Estate Planning Recommendation—SLATs

Current Tax Environment

- Currently, the exemption from the Federal estate and gift tax is $12,060,000
- This exemption can be used either on gifts made during lifetime, or by a person's estate at death
  - For example, if someone makes no gifts during lifetime, then the estate tax (which is currently 40%) will apply only to the extent that the estate exceeds $12,060,000
  - Accordingly, an estate of $12,160,000 million would be subject to a tax of $40,000 (40%*[12,160,000 – 12,060,000])
  - Alternatively, if gifts of $6,060,000 are made during lifetime, then the estate tax will apply only to the extent that the remaining estate exceeds $5 million

Possible Changes

- The Biden administration has proposed
  – Reducing the estate tax exemption to $3.5 million; and
  – Reducing the exemption for lifetime gifts to $1 million
- And even if Congress does nothing, the current exemption of $12,060,000 is scheduled to be reduced by 50% on January 1, 2026—Congress would have to act to keep the exemption at the current level
- ***Accordingly, we recommend that clients use the $12,060,000 million exemption (or a major portion of it) while it is still available***

Specific Recommendations

- We recommend:
  - That each spouse in a married couple create a “SLAT”; and
  - That each spouse then contribute as much to the SLAT as he or she is comfortable giving; and
  - That thereafter the spouses allow income and gains to accumulate in the SLATs for as long as possible

Some Definitions

- **SLAT: *Spousal Lifetime Access Trust***
  - A trust for the benefit of the spouse and descendants of the grantor (or creator)
  - A SLAT is usually designed so there are no separate shares as long as the grantor's spouse is alive
  - Therefore, the grantor's spouse could receive 100% of the assets contributed to the SLAT
  - For income tax purposes a SLAT is an IDGT
- **IDGT: *Intentionally Defective Grantor Trust***
  - A trust over which the grantor has (i) retained enough control to remain taxable on the trust's income (under Sections 671-679*), but (ii) released enough control so that the trust assets are not included in the grantor's taxable estate (under Sections 2031-2044).
  - In other words, the grantor is deemed to own the trust assets for income tax purposes, but not for estate tax purposes.

*All "Section" references are to the Internal Revenue Code of 1986, as amended.

SLAT
Creating the Trust

- We recommend that each spouse create a SLAT
  - Each spouse's SLAT would be for the benefit of the other spouse and the couple's current and future descendants
    - The "grantor" (or creator) could serve as one of the Trustees of the SLAT, but the grantor would have to have an "Independent Trustee" acting as a co-trustee
    - An "Independent Trustee" is a Trustee who is not also a beneficiary, but it need not be a truly "independent" party—a friend or sibling of the grantor would suffice

SLAT
How it Works—Trust Terms

- As mentioned above, each SLAT would be for the benefit of the grantor's spouse and descendants
- The Independent Trustee of each trust will be able to distribute the trust property to any one or more of the beneficiaries—distributions need not be equal
  - Accordingly, there would be no limit on the amount that could be distributed to the spouse to support lifestyle needs
  - In effect, it would be possible to "reverse" the gifts by having each spouse's SLAT distribute all of its assets to the other spouse

SLAT
How it Works—Trust Terms

- Although distributions can only be made by the Independent Trustee:
  - The grantor of each SLAT can be given the right to remove and replace the Independent Trustee; and
  - After the grantor's death, the surviving spouse can have the power to remove and replace the Independent Trustee
- Each SLAT would provide that after both spouses have died, the remaining property in each SLAT will be divided into equal shares for the children

SLAT
How it Works—Trust Terms

- The children's shares could either be distributed to them outright, or held in further trust for them
  - We recommend that the shares be held in further trust for life, and that the children be given the power to remove and replace the Independent Trustee, to ensure that they always have access to the trust funds
  - As long as the shares remain in trust, they will be protected from creditors, and assuming that "GST" tax exemption is allocated, the children's shares will not be subject to estate tax at their deaths

SLAT
How it Works—Trust Terms

- If each child's share is held in further trust for life, then upon each child's death:
  - Each child can be given a "power of appointment" which will allow him or her to direct, by Will, how the assets of the trust will pass upon the child's death
  - If the power is not exercised, then each child's share will be divided into shares for her children (the grantor's grandchildren) and held in further trust for them
  - If a child is not survived by children, the deceased child's share will be held in further trust for the other child or children of the grantor, or their respective descendants

Advantages

- Ensures use of the gift tax exemption before it is reduced
- Allows access to the assets gifted if needed
- If not needed, allows income and capital gains to build up in the SLATs, where it will NOT be subject to estate tax
- Requires the grantor to pay tax on the income and gains received by each SLAT, which will further deplete the grantor's taxable estates

Disadvantages

- When one spouse dies, the surviving spouse will effectively lose access to one-half of the assets
  - For example, if the husband dies first, the wife will still be the beneficiary of the trust the husband created, but she will not be able to access the assets in the trust she created for her husband's benefit—those assets will be permanently set aside for the children
  - But in this case, the wife could potentially borrow the assets in her SLAT if needed

Disadvantages

- The SLATs will receive the grantor's basis in the assets contributed to them
  - But if the grantor holds the assets till death, the basis in the assets will be "stepped up" to fair market value
  - Given that the estate tax is at a higher rate than the capital gains tax rate (40% vs. 23.8%) and that the estate tax is a tax on ***value***, not gain this will only be a disadvantage if the exemptions are so large at the grantor's death that the grantor's estate would not have been subject to estate tax had the grantor kept the assets

Grantor Retained Annuity Trusts (“GRATs”)

GRAT
What is it?

- **The term "GRAT" is an acronym for "*Grantor Retained Annuity Trust*"**
- A "GRAT" is a trust that pays the creator (or "grantor") a fixed dollar amount (an "annuity") for a term of years

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GRAT
How it Works

- A person wishing to make a gift (the "grantor") transfers assets to a trust and retains the right to receive a fixed dollar amount (an "annuity") each year for a specified term
- The GRAT is a "grantor trust" for income tax purposes, meaning that the grantor pays the tax on all income realized by the trust (interest, dividends, capital gains, etc.), but the grantor's receipt of the annuity is a nontaxable event
- Assuming the grantor survives, at the end of the term, the remaining trust assets pass to the grantor's children or other beneficiaries* free of any gift taxes
- Upon creation of the GRAT, the grantor will be deemed to have made a gift equal to the value of the assets transferred to the trust, reduced by the present value of the grantor's retained interest (i.e., the annuity)
  - *The longer the term, and the lower the discount rate, the higher the present value of the grantor's retained annuity and thus the lower the taxable gift*

*Including grandchildren as beneficiaries will have generation-skipping transfer (or "GST") tax consequences, because the grantor's GST tax exemption cannot be allocated to the GRAT until the end of the GRAT term

GRAT
How it Works

- When calculating the present value, the IRS assumes that the trust assets will grow at a certain rate (**in June 2022, the rate is 3.6%**)
  - This rate, which changes every month, is known as the "Section 7520 rate" and is also commonly referred to as the "hurdle rate"
- ***Any appreciation in excess of the hurdle rate will pass to the remainder beneficiaries gift-tax free***
- It is possible to set the annuity rate so high that the presumed value of the remainder (the taxable gift) is zero (or nearly zero), so no (or very little) gift tax will be incurred upon the creation of the GRAT
  - Such a GRAT is sometimes referred to as a "zero GRAT"

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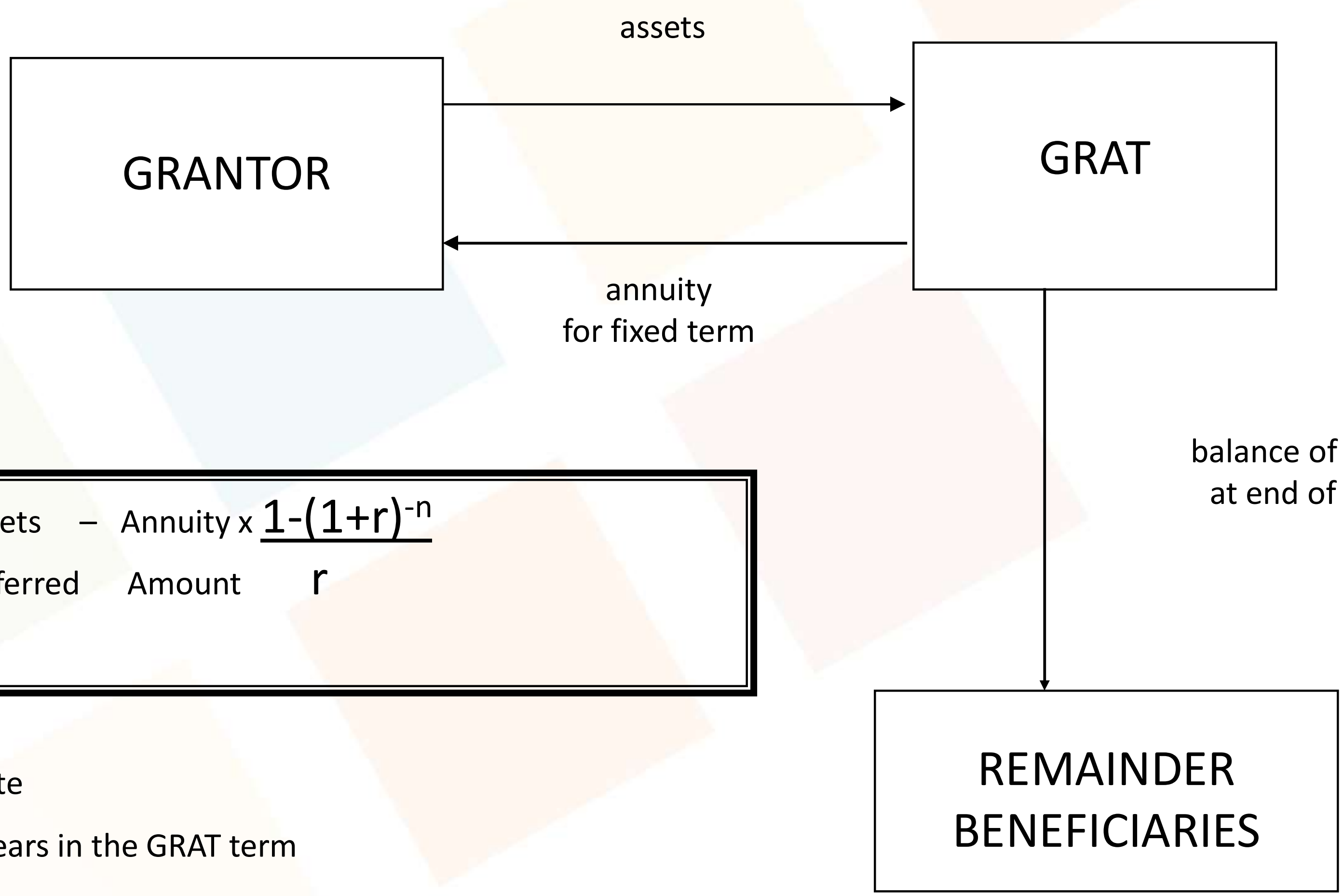
GRAT Diagram



$$\text{Taxable Gift} = \text{Assets Transferred} - \text{Annuity Amount} \times \frac{1-(1+r)^{-n}}{r}$$

r=the hurdle rate

n=number of years in the GRAT term

GRAT - A Numerical Example

- **Suppose a grantor transfers $10,000,000 to a 10-year GRAT**
- **The Grantor retains the right to receive $1,113,260 from the GRAT every year for 10 years**
- **At the end of the 10-year period, the assets remaining in the GRAT will pass to the grantor's children (or a trust for their benefit)**
- **Based on a hurdle rate of 2%:**
  – The present value of the grantor's retained annuity is $9,999,969, and
  – The ***gift tax value*** of the remainder is $31, and
  – The grantor pays very little gift tax (or uses very little exemption) upon the creation of the GRAT ($12.40)

- However, the ***actual value*** of the amount passing to the children will depend upon the growth rate of the assets in the GRAT, for example:

Growth Rate of GRAT Assets	Amount Passing to Children
4%	$1,436,524
6%	$3,234,825
8%	$5,461,939
10%	$8,194,927
12%	$11,522,177

GRAT
Things to Consider

- If the grantor dies before the end of the GRAT term, then all of the GRAT assets will be included in the grantor's taxable estate
  - Of course, this is no worse than if the grantor had not created the GRAT in the first place
- If the GRAT assets do not appreciate at a rate higher than the hurdle rate, then the amount passing to the grantor's children will be less than anticipated
  - As a result, the GRAT will have been a waste of gift tax exemption (or gift tax dollars)
  - However, this problem can be avoided by setting the annuity so high that the deemed value of the remainder is near zero, like the GRAT in this example
- *NOTE: Because the GRAT assets must appreciate at a rate higher than the hurdle rate, GRATs work best when the "Section 7520 rate" is low (as it is now)*

GRAT
Designing the Right GRAT for the Client

- **Multiple Short-Term GRATs vs. A Single Long-Term GRAT**
  - Having a relatively short term (2-5 years) will increase the chances of outsized appreciation (because returns tend to moderate over time). It will also decrease the risk of the grantor dying during the term
  - Having a longer term will lock-in the hurdle rate, which can be advantageous in a rising interest rate environment
- **Simultaneous GRATs with Different Portfolios**
  - Creating several GRATs with different investments (a small cap GRAT, a large cap GRAT, a growth stock GRAT, a value GRAT, etc.) will increase the chances that one of them will beat the hurdle rate
  - This is because the gains in one asset class will not be brought down by losses in another, as they would if all of the asset classes were within the same GRAT
  - See the Asset Class Returns Over time on the next page.
- **Increasing Annuity**
  - The regulations allow a GRAT annuity to increase by 20% each year (so the Grantor receives less in the early years and more in the later years)
  - This feature should always be considered because it allows for more funds to be invested for a longer period and thus reduces the effects of bad markets in the early years of the GRAT

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Asset Class Returns over Time

Asset Class Returns

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total
EM 39.8%	HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%	EM 37.8%	Cash 1.8%	Lg Cap 31.5%	Sm Cap 20.0%	REIT 41.3%	Lg Cap 356.8%
Int'l Stk 11.6%	Cash 1.7%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%	Int'l 25.6%	HG Bnd 0.0%	REIT 28.7%	EM 18.7%	Lg Cap 28.7%	Sm Cap 249.1%
AA 7.6%	AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%	Lg Cap 21.8%	HY Bnd -2.3%	Sm Cap 25.5%	Lg Cap 18.4%	Sm Cap 14.8%	REIT 194.8%
HG Bnd 7.0%	HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.0%	EM 11.6%	Sm Cap 14.7%	REIT -4.0%	Int'l Stk 22.7%	AA 9.8%	Int'l Stk 11.8%	HY Bnd 173.1%
Lg Cap 5.5%	Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%	AA 14.6%	Lg Cap -4.4%	AA 18.9%	Int'l Stk 8.3%	AA 10.9%	AA 153.4%
Cash 4.4%	Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%	REIT 8.7%	AA -5.6%	EM 18.9%	HY Bnd 7.5%	HY Bnd 5.4%	EM 102.1%
HY Bnd 2.2%	REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%	HY Bnd 7.5%	Sm Cap -11.0%	HY Bnd 14.4%	HG Bnd 6.1%	Cash 0.0%	Int'l Stk 82.4%
Sm Cap -1.6%	Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%	HG Bnd 3.5%	Int'l Stk -13.4%	HG Bnd 8.7%	Cash 0.6%	HG Bnd -1.5%	HG Bnd 82.4%
REIT -15.7%	EM -53.2%	Cash 0.1%	Cash 0.1%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%	Cash 0.8%	EM -14.3%	Cash 2.2%	REIT -5.1%	EM -2.2%	Cash 12.9%

Abbr.	Asset Class – Index	Annual	Best	Worst
Lg Cap	Large Cap Stocks – S&P 500 Index	10.66%	32.4%	-37.0%
Sm Cap	Small Cap Stocks – Russell 2000 Index	8.69%	38.8%	-33.8%
Int'l Stk	International Developed Stocks – MSCI EAFE Index	4.09%	32.5%	-43.1%
EM	EM Stocks – MSCI Emerging Markets Index	4.80%	79.0%	-53.2%
REIT	REITs – FTSE NAREIT All Equity Index	7.47%	41.3%	-37.7%
HG Bnd	High Grade Bonds – Bloomberg Barclays U.S. Agg Index	3.99%	8.7%	-2.0%
HY Bnd	High Yield Bonds – ICE BofA US High Yield Index	7.02%	57.5%	-26.4%
Cash	Cash – S&P U.S. Treasury Bill 0-3 Mth Index	0.81%	4.4%	0.0%
AA	Asset Allocation Portfolio*	6.66%	24.6%	-22.4%

Past performance does not guarantee future returns. The historical performance shows changes in market trends across several asset classes over the past fifteen years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 12/31/21.

*Asset Allocation Portfolio is 15% large cap stocks, 15% international stocks, 10% small cap stocks, 10% emerging market stocks, 10% REITs, 40% high-grade bonds, and annual rebalancing.