



COMMITTEE REPORT: DOMESTIC RELATIONS

By **Christen K. Douglas** & **Joseph J. Viviano**

Access Denied: Spousal Lifetime Access Trusts in Divorce

How to avoid and navigate surprising tax consequences

A **spousal lifetime access trust** (SLAT) is a popular estate-planning tool for married couples, particularly those who don't have the means (or desire) to permanently transfer wealth outside of the marital estate. A SLAT is usually structured as a pot trust in which the grantor's spouse and descendants are discretionary current beneficiaries. SLATs can be powerful tools because they give their grantors indirect access to completed gifts. Using a SLAT, grantors can give away their full lifetime gift tax exclusion amounts while retaining indirect access to the property transferred through potential distributions to their spouses. While many grantors and their advisors appreciate the benefits SLATs provide, they sometimes fail to anticipate the tax consequences that can result on the grantor's divorce.

Although SLATs have been around for years, they became particularly popular when the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was set to expire at the end of 2012. Absent congressional action, the lifetime gift tax exclusion amount was scheduled to decrease from \$5 million to \$1 million. To avoid losing the benefit of the expiring, larger exclusion amounts, many clients rushed to create SLATs. This strategy was especially favored among wealthy (but not uber-wealthy) individuals who weren't sure they could afford to make large gifts and completely lose future access to those funds.

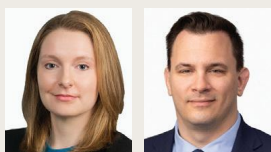
Another avalanche of SLATs is on the horizon due to the impending sunset of many provisions of the Tax Cuts and Jobs Act of 2017 (the TCJA). Effective as of Jan. 1, 2018, the TCJA increased the lifetime gift tax exclusion amount from \$5 million to \$10 million, plus an annual adjustment for inflation.¹ For 2023, the exclusion amount is \$12.92 million. That amount will continue to increase for inflation each year but is scheduled to decrease by half on Jan. 1, 2026.² Advisors are already clearing their calendars for the fourth quarter of 2025 to field requests from clients who will be eager (if not panicked) to use their remaining exclusion amounts before the end of that year.

Issues on Divorce

Notwithstanding their benefits, SLATs can have unexpected and undesirable consequences for the grantor or the grantor's spouse on divorce. These consequences can be avoided with proper planning. Unfortunately, in rushing to create SLATs at the eleventh hour, clients and their advisors may fail to consider the impacts of divorce on SLATs. The failure to anticipate divorce when creating a SLAT can turn a once great planning opportunity into an expensive nightmare for the couple.

Transfer tax. Absent an express provision in the trust instrument, it's often unclear whether an ex-spouse will: (1) remain a beneficiary of a SLAT after the parties divorce, and (2) continue to hold any office under the trust in which they were acting or designated to act prior to divorce.³ The answer depends on the express language of the trust instrument, guided by the grantor's intent if the instrument is silent or ambiguous.⁴ Case law is divided in interpreting trust instruments that are silent regarding the definition of "spouse" and the

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effect of divorce. Some courts have held that an ex-spouse's interests in a trust are unaffected by divorce;⁵ others have held the opposite.⁶ The Uniform Trust Code provides no guidance on this question.⁷

Given that the grantor used part or all of their lifetime gift tax exclusion amount (and often an equal amount of their generation-skipping transfer (GST) tax exemption) to fund the SLAT, distributions from the SLAT to the grantor's ex-spouse are tax inefficient. Transfers to the beneficiary spouse can easily be made from the grantor free of gift tax during marriage and on divorce. To the extent the ex-spouse remains a beneficiary of the SLAT after the divorce and depletes the assets of the SLAT by taking distributions, the grantor could incur additional transfer taxes to replenish the amount passing to the grantor's descendants at a time when they had no remaining exclusion amount. Grantors, therefore, typically assume and intend that distributions will only be made to their spouses during their marriage and only in the event of an emergency. However, following a divorce, the ex-spouse may decide they need distributions from the SLAT to maintain their lifestyle. This risk is especially high if the ex-spouse enjoyed a high standard of living as a result of their marriage to the grantor, but the grantor's financial resources are protected from division and allocation in the divorce proceeding for some reason, such as the existence of a premarital agreement. The risk is exacerbated when the grantor's ex-spouse can make distributions to themselves as trustee of the trust.

The ex-spouse's status as a beneficiary of a SLAT can also impede future estate planning. The grantor likely won't want to transfer additional assets to the SLAT so long as the ex-spouse remains a beneficiary of the trust. If the grantor used all the grantor's lifetime gift tax exclusion amount and GST tax exemption to fund the SLAT and hasn't created any other trust for the benefit of their descendants, it may become more difficult for the grantor to employ other common estate-planning strategies, such as selling appreciating assets to a trust for descendants. One tax-efficient option that would still be available to the grantor is a grantor retained annuity trust (GRAT), which doesn't require a significant gift tax exclusion amount to create and fund, but is only effective in transferring wealth if the assets appreciate significantly.

Income tax. For most grantors, the potential transfer-tax issues that could result from a post-divorce SLAT are outweighed by the immediate income tax consequences. Under Internal Revenue Code Section 677(a), the grantor is generally treated as the owner for income tax purposes 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 distributed or accumulated for future distribution to the grantor's spouse.⁸ This rule only applies "during the period of the marriage of the grantor" to their spouse.⁹ Pursuant to the so-called "spousal unity" rule in IRC Section 672(e)(1)(a), however, the grantor is treated as if they hold any power or interest held by an individual who was the grantor's spouse "at the time of the creation of such power or interest." Under the spousal unity rule, the identity of the grantor's spouse is determined at the time the SLAT is created and remains fixed even if the marriage subsequently dissolves. Thus, the grantor will remain liable for paying all income taxes attributable to a SLAT after divorce if the ex-spouse continues to be a beneficiary and possibly even if their ex-spouse ceases to be a beneficiary depending on the terms of the trust instrument.

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Although IRC Section 682 wasn't a panacea, it previously offered at least some income tax relief to grantors on divorce. Section 682 generally provided that the post-divorce income of a grantor trust, including a SLAT, was taxable to the grantor's ex-spouse to the extent the income was "paid, credited, or required to be distributed" to the ex-spouse.¹⁰ However, the TCJA repealed Section 682 for all grantors whose divorce or separation instrument was executed after Dec. 31, 2018.¹¹



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The income tax consequences of a SLAT that continue after the grantor's divorce could be catastrophic to the grantor. For example, consider a SLAT that was funded with stock that has zero basis. The grantor and the grantor's spouse execute a separation agreement after Dec. 31, 2018. The trustee of the SLAT then sells the stock for \$25 million and distributes the proceeds to the grantor's ex-spouse. The grantor would be responsible for paying tax on \$25 million of gain, and the grantor's spouse would receive the sale proceeds tax free.

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Avoiding Problems

Many of the problems that arise from SLATs after divorce can be solved with careful drafting and communication. To avoid adverse transfer-tax consequences, the SLAT could provide that the grantor's spouse ceases to be a beneficiary and officeholder of the trust on the date the parties become legally separated or one of them files for divorce. Standing alone, however, this provision could be insufficient to turn off the SLAT's grantor trust status, given that other provisions of the trust instrument likely also cause the trust to qualify as a grantor trust for income tax purposes. The grantor, however, may be comfortable continuing to pay the SLAT's income taxes so long as the ex-spouse is no longer a beneficiary of the trust. If not, the trust instrument should provide a mechanism for turning off grantor trust status in the future.

If the definition of "spouse" or the effect of divorce isn't clear under the trust instrument, it could be clarified before divorce via the

exercise of a power of appointment, decanting or judicial or nonjudicial construction, reformation, modification or termination of the trust. For example, a nonjudicial settlement could construe the word "spouse" as meaning the individual to whom the grantor is married at the time the beneficiary's interest is determined. These issues could also be addressed via a postnuptial agreement. However, many clients will be reluctant to prospectively take these actions for fear of damaging their marital relationship.

Although the strategies for resolving these issues don't materially change after divorce, the problem with waiting until after the parties are in the throes of matrimonial discord to address issues with SLATs is that the grantor's spouse will be highly motivated to block or at least oppose their implementation. The grantor's spouse must consent to any nonjudicial settlement agreement to construe, reform, modify or terminate a SLAT—and the consent is unlikely to be forthcoming absent a concession from the grantor in a marital settlement agreement. Any judicial proceeding to achieve the same objectives will be costly and its outcome uncertain. Unless the trust instrument grants the power to modify or amend the SLAT to a person acting in a nonfiduciary capacity, the trustee may be the only person who can solve the problems the SLAT poses on divorce.

A trustee who's concerned for the grantor's plight has options for fashioning a remedy. For example, under the terms of the trust instrument or applicable state law, the trustee may be able to decant the SLAT to eliminate the ex-spouse's interests or to reimburse the grantor for income taxes attributable to the SLAT.¹² However, trustees who exercise these powers to benefit the grantor do so at their own peril. Because such an exercise of these powers would benefit a non-beneficiary of the SLAT, the trustees could expose themselves to a beneficiary's claim for breach of fiduciary duty. A trustee who decides to exercise these powers to benefit the grantor should seek a release from the beneficiaries and require the grantor to indemnify the trustee (in addition to confirming that the grantor could satisfy such indemnification).

In addition to any action taken to rectify the



potential consequences of a SLAT at the trust level, the grantor and the grantor's spouse should address their understanding and intent regarding the SLAT in their property settlement agreement. Such a resolution could include the ex-spouse releasing their interest in the SLAT in exchange for a greater amount of the marital property owned outside the SLAT or a payment from the grantor. It could also require the ex-spouse or trustee to reimburse the grantor for income taxes attributable to the SLAT, which would likely also require modifying the trust instrument or entering into a separate agreement with the spouse.

Anticipate Risks

SLATs should continue to be a popular planning tool for married individuals who haven't entirely used their lifetime gift tax exclusions, but advisors should anticipate the risks of divorce when creating these trusts. Advisors should also be aware that these risks aren't unique to SLATs—they apply to all trusts in which the grantor's spouse has a current beneficial interest, including lifetime qualified terminable interest property trusts. And finally, a word of caution. As awkward as it may be to discuss the potential of divorce before there are any signs of discord, an advisor who represents both the grantor and the grantor's spouse should discuss these issues with the couple when they're creating and funding the SLAT. The couple could even memorialize their understanding that: (1) the spouse who's the settlor of the trust is contributing marital property to the SLAT (if that's the case), and (2) the beneficiary spouse either will or won't continue to be a beneficiary if they divorce. Clarifying the couple's understanding in a simple one-page document could save them time and money on divorce. 🔄

Endnotes

1. Internal Revenue Code Sections 2505(a) and 2010(3).
2. IRC Section 2010(3)(C).
3. See *In re Erny's Trust*, 202 A.2d 30, 32 (Pa. 1964) (recognizing that "the word 'wife' doesn't inflexibly and immutably refer to the wife who survives, when another was wife at the time the will or trust was made, or to the wife at the time the will or trust was made") and *Bogert's The Law of Trusts and Trustees*, Section 182.

4. 71 A.L.R.2d 1273, Section 2.
5. See, e.g., *Rogers v. Rogers*, 174 Misc. 841, 844 (N.Y. Sup. Ct. 1940), *aff'd*, 262 A.D. 798 (N.Y. App. Div. 1941) (holding that "[t]he law seems to be well established that where a gift is given to the wife of a married man, it refers to the then wife, and not to one whom he may subsequently marry"), *Porter v. duPont*, 41 Del. Ch. 336 (1963) (finding that designating an individual as the grantor's "'wife' should be regarded as merely descriptive of the relation of the beneficiaries at the time of execution of the instrument, and not as words implying a condition that the beneficiary so described must occupy that status at the time of vesting of the gift in order to be entitled thereto") and *In re Erny's Trust*, *supra* note 3, at p. 33.
6. *Wells Fargo Bank v. Marshall*, 20 Cal. App. 4th 447, 458 (1993) and *Matter of Trust of Killian*, 459 N.W.2d 497, 501 (Iowa 1990).
7. Section 112 of the Uniform Trust Code states only that:

[t]he rules of construction that apply in this State to the interpretation of and disposition of property by will also apply as appropriate to the interpretation of the terms of a trust and the disposition of the trust property.

Under Section 2-804 Uniform Probate Code, the interest of an ex-spouse in a governing instrument as a beneficiary or designated officeholder is revoked on the divorce, but this section only applies to governing instruments that are revocable.

8. The general rule in IRC Section 677(a) is subject to two exceptions. Pursuant to these exceptions, a trust isn't a grantor trust under Section 677(a) if the power to distribute or accumulate income for the benefit of the grantor or their spouse is exercisable: (1) only with the approval or consent of an adverse party, or (2) after an event such that the grantor wouldn't be treated as the owner under IRC Section 673 if the power were a reversionary interest.
9. Treasury Regulations Section 1.677(a)-1(b)(2).
10. Treas. Regs. Section 1.682-1(a)(1)(i).
11. Tax Cuts and Jobs Act of 2017, Sections 11051(a), (b)(1) and (c), PL 115-97; Notice 2018-37.
12. At least six states have enacted statutes authorizing the trustee to reimburse the grantor for income taxes attributable to a grantor trust: Colorado (C.R.S. Section 15-5-818), Delaware (12 Del. C. Section 3344(a)), Florida (Fla. Stat. Section 736.08145(1)(a)), Nebraska (Neb. Rev. Stat. Section 30-3881(b)), New Hampshire (N.H. Rev. Stat. Section 564-B:8-816(c)) and New York (N.Y. Est. Powers & Trusts Law Section 7-1.11(a), limited to income attributable to trust principal).