EQUITABLE

Planning perspective

Flexible planning

Spousal Lifetime Access Trusts and Private Split-Dollar

Why now, more than ever?

When the conversation turns to estate planning, your clients may balk, thinking they're not wealthy enough, or that irrevocable gifts or planning may not be a good choice. However, irrevocable doesn't mean inflexible. Your clients might want to consider planning now while conditions are optimal — high gift exemptions, low discount rates and tax changes may be looming on the horizon. For a longer discussion on these potential changes, see Equitable's eNotice on recent proposals.

This Planning Perspective will showcase two highly flexible planning techniques that may fit some of your clients.

Spousal Lifetime Access Trust (SLAT)
Private financing

Why should clients plan now?

Clients are becoming increasingly concerned that higher taxes may be on the way. This is a top item trending in the news across both income tax and wealth transfer tax categories. As we look at the deficit that's built up over the past several decades, it seems like higher taxes may be inevitable. As a result:

Clients are looking for income tax-efficient ways to generate income.

- The current top federal income tax rate for both individuals and trusts is 37%, but many expect it to increase.
- Income generated in a trust where the trust is paying the tax has little leeway before it is taxed at the top rate. Some proposals would eliminate or reduce the effectiveness of trusts where the grantor is paying the tax.

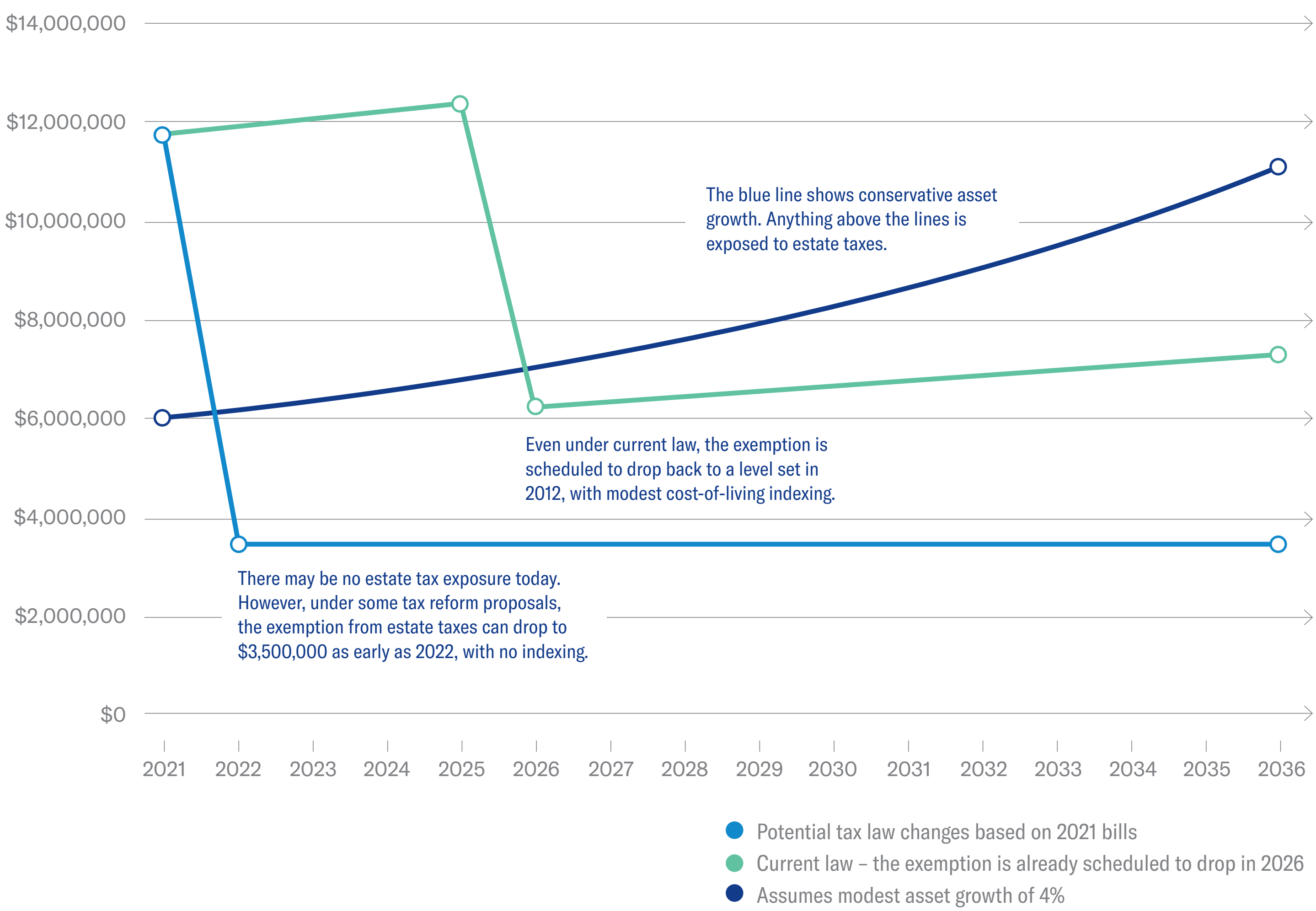
President Biden's American Families Plan is focused on taxing capital gains at increased rates, whether the transfer is during a person's lifetime or upon death, with relatively few exceptions.

- Although not in President Biden's proposals, progressive Democrats are looking at steeply increased estate and gift taxes, with reduced limits on lifetime gift transfers.
- Some proposals are seeking to limit the ability to gift into what's known as grantor trusts, reducing the gifting capacity for even modest estates.
- No one knows how these initiatives will play out; most likely there will be some Congressional compromise, but change appears to be inevitable.

The lifetime exemption amount before estate and gift taxes begin currently stands (in 2021) at $11.7 million per individual and over $23 million per couple.

- In 2026, that amount is scheduled to drop to the $5 million exemption that was enacted in 2012 with adjustments for inflation indexing. It's estimated the indexed amount might be about $6.5 million in that year. Even if no changes are passed by Congress before the mid-term election, many more people will still be at risk for estate taxes. See the chart below to get a sense for how this might play out for a client with an estate at $6 million.

Estate tax exposure is still there, even for modest net worths.



Interest rates stand near all-time lows.

The chart below shows the Applicable Federal Rate (AFR) today, 10 and 20 years ago. This rate (based on each month's average Treasury Bill rates) must be used in assumptions related to many planning strategies.

	Short-term AFR Loans up to 3 years	**Mid-term AFR** Loans 3-9 years	**Long-term AFR** Loans more than 9 years	**Unified credit or lifetime exemption**
June 2021	0.13%	1.02%	2.08%	$11,700,000
June 2011	0.46%	2.27%	4.05%	$5,000,000
June 2001	4.15%	5.02%	5.75%	$675,000

That is not a typo. In 2001, the unified credit exemption allowed only the first $675,000 of a client's estate to avoid federal estate taxes. And, the AFR rates were considerably higher.

In 2021, this confluence of events is unique because it allows for many planning options, and many that are likely to change.

- We're seeing an all-time high exemption for gift and federal estate taxes now, but these numbers are likely to decrease.
- Today's relatively low federal estate tax rate of 40% could run higher under some proposals or even be a 43.8% capital gain rate.
- We may see possible limitations on annual gifts.
- We could see possible changes to the status of trusts where gifts are made after 2021.
- Many tax proposals don't have an effective date or have one beginning on January 1, 2022.
- Interest rates are near all-time lows, but expected to rise over time.

As you'll see echoed elsewhere in this Planning Perspective, the time to plan may never be better. However, many clients are hesitant to plan because of phrases like irrevocable trust — a fear of gifting items they may need — even if they have sufficient other assets. However, there are strategies offering the ability to plan and retain flexibility.

Let's look at two popular planning strategies — the Spousal Lifetime Access Trust and private financing. Both offer considerable flexibility in planning for families.

Let's look at each strategy and see where life insurance might be appropriate.

Why a Spousal Lifetime Access Trust?

A Spousal Lifetime Access Trust (SLAT) allows a client to gift substantial amounts into a grantor trust, especially in 2021, with the idea that these assets be used to support a spouse's HEMS (health, education, maintenance and support). The trust can be set up to care for at least one spouse's needs, thereby freeing up household income.

Once gifted, these assets and future asset growth remain outside of both spouse's estates, even while benefiting one spouse. At the same time, the gifted assets can be managed in the trust just as they were before they were gifted to the trust; it simply involves a title change. If properly structured, the taxes on these trusts can be paid for by the couple at their income tax rate instead of the higher trust tax rate. This preserves the full asset growth within the trust, while paying income taxes further reduces the couple's taxable estate.

The key, however, is that by having one spouse as the trust's grantor and the other spouse as the trust beneficiary, the trust can give the trustee(s) discretion to distribute either principal, interest or both to the beneficiary (non-grantor spouse).

In some instances, the gifted amounts may be borrowed back by the grantor spouse, so long as the loan is considered "at arm's length," meaning it uses today's low interest rates, which can make the loan very attractive.

An example of SLAT

Meet Meg and Ryan

A couple, Meg and Ryan, have a $7 million estate, made up of a primary residence, a large IRA and 401(k), and investment accounts.

While exempt from federal estate taxation today, a drop in the lifetime exemption could easily create an estate tax problem for the couple. Ryan creates a SLAT to benefit Meg and gifts $3 million of liquid assets. This has the effect of:

- Reducing the couple's estate to $4 million.
- Providing a source of funds to benefit Meg.
- Keeping any asset growth on the $3 million out of the couple's future estate. Even at a modest 5% average annual return, the couple could see that amount grow to nearly $8 million over 20 years. That additional $5 million of growth, plus the original $3 million, is now out of the couple's estate.

If needed, Ryan could borrow some or all of the $3 million, provided he did this in an arm's length fashion between himself and the SLAT.

In some instances, it might make sense to have the trust buy a life insurance policy with some of the assets. This can offer the taxpayer more tax efficiency than other assets. Using a variable life insurance contract can allow an asset manager to approximate the portfolio they have already constructed for the family.

For more information about asset location, see Equitable's **asset location flyer**.

A life insurance policy that insures the life of the trust grantor within a SLAT offers a number of benefits:

- Tax-efficient growth of trust assets based on IRC §7702 (as noted on previous page).
- The ability to make policy distributions during the insured's lifetime that can be received as income tax-free distributions to the spouse beneficiary.
- In the event the grantor spouse dies, tax-free death proceeds can enhance the amounts available to the spouse beneficiary.

This example shows how this works with a life insurance policy as one of the assets in the trust.

Premium paid with separate property gifts from insured spouse → Life insurance policy held in the SLAT (irrevocable trust)

→ Potential for tax-free trust distributions/loans to the non-insured spouse

→ Income and estate tax-free death benefits to spouse and heirs

Please note, life insurance policies on a single life are normally used in a SLAT, but survivorship life insurance may be used as well. Where survivorship life insurance will be purchased by the trust, special drafting issues must be considered to include eliminating the non-insured spouse as a co-trustee.

Why private financing?

As an alternative to a gift, a client can make a loan to their ILIT or other irrevocable trust. If properly drafted as an arm's length loan, with a full expectation of being repaid with an AFR-based market rate of interest charged on the loan, clients can help seed a trust to achieve key planning objectives. Although this doesn't move funds out of a client's estate (the note and repayments are still assets in their estate), the approach allows a client to move the asset's growth and income out of their estate. At today's very low interest rates, this can offer tremendous leverage where an asset is appreciating or generating income.

This approach gives a client the ability to:

- Put money into a trust, receive a collateralized note and have the flexibility to receive the funds back at a future point in time.
- Provide a steady stream of income to the trust by loaning a large income-generating asset, such as real estate, to the trust.
- Continue to manage the funds loaned to the trust as they were before, just under a different account now associated with the trust.
- Seed a trust with funds to achieve other aims, such as paying premiums on a life insurance policy (as shown in the graphic on the following page).

Where a life insurance policy is involved and where it serves as collateral for the loan, this arrangement might also be referred to as private split-dollar, or "loan regime" split-dollar.

Note: Depending on what legislation currently in Congressional Committee passes, some gifting options may be limited, and this arm's length loan approach may become an attractive alternative to waiting until the legislation is finalized.

An example of private financing:

Meg and Ryan

A couple, Meg and Ryan, have a $7 million estate, made up of a primary residence, a large IRA and 401(k), and investment accounts.

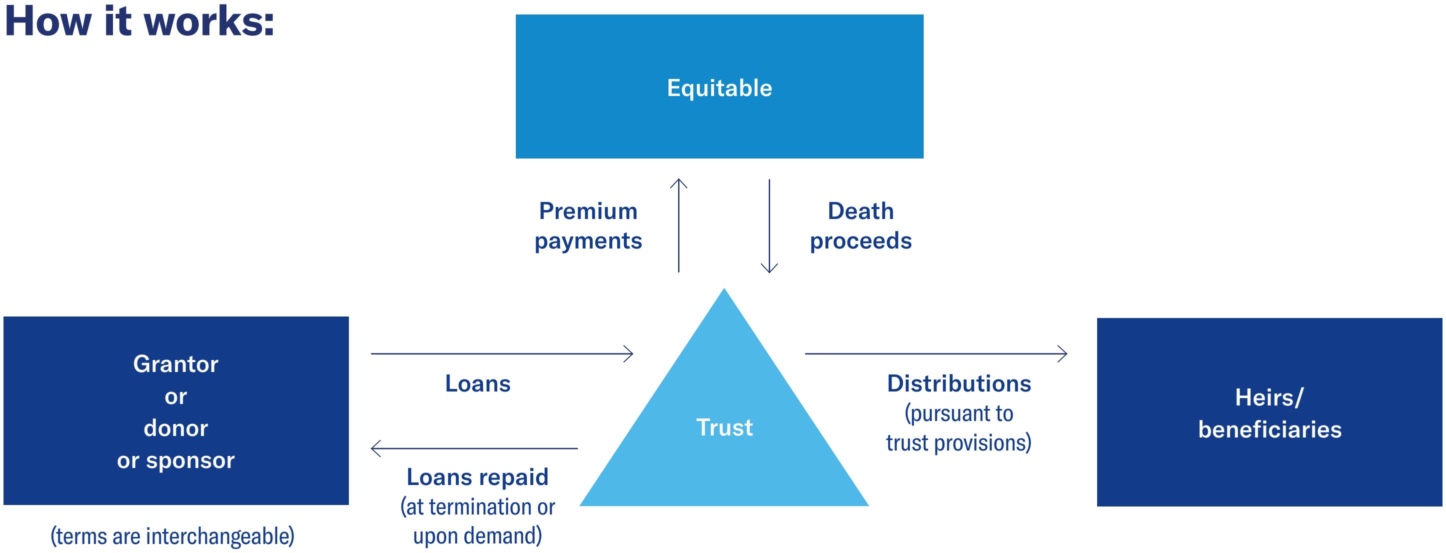
Ryan loans the $3 million to an irrevocable trust for a 9-year loan, locking in today's low mid-term AFR of 1.02%. The assets are assumed to grow at 5% before taxes (taxes are paid by the grantor of the trust). This allows:

- The trust to pay Ryan the 1.02% each year (or $30,600).
- The balance of the 5% growth (3.98%) to remain in the trust. Based on average annual returns, the trust assets will grow to over $4.2 million over 9 years.
  - However, only $3 million would need to be paid back. In effect, the couple has moved $1.2 million out of their estate.
- The family's asset manager to continue to manage the funds just as they always have done.
- Some of the annual return to be used to purchase life insurance in the ILIT, which provides the trust with some tax efficiency and leverages the gift.

As noted above, if there are limitations placed on future gifting, this loan strategy is a good alternative.

For more information about private financing and private split-dollar, see Equitable's **private split-dollar overview.**

How it works:



Flexible estate planning

Comparing a SLAT to private financing (aka private split-dollar).

Both options offer considerable flexibility for clients hesitant to forever part with assets.

- With a SLAT, a client can borrow back from the trust, but more likely the trust will provide for their spouse.
- With private financing, or private split-dollar, a client will retain access to the loan principal while the loan amounts grow outside the client's estate and help fund other planning goals, such as life insurance.

Both approaches offer considerable benefits in today's low interest rate/high lifetime exemption environment — conditions that are likely to change in the near future.

Let's compare each of these approaches.

Spousal Lifetime Access Trust (SLAT)	Private financing/private split-dollar
Benefits children or other trust beneficiaries.	Benefits children or other trust beneficiaries.
Assets gifted into the trust are permanently removed from the client's estate.	Assets are loaned to a trust, so the client can receive the funds back at a future point in time.
Asset growth and income are removed from the client's estate.	Growth and income on the loaned assets are removed from the client's estate.
Clients can indirectly access the funds either by a distribution to a spouse or by borrowing trust assets.	Clients will eventually receive the loan back. They can call the loan early, although this may affect the loan terms.
There is creditor protection. Gifts made to the trust are beyond the reach of personal creditors,[1] although once funds are released to a spouse, they may be garnished by creditors.	There is some creditor protection. Assets in the trust (including any life insurance cash values and death benefits) are protected from creditors. The loan principal could be attached by creditors. Once funds are repaid or distributed, they would be subject to creditors.

Other considerations

As with all planning approaches, there are both advantages and other considerations that need to be weighed. Let's review some of these other considerations.

Threat of divorce
If there is a concern about the stability of a marriage, a SLAT might not be an appropriate approach. If there was a divorce, the distribution of assets to a spouse might steer the assets away from the anticipated household income. A SLAT can be drafted to reflect the spouse of the grantor at any point in time, as opposed to a specified individual, but this might not be practical.

1 This assumes the gift is made before there is a creditor threat. Otherwise, a court may rule the gift was made to avoid the creditor.

Loss of access on a first death

There might be a concern that property gifted into a SLAT would be lost if the beneficiary spouse were to pre-decease the grantor spouse gifting the assets. If that occurred, the contingent beneficiaries (usually the couple's children or a charity) would become the beneficiaries.

- This can be addressed by setting up a SLAT for each spouse so that at one spouse's death, the surviving spouse would still be a beneficiary of the trust established for their behalf. Care will need to be taken so each trust is not identical to the other; if they were, the IRS could argue no gift was made under the "Reciprocal Trust Doctrine."
- Additionally, each trust could buy life insurance on the other spouse to provide an uptick in trust assets, if one spouse were to die, to make up for any potential loss.

Community property

Under either approach, where there is a community property state involved, care needs to be taken that assets are contributed or loaned from individual property. This may be magnified if the spouse is the beneficiary under a SLAT approach.

	Single life policy	Joint life policy
Grantor	Insured spouse	Spouse A
Trust beneficiary	Non-insured spouse	Spouse B
Trustee	May be third party and non-insured spouse with limits on that spouse's powers or third party alone	Third party
Contributions from	Insured spouse only	Spouse A only (must be separate property)
Limits on distributions	Non-insured spouse trustee may distribute to themselves for health, education, maintenance and support. Third-party trustee may distribute to non-insured spouse for supplemental retirement income	Third-party trustee may distribute to Spouse B for supplemental retirement income or health, education, maintenance and support

Arm's length transactions

It's important that all transactions (gifts and loans) are made with care. This is especially true regarding loans, as these will need to be made at a market rate of interest, and usually for a specified period. Loans that aren't carefully made can trigger unintended gift transactions or include more income in a client's tax year than anticipated.

Careful legal drafting is required

Neither of these approaches should be set up lightly. Care should be taken to ensure the documents respect decades of legal and tax precedent to avoid any risk of estate inclusion. Special care should also be taken when distributions are made or if loans are transacted, so these are never perceived as going directly to the trust grantor.

Lock in today's interest rates
When a private loan (also known as loan regime split-dollar) is involved, you may want to take advantage of today's low interest rate environment and lock in an appropriate AFR interest rate. If an interest rate and loan term aren't specifically stated, the planning can get complicated. That could force the arrangement into short-term interest rates that can fluctuate widely over the years or trigger imputed income under what's known as the original interest discount rules. Our recommendation is to lock in a rate today; clients can still renegotiate loans in later years.

Trust would need funds to pay interest each year in private loan arrangements
You may want to find a way to have the trust pay interest each year in these arrangements. If the plan is to have the loan accrue interest each year, that compounded amount can become substantial, enough so that it could reduce the trust principal and/or the death benefit available to the trust beneficiaries.

Conclusion

Both SLAT and private financing arrangements are attractive planning approaches. They've been successfully used over the last several decades and offer the client flexibility. However, given today's conditions of historically low interest rates and the strong possibility of the estate or gift tax changes discussed above, these approaches may be more attractive than ever for clients who want flexibility in their estate planning.

For all the reasons discussed above, the possibility of 2021 tax changes and the certain changes that will occur by 2026, it makes sense to plan sooner rather than later. Looking back at each of the last three major tax bills, we see President Obama's 2010 Tax Relief Act was signed into law on December 17, 2010, and President Trump's Tax Cut and Jobs Act was signed on December 22, 2017. Most of the changes introduced by both bills went into effect on the following January 1, leaving less than 2 weeks for clients to react to the changes. The American Taxpayer Relief Act cut it even closer, passing Congress in a special session on January 1, 2013, and signed into law January 2, 2013, retroactive back to the start of the year.

The major difference between then and now is the direction of the changes. While the recent tax changes were beneficial, in that they increased estate planning limits, what we are seeing now is a possible decrease in exemptions and thresholds, and an increase in tax rates. If history repeats and President Biden's plan passes in December, there may be only a short window of opportunity to react.

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