ADU insights

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The "Use It or Lose It SLAT[1]"

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The Tax Cuts and Jobs Act of 2017 temporarily doubled the federal estate and gift tax exemption through the end of 2025. As a result, the exemption went from $5 million (annually indexed for inflation) to $10 million (annually indexed for inflation). With inflation adjustments, in 2020 the original exemption amount is $5.79 million, and when you factor in the temporary doubling of the exemption, an individual currently has a federal estate and gift exemption of $11.58 million. For a married couple, in 2020, this indexed amount is $23.16 million. At the beginning of 2026 the temporarily doubling of the federal estate tax exemption is slated to expire and the exemption will fall back to $5 million (indexed for inflation) for an individual and $10 million (indexed for inflation) for a married couple.

Wealthy individuals have a golden opportunity to transfer at least an extra $5.79 million (and married couples at least an extra $11.58 million) free of federal estate taxes to subsequent generations, but only if they act before this legislation expires at the end of 2025. In reality, they may not even have that much time to act, as the 2020 elections could change the political landscape and lead to a repeal of this federal estate tax legislation before it is set to expire. Those who don't act in time risk losing the benefit of the doubled exemption and missing out on this potentially once in a lifetime opportunity.

However, there are a couple of potential issues to overcome when it comes to taking advantage of this opportunity:

ISSUE #1: It is an "all or nothing" proposition.

If we use the analogy of the original exemption amount of $5 million (indexed for inflation) as being the milk and the temporarily extra amount of $5 million (indexed for inflation) as being the cream, in an ideal world a wealthy individual would just skim the cream off the top and make a gift of the extra exemption amount before the legislation expires, thus retaining the original exemption amount to gift later or use at death.

However, the IRS has issued guidance clarifying that this tactic won't work.[2] The IRS guidance indicates that any use of the lifetime gifting exemption "draws up from zero." In other words, any pre-2026 gifts effectively reduce the post-2025 exemption amount, thus leaving the individual with little to no remaining exemption amount after 2025. This is illustrated in the following example:

EXAMPLE: Assume a single taxpayer worth $20 million and who has made no prior taxable gifts decides to make a gift of $5.79 million in 2020 to use the extra exemption amount before it expires (i.e., she just wants to gift her extra exemption amount, which is half of her total 2020 federal estate tax exemption of $11.58 million). Also assume

1 Spousal Lifetime Access Trust
2 https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-25601.pdf.

that the federal estate tax exemption falls back to $5 million as indexed for inflation in 2026 and that the indexed amount in 2026 is $6.2 million. Finally, assume that the taxpayer dies in 2026.

2026 inflation adjusted estate tax exemption amount:	$6,200,000
Less value of prior taxable gifts (i.e., 2020 gift):	-$5,790,000
Equals remaining exemption amount in 2026:	$ 410,000

So instead of having $6.2 million of exemption left in 2026, the deceased taxpayer's estate would only have $410,000 left, as the taxpayer's gift of $5.79 million in 2020 ends up using up the first $5.79 million of exemption available in 2026. Thus, the taxpayer would have achieved very little benefit from making the $5.79 million gift in 2020.

ISSUE #2: Many wealthy individuals and couples are concerned about giving up control and access to a significant portion of their assets during their lifetime, regardless of how wealthy they are.

Overcoming Issue #1: How to Use the Extra Exemption Amount Without Losing It

The only sure-fire way to utilize the extra exemption amount without losing it is for an individual to gift his or her entire remaining exemption amount prior to 2026 (or prior to the legislation being repealed). This would mean that a single individual attempting to take advantage of the temporary doubling of the estate tax exemption in 2020 would need to make a gift of his or her entire exemption amount of $11.58 million. And a married couple would need to make a gift of their entire combined exemption amounts of $23.16 million. That's asking a lot, even for people who are very wealthy.

There is a middle ground solution for married couples to consider. Instead of gifting their entire combined exemption amounts of $23.16 million, one spouse could gift his or her entire exemption amount of $11.58 million and the other spouse could choose to not make a gift and retain his or her original estate tax exemption amount of $5.79 million (plus future inflation adjustments) to use in the future or at death. The latter spouse would not have taken advantage of the temporary doubling of the federal estate tax. However, the couple would have at least taken advantage of an extra $5.79 million of estate tax exemption and would guarantee that they could transfer a minimum of $17.37 million ($11.58M plus $5.79M) free of federal estate taxes to heirs.

Overcoming Issue #2: How to Potentially Retain Control and Access to the Gifted Assets

As just discussed, taking advantage of the temporarily doubling of the federal estate tax exemption is going to require using the entire exemption amount before this legislation expires or is repealed. A lot of wealthy people are probably reluctant to make such a significant transfer of assets due to their fear of giving up control and/or running out of money during their lives. Regardless of how irrational the fear may be in some cases of extreme wealth, it is nevertheless a concern that needs to be properly addressed.

This is where the Use It or Lose It SLAT comes into play in the case of married couples. This estate planning strategy is intended to permit married couples to gift away significant assets and take advantage of the temporary doubling of the federal estate tax exemption without necessarily giving up total control and access.

The Use It or Lose It SLAT involves one spouse (the grantor) establishing a spousal lifetime access trust for the benefit of the other spouse (the spousal beneficiary) and children. The

grantor spouse then gifts his or her entire federal estate tax exemption amount into the trust. Since the other spouse is the beneficiary of the trust, the couple continues to enjoy access to the gifted property via the rights of the spousal beneficiary.

Additional control and flexibility can be achieved by adding the following features:

- Make the spousal beneficiary the trustee of the SLAT[3] – this provides the couple with greater control over the assets.
- Don't name the spousal beneficiary by name in the trust document (i.e., the beneficiary of the SLAT should be "my current spouse") – this allows a new spouse to step in as beneficiary of the SLAT in the event of a divorce or the death of the spousal beneficiary prior to the grantor spouse and alleviates the concern of the grantor spouse losing indirect access to the assets.
- Include a grantor loan provision in the trust – this also alleviates the concern of the grantor spouse losing indirect access to the funds in the event of divorce or the death of the spousal beneficiary and would permit the trustee to make arm's length loans to the grantor spouse.
- Have each spouse create a SLAT for the benefit of the other spouse[4] – this is an additional way of alleviating the concern of the grantor spouse losing indirect access to the funds in the trust the grantor spouse established, because he or she would have direct access to the other trust via being the spousal beneficiary of that trust.

The Potential Role of Life Insurance in a Use It or Lose It SLAT

Once the assets have been gifted into the SLAT and the temporary doubling of the federal estate tax exemption has been taken advantage of, it may make sense to consider purchasing life insurance as an asset within the trust.

One option, if liquidity is needed for estate taxes or there is a desire to create a legacy for children and future generations, is to purchase a death benefit oriented policy in the trust insuring just the granter spouse or both spouses.[5] Either a portion of the assets in the trust could be used to purchase the life insurance, or the income from the assets could be used to pay the annual life insurance premiums. Note that if there is a desire to use the insurance proceeds to benefit future generations, generation skipping provisions could be included in the trust.

Another option would be to purchase an accumulation-oriented life insurance policy (i.e., maximum premium/minimum death benefit) in the trust to obtain tax-deferred growth for at least a portion of the trust assets and create a tax-deferred asset that could potentially be accessed income tax-free[6] for the benefit of the spousal beneficiary, children, and perhaps even grandchildren. Depending on the age of the couple, it may make sense to insure one or both of them, or alternatively, one or more of their children.

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3 If the spousal beneficiary is also the trustee, then his or her discretion as trustee to make distributions to him or herself would need to be limited by what are known as ascertainable standards (health, education, maintenance, and support) in order to avoid inclusion of the trust assets in his or her estate.

4 If each spouse establishes a SLAT for the other spouse, the IRS may apply the "reciprocal trust doctrine." Under the reciprocal trust doctrine, two identical or substantially similar trusts may be ignored for federal tax purposes. The clients' tax and legal advisors must carefully consider the reciprocal trust doctrine when contemplating establishing SLATs for the benefit of each spouse.

5 If a second-to-die policy is purchased in the trust insuring both spouses, then the spousal beneficiary should not be the trustee of the trust. If the spousal beneficiary were to be the trustee, this would cause him or her to possess incidents of ownership in the policy and cause estate inclusion pursuant to IRC section 2042.

6 For federal income tax purposes, tax-free income assumes, among other things: (1) withdrawals do not exceed tax basis (generally, premiums paid less prior withdrawals); (2) policy remains in force until death (any outstanding policy debt at time of lapse or surrender that exceeds the tax basis will be subject to tax); (3) withdrawals taken during the first 15 policy years do not cause, occur at the time of, or during the two years prior to, any reduction in benefits; and (4) the policy does not become a modified endowment contract. See IRC §§ 72, 7702(f)(7)(B), 7702A. Any policy withdrawals, loans and loan interest will reduce policy values and may reduce benefits.

Conclusion

Wealthy individuals and couples have an extraordinary opportunity to transfer a considerable amount of wealth to heirs free of federal estate taxes. But this opportunity may not last much longer and will require that they transfer a significant portion of their assets. Compounding the situation is the fact that many people may be reluctant to make gifts during their lifetimes due to concerns about giving up control and access. However, there are strategies available, such as the Use It or Lose It SLAT, that may make it more palatable for wealthy individuals and couples to take advantage of this unique federal estate tax legislation before it expires or is repealed.

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