insult to injury, the SLAT would remain a grantor trust in these circumstances and Settlor would have to continue to pay the income tax attributable to the SLAT's assets.19 More commonly, the SLAT would have a "divorce clause" that eliminates Spouse as a beneficiary upon divorce (or even filing for divorce), such that both Settlor and Spouse would lose access to the SLAT's assets.

[18] Treas. Reg. § 26.2632-1(c)(2)(ii)(B).

[19] *See* IRC § 672(e)(1)(A).

VII. Remainder/Reversion To Grantor

Some states have laws that would allow the settlor of a SLAT to be a beneficiary of the trust after the death of the settlor's spouse. These would include virtually all domestic asset protection trust (DAPT) states, such as Alaska, Delaware, South Dakota, Nevada, New Hampshire and Wyoming, as well as other states that enacted SLAT-specific laws that provide that the contributing spouse of a SLAT will not be treated as the contributor spouse upon the death of the initial beneficiary-spouse.[20] Florida recently enacted a SLAT-specific law, joining ten other "SLAT-friendly" states, but the spouse must be a beneficiary for life, as the grantor can only become a beneficiary after the spouse's death.[21] Of course, such a provision should not be used if the SLAT owns insurance on the settlor's life.

Retaining a reversion in a SLAT or an interest in the remainder trust is not free from risk. The IRS might apply Section 2036 or 2038 to include the assets in the settlor's estate, as with other self-settled trusts. The settlor's interest in the trust should be purely discretionary (i.e., no retained interest for HEMS) and the settlor should not have a power of appointment.

Instead of retaining a reversion, the settlor could grant the original spouse-beneficiary a limited power of appointment (LPA) which includes the settlor among the objects of the power. The spouse-beneficiary could exercise this power in his or her will, appointing the assets to a trust for the settlor. This structure could reduce the Section 2036 risk since the settlor did not "retain" an interest in the original trust—unless the IRS can demonstrate there was a pre-arranged plan and apply the step-transaction doctrine. The new trust for the settlor should be set up in a DAPT or SLAT-friendly state, as the original settlor for transfer tax purposes would not have changed.

VIII. Traditional Grantor SLATs Under Attack -- A Non-Grantor SLAT to the Rescue?

In September 2021, the House Ways and Means Committee released proposed legislation that would essentially eliminate wealth transfer planning using grantor trusts. Proposed new Code Section 2901 would subject a grantor trust created on or after the date of enactment (or any portion of a grantor trust that was created before enactment which is attributable to a contribution made on or after enactment) to estate tax in the grantor's estate, and would treat any distribution made from such a grantor trust to a

[20] The other 10 states are as follows: Mississippi (Miss. Code §91-8-504(d)); Virginia (Va. Code §64-2-747); Arizona (AZ. Rev. Stat. §14-10505(e)(3)); Arkansas (AR. Code §28-73-505(c)(1)); Georgia (O.C.G.A. §53-12-82); North Carolina (N.C. G.S. §36C-5-505(c)(2)); South Carolina (SC. Code §62-7-505); Oregon (OR. Rev. Stat. §130.315); Texas (Tex. Prop. Code Ann. §112.035(g)); Wisconsin (Wisc. Stat. §701.0505(2)(e)).

[21] *See* Gassman, Shenkman and Blattmachr, "Land Mines and Safe Havens for SLAT Planning — Part 1", Estates, Gifts & Trusts Journal (BNA), 47 EGTJ (Issue No. 04, 07/14/22). Also, the trust cannot have a divorce clause.

beneficiary other than the grantor's spouse as a gift. Moreover, under proposed new Code Section 1062, a sale or exchange of property between a grantor and grantor trust (other than the grantor's revocable trust) would no longer be ignored for income tax purposes. As such, the grantor would recognize gain as a result of a sale or exchange of appreciated property to a grantor trust and vice versa. (Grantor's spouse should still be able to sell or exchange property with grantor trust without income tax consequences as no gain or loss is recognized on a transfer of property between spouses[22] and grantor trust is grantor for income tax purposes.) Fortunately, this legislation was not enacted. A non-grantor SLAT might actually prove useful, either to avoid or defer state income taxes or to multiply the tax exclusion provided to qualified small business stock (QSBS). In California, for example, if none of the trustees of a non-grantor are located in California and the California beneficiaries only have a contingent right to distributions (i.e., discretionary), then California does not tax the trust, although a distribution will carry out DNI to the beneficiary and be taxable to him or her. Further, Code Section 1202 excludes 50-100% of the gain realized upon the sale of QSBS, depending on when it was acquired, with a cap of $10 million per taxpayer (or 10 times basis if greater). By *gifting* stock to non-grantor trusts (such as a non-grantor SLAT), one can increase the number of taxpayers and multiply the $10 million QSBS exclusion accordingly.

Is it even possible to structure a SLAT as a non-grantor trust? Code Section 677(a) provides that "the grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; [or] (2) held or accumulated for future distribution to the grantor or the grantor's spouse . . ." An "adverse party" is defined in Code Section 672(a) 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."

So, the decision to distribute OR accumulate for future distribution to the grantor's spouse (i.e., the decision to not distribute) must be made by, or require the consent or approval of, a beneficiary of the trust other than the grantor's spouse in order to avoid grantor trust treatment. Does this mean *all decisions to distribute or not to distribute to any beneficiary* must require consent of another (non-spouse) beneficiary because those decisions all impact what funds will be accumulated for potential distribution to the spouse in the future? Further, how does one consent to inaction (i.e., not making distributions) unless the adverse party beneficiary IS the trustee?

If an "adverse" beneficiary exercises discretion to make or consents to making a distribution to another beneficiary, is the adverse beneficiary making a gift? Regulations Section 25.2511-1(g)(2) provides that if a *trustee* has a beneficial interest in trust property, a transfer of the property by the trustee is not a gift if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard (e.g., education, support, maintenance or health) which is set forth in the trust instrument. So, provided the adverse beneficiary is distributing or consenting

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22 IRC § 1041.

to a distribution to another beneficiary in his or her capacity as trustee and such distribution is being made pursuant to an ascertainable standard, the adverse beneficiary should not be making a gift.

The foregoing suggests that a beneficiary of the SLAT (other than Spouse) should be the trustee of the SLAT limited by ascertainable standards to ensure both that such beneficiary (1) is participating in all decisions not only to make but also to withhold distributions and (2) is not making a gift when he or she makes a distribution to another beneficiary. However, can such beneficiary qualify as an "adverse party" as required by Code Section 677 when he or she is serving as a fiduciary? Can one wear both hats at the same time (i.e., be an adverse fiduciary)? Regulations Section 1.672(a)-1(a) says that "[a] trustee is not an adverse party merely because of his interest as trustee," which implies that a trustee can be an adverse party if he also has other interests (i.e., as a beneficiary). Also instructive is *Paxton v. Commissioner of Internal Revenue,*[23] in which the Ninth Circuit affirmed a Tax Court decision that upheld the IRS's determination that taxpayers were taxable on income of a trust they had established because it was a grantor trust. At issue was whether certain powers of the trustees of the trust, including a power to distribute trust income, were held by adverse parties. The Ninth Circuit concluded as the Tax Court had before it that "whether the economic arrangements of the trust cause the interest of a trustee to be adverse to that of a grantor is a factual question." In other words, neither the Tax Court nor the Ninth Circuit concluded that a trustee could not be an adverse party as a matter of law. The Court then went on to consider the trustees' respective interests and powers and concluded that these interests and powers were not substantial enough or of the type to make the holder thereof an adverse party.[24]

While requiring a beneficiary of a SLAT (other than Spouse) to serve as trustee or otherwise consent to distributions may avoid grantor trust treatment, such a requirement may raise other issues. Let's take the typical SLAT where Spouse and children are the beneficiaries:

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23 520 F.2d 923 (9th Cir. 1975), *aff'ing* 57 T.C. 627.

24 The trust in this case (known as the "F.G. Paxton Family Organization") was a trust created by the taxpayers to which they transferred their 86.38% interest in a closely-held corporation in exchange for "Units of Interest." The remaining shareholders of the corporation also transferred their stock to the trust in exchange for Units of Interest. Of the trustees named, only two were asserted to have any interest in the trust. One of these trustees held Units of Interest in the trust but this trustee's units were apparently not rights to present benefit but to a share of the assets at trust termination. The court found that each dollar distributed presently cost this trustee less than four cents and that "so slim a restraint upon the power to distribute income and assets of the trust to the [taxpayers] is not sufficient to protect them from all tax whatsoever." As such, they found that trustee was adverse not as to the entire trust but only as to his share and "without setting out a formula for acceptable percentages," the court could affirm as not clearly erroneous the Tax Court's finding that such trustee was not an adverse party. The taxpayers also asserted that the trust gave another trustee what amounted to a general power of appointment over the trust, thereby making him an adverse party, but the court disagreed.

- Settlor and Spouse may not want to have to ask their child(ren) for consent before any distribution can be made to Spouse. Clients are generally attracted to SLATs because they provide a means to make tax-efficient wealth transfers for their children while retaining a mechanism to re-acquire transferred property should that become necessary or desirable. The structure may be significantly less attractive if this re-acquisition requires their children's consent. The children might not consent, which could make for uncomfortable family relationships, at a minimum.

- What if the children are minors or otherwise lack capacity? Then they can't serve as trustees and, as discussed above, that is probably advisable both to ensure avoidance of grantor trust treatment under Code Section 677 and to avoid gifts by the children when distributions are made. And, even if the children's consent to distributions outside of a fiduciary role can meet both of these objectives, they can't give such consent if they are minors or are incapacitated. Presumably a guardian ad litem or other legal representative (perhaps even one designated in the trust, as is done in the "ING" rulings) could consent to a distribution in a child's place but why would such a representative ever consent to a distribution to someone other than the child? Perhaps adults other than Spouse and children (e.g., other family members or friends) could be included as beneficiaries and given the distribution or consent power instead of the children. However, involving others outside the immediate family in this way may not be palatable to the clients.

Grantor trust status may not be avoided by making Spouse a beneficiary only after Settlor's death, as Code Section 677 applies if the trust's income may be held or accumulated for future distribution (e.g., after Settlor's death) to Spouse. Similarly, excluding Spouse as a beneficiary but allowing him or her to be added as one may lead to grantor trust treatment under Code Section 674, even if Spouse may only be added after Settlor's death. And, speaking of Code Section 674, it should be noted that this discussion of creating non-grantor SLATs has been focused on avoiding grantor trust status under Code Section 677. Care must be taken when designing the trust and selecting trustees and other powerholders to avoid grantor trust status under other Code sections, particularly Code Section 674 and 675.

A possible solution to the problem of creating a non-grantor SLAT would be for a friend of Settlor's ("Friend") to create a trust for (Settlor's) Spouse and children and for Settlor to create a trust for Friend's spouse and children. Code Section 677 would not apply to these trusts but the arrangement certainly invokes the reciprocal trust doctrine (discussed above) and the terms of the trusts and the gifts thereto would need to be structured to avoid its application.

Finally, a non-grantor SLAT might be an attractive way to remove assets from the estate, provide the spouse with access as a beneficiary, and avoid or defer state income taxes, depending on where the settlor lives.