Summer Newsletter 2021: The Spousal Lifetime Access Trust

In this newsletter, I discuss two topics: 1) Expectations of privacy when it comes to trust terms for clients with children divorcing and 2) A relatively new type of trust that maximizes the use of estate tax exemption between spouses.

IS YOUR TRUST REALLY A PRIVATE DOCUMENT?

People typically have several goals in mind when they are looking to create or tweak an estate plan, and important to some may be the desire for privacy. Estate planning professionals are versed in the various estate planning vehicles that can effectively avoid scrutiny of one's wealth and the nature of one's estate plan, during life and after death. For example, while a simple will may require probate at death, with the filing of the will and disclosure of estate assets, trusts are private documents that avoid probate of trust assets at death. There are often workarounds to disclosing the trust document itself in financial or real estate matters.

When it comes to privacy, individuals often do not want their children to learn the magnitude of their assets or the child's anticipated inheritance specifics. In that case, they certainly would prefer to shield such information from their child's would-be ex-spouse. However, despite the careful crafting of a New Hampshire estate plan to maintain one's privacy, a person may be shocked to learn that they are expected to disclose details of their estate if their adult child gets divorced in Massachusetts. Therefore, even if you are a New Hampshire resident with an

estate plan, your confidential information may be affected by a divorce proceeding in Massachusetts.

Under Massachusetts law, a divorcing spouse has a right to the disclosure of certain information regarding the other spouse's expected inheritance. When dividing a divorcing couple's marital assets, a Massachusetts court may take into consideration, among other factors, "the opportunity of each [party] for future acquisition of capital assets and income," even though such expectancy interests are not subject to equitable division between the parties. Mass. General Laws, ch. 208, § 34. Future inheritance also becomes relevant to alimony determinations.

During the 1990 divorce of Allan and Elizabeth Vaughan, Elizabeth's right to disclosure of Allan's likelihood of future inheritance came into direct conflict with the right of Allan's parents to privacy concerning their assets and their estate plan. Allan's parents were unwilling to provide their estate planning documents but ultimately had to accept the compromise of the Supreme Judicial Court of Massachusetts by providing affidavits stating (1) their approximate net worth – plus or minus $500,000, (2) a general description of their current estate plan, and (3) the date their estate plan was significantly amended.* What came to be known as the "Vaughan Affidavit" is now ubiquitous in a Massachusetts and New Hampshire divorce context. Failure to request one, particularly in a long-term marriage where the parents are older, could mean that a divorcing party is leaving assets on the table.

But it is not just parents of a divorcing child who may be the recipient of a demand for a Vaughan Affidavit. Grandparents, aunts and uncles, and other relatives may also be required to disclose information that they would prefer to be kept confidential. Though unpleasant, a Vaughan Affidavit is generally preferable to the alternatives of document production, extensive questioning via deposition, or even jail time for civil contempt. However, the Vaughan Affidavit is a requirement unique to Massachusetts and New Hampshire, so if you find yourself on the receiving end of a demand for a Vaughan Affidavit, or if one of your children or grandchildren are getting divorced in Massachusetts and New Hampshire yourself, be sure to reach out to me for guidance.

We Have a New Type of Irrevocable Trust, and it is Called a SLAT:

The Tax Cuts and Jobs Act of 2017 (TCJA) markedly increased the federal gift and estate tax applicable exclusion amount (colloquially known as the gift and estate tax “exemption”). In 2017, before the enactment of the TCJA, the federal gift and estate tax exemption were $6.49 million. In 2021 (after the enactment of the TCJA), the federal gift and estate tax exemption are $11.8 million. Thus, today, a married couple can transfer (without considering other exclusions, such as the gift tax annual exclusion) approximately $23.6 million before having to pay a gift or estate tax. Unless Congress takes further action, the exemption amount is scheduled to revert (sunset) to pre-2018 exemption levels (indexed for inflation) on January 1, 2026. Because the exemption amount is indexed for inflation, it is not possible to

know exactly what that amount will be in 2026, but it is anticipated to be approximately $6 million per individual.

The Treasury Department has issued regulations confirming that should the estate and gift tax exemption revert to pre-2018 levels, taxpayers who take advantage of the increased exemption amount during the time it is available will not be adversely affected when the exemption amount returns to $5 million (indexed for inflation) after December 31, 2025. Hence, there will be no so-called "clawback" of the exemption amount used during the period of the increased exemption amount over the amount available at death should the exemption amount revert to pre-2018 levels.

The prospect of a 2026 sunset of the higher exemption amount, as well as the always present political uncertainty in the United States (such as after a congressional or presidential election, which could accelerate a reduction in the exemption amount), has prompted many families to look for ways to use the increased exemption amount before it decreases.

What Is A SLAT?

At its most basic premise, the SLAT is a gift from one spouse (the donor spouse) to an irrevocable trust for the benefit of the other spouse (the beneficiary spouse). Although similar to a so-called "bypass" or "credit shelter" trust, which: (1) Receives assets having a value up to a deceased spouse's remaining exemption from the federal estate tax; (2) Potentially benefits the surviving spouse; and (3)

Prevents the value of the trust (the assets transferred and appreciation thereon) from being included in the surviving spouse's gross estate (and subject to estate tax) when the surviving spouse dies, the SLAT is funded by gift while both spouses are alive.

The beneficiary spouse can receive distributions from the SLAT, yet the SLAT is designed to be excluded from the beneficiary spouse's gross estate and to not be subject to estate tax when the beneficiary spouse dies. To prevent the value of the assets of the SLAT from being included in the beneficiary spouse's gross estate, the SLAT will not qualify for the gift tax marital deduction (either because the donor does not make the necessary election, or the terms of the trust prevent it from qualifying).

This allows the donor spouse's exemption from the gift and estate tax to be applied to the value of the assets transferred to the SLAT, sheltering the transfer from gift tax. Of course, if the value of the assets transferred to the SLAT exceeds the amount of the donor spouse's available gift tax exemption, a gift tax will be paid — not the desired result.

The terms of a SLAT can be flexible. To qualify for the federal gift tax marital deduction, the beneficiary spouse must, generally, receive all of the trust's income for life. However, because a SLAT does not qualify for the federal gift tax marital deduction, this restriction does not apply. Although the SLAT can be drafted to require the beneficiary spouse to receive the trust's income for life, this is not

necessary, allowing the SLAT to have multiple current beneficiaries, such as the beneficiary spouse and the couple's descendants.

A SLAT allows the donor spouse to transfer up to the donor spouse's available exemption amount without a gift tax. When the donor spouse dies, the value of the assets in the SLAT is excluded from the donor spouse's gross estate and is not subjected to the federal estate tax. However, because the donor spouse will have used the exemption amount to shelter assets transferred to the SLAT from the federal gift tax (so that the exemption amount used is no longer available to shelter assets in the donor spouse's estate from estate tax), it is the appreciation on the assets in the SLAT that truly escapes federal estate tax. Because there is no clawback, any exemption amount used when the trust was funded over the exemption amount allowed at the time of the donor spouse's death should also escape federal estate tax. The donor spouse can allocate the exemption amount from the generation-skipping transfer tax to the SLAT, making it exempt from future estate tax for many generations.

To achieve these tax benefits, the SLAT must be an irrevocable trust. To that end, when creating a SLAT, the donor spouse must irrevocably transfer assets to the SLAT, forever parting with the income from and use of those assets. Yet, income from and perhaps the assets themselves may not be lost to the couple. Depending on the terms of the SLAT, the beneficiary spouse, as a potential beneficiary of the SLAT, could receive distributions of income or principal from the SLAT, allowing the beneficiary spouse (and the donor spouse, indirectly) to access the transferred

assets if needed. Of course, by accessing the assets in the SLAT, unless those assets are consumed, the couple returns assets to one of their estates, potentially subjecting their value to estate tax at death and losing some of the benefits of the original transfer. This “leakage” should be avoided, if possible.

Transferring assets to a SLAT may also provide a measure of protection from creditor claims on both the donor spouse and the beneficiary spouse. Provided that the transfer to the SLAT is not a fraudulent conveyance, because the donor spouse has parted with dominion and control over the transferred assets and has not retained any interest in or become a trustee of the SLAT, the transferred assets should be free from the claims of the donor spouse’s creditors. Further, if the terms of the SLAT include a proper spendthrift clause, preventing the assignment of the SLAT’s assets by its beneficiaries, and if the beneficiary spouse has only a discretionary interest in the SLAT (that is, the beneficiary spouse will receive trust income or principal only in the discretion of an independent trustee), then the assets of the SLAT should also be exempt from the beneficiary spouse’s creditors.

However, if the beneficiary spouse has the right to receive income or principal from the SLAT (for example, if the terms of the SLAT require income to be paid to the beneficiary spouse), the beneficiary spouse’s creditors could obtain that property as it is paid to the beneficiary spouse.

Some General Rules About SLATs:

The general rules regarding the creation of irrevocable trusts that are intended not to be included in the donor's or beneficiary's gross estate should be followed when creating a SLAT. For example, when naming a trustee:

-The donor spouse should not be a trustee of the SLAT. If the beneficiary spouse is the trustee of a SLAT, distributions should be mandatory or subject to an ascertainable standard.

-An ascertainable standard restricts distributions from the SLAT to providing for a beneficiary's health, education, maintenance, and support. These are measurable amounts and can be enforced by the court having jurisdiction over the SLAT.

-Of course, to the extent that the beneficiary spouse has the right to receive income or principal from the SLAT, the beneficiary spouse's creditors may be able to attach those assets.

-Consider appointing a trustee who does not have an interest in the trust to make discretionary distributions among several beneficiaries (including the beneficiary spouse).

-The donor spouse should contribute individually owned assets to the SLAT. Jointly held assets (or assets held as a tenancy by the entirety) must be broken

into individually owned assets before the donor spouse contributes them to the SLAT.

-Because transfers between spouses are not subject to gift tax, the donor spouse can receive a gift of property from the beneficiary spouse, which is then contributed to the SLAT. Some amount of time should elapse between the gift to the donor spouse and when the donor spouse contributes assets to the SLAT. Not allowing enough time to elapse between transfers could permit the IRS to invoke the "step-transaction doctrine," which collapses multiple steps into one single integrated transaction. In that event, the beneficiary spouse could be deemed to have contributed assets to the SLAT, potentially causing some (or all) of its value to be included in the beneficiary spouse's gross estate and subjected to estate tax. Note also that dividing a tenancy by the entirety between the spouse's subjects one-half of the property to the creditors of each spouse, eliminating the creditor protection offered by the non-severable tenancy by the entirety.

Some married couples, desiring maximum tax benefit, will create two SLATs, with each spouse creating a SLAT for the other. This allows each spouse to fund a SLAT with the maximum exemption available to the spouse. Nevertheless, when each spouse creates a SLAT for the other, it is important to draft the trusts so that the IRS will not invoke the reciprocal trust doctrine, which would cause the value of the trust that each spouse created for the other spouse to be subjected to estate tax in the creator spouse's estate.

The reciprocal trust doctrine is designed to avoid abusive situations, such as where two spouses create identical SLATs for the other, seeking to avoid estate taxation on the value of the trusts. The reciprocal trust doctrine allows the IRS to "uncross" the trusts so that each spouse is deemed to have created a trust for such spouse's own benefit. As a result, the value of each trust will be included in the gross estate of the spouse who created the trust and subjected to estate tax when that spouse dies. The process of carefully drafting and funding multiple trusts can help avoid the application of the reciprocal trust doctrine. In short, the two trusts should have different terms so that they are not deemed to be reciprocal by the IRS.

Summer Office Announcement:

We have all been vaccinated at the office, but we will continue to only allow scheduled appointments due to concerns regarding COVID-19 and its variants. We are still requiring mask usage inside and during meetings. We will continue to offer meetings on Zoom, FaceTime, or by phone. We will also continue to sanitize surfaces in between meetings and follow the CDC's latest health guidelines.

Sincerely,

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