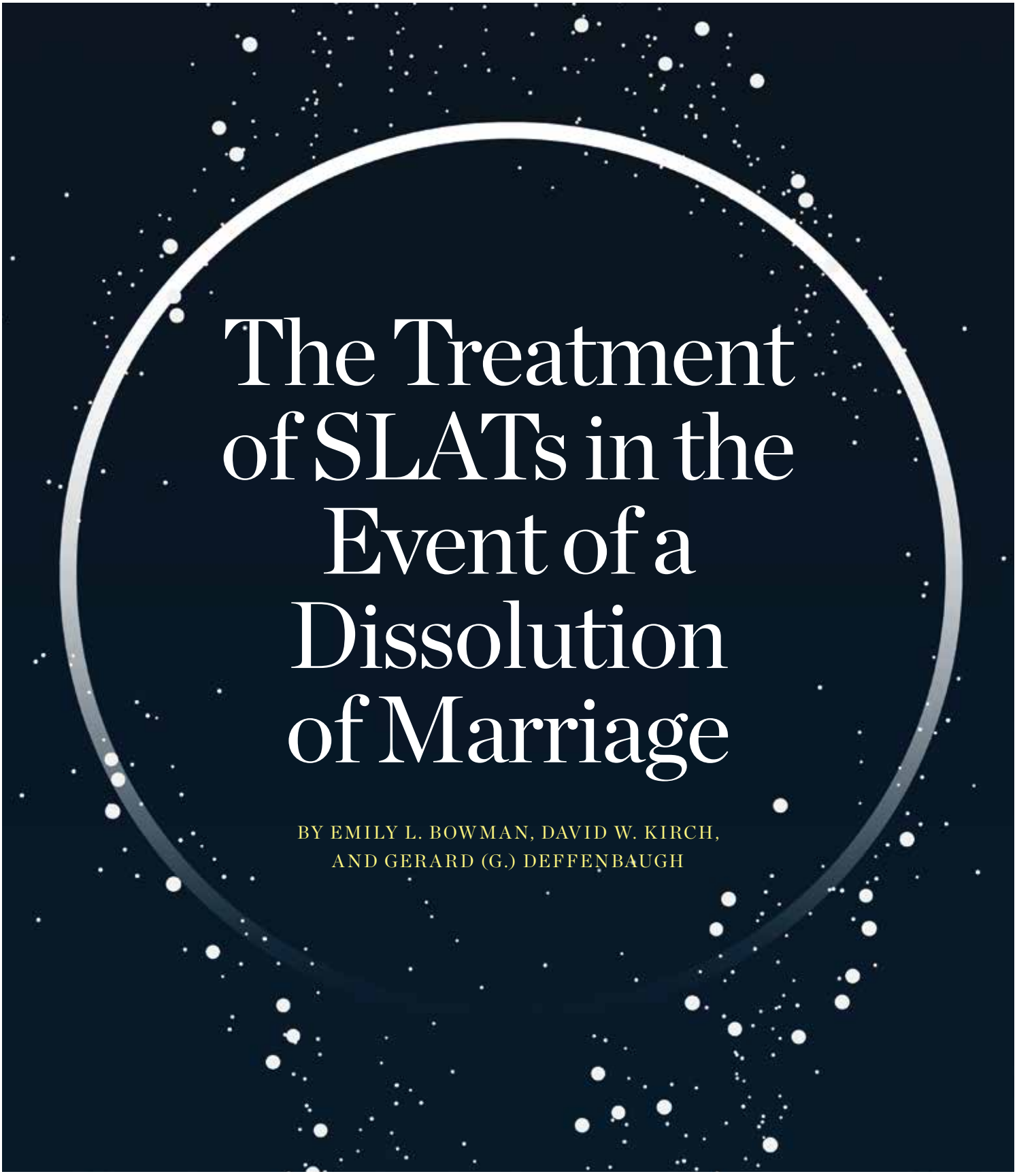

The Treatment of SLATs in the Event of a Dissolution of Marriage

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This article explains key issues for determining how beneficial interests in a spousal limited access trust could be considered in a Colorado dissolution of marriage proceeding, both when a person establishes a SLAT and later if that person is a party to a Colorado dissolution of marriage proceeding.

A spousal limited access trust (SLAT) is an irrevocable trust in which one party—the grantor[1]—establishes and funds a trust with certain assets and gives the grantor's spouse various beneficial interests in the trust in such a way that the trust is not included in the beneficiary spouse's taxable estate. A SLAT may be an appropriate tool for a person who wants to lock in the current unified estate and gift tax exemption amount, which is set to be reduced by half at the end of 2025. However, significant unintended consequences could result if the grantor and the grantor's spouse later dissolve their marriage, and such issues should be addressed during the drafting of the document establishing a SLAT. This article discusses the potential surprises that could occur under Colorado statutory and case law (including the impact of the SLAT on the division of marital property and the potential for a grantor's former spouse to retain unintended benefits from the SLAT if a dissolution of the grantor's marriage occurs after creating the trust), as well as various possible drafting techniques that may help avoid these or other unwanted surprises.

Estate Planning Reasons to Use a SLAT

A SLAT is a type of "estate freeze" tool intended to reduce tax liability on transferred assets, while often still allowing the grantor spouse an indirect benefit in the transferred assets. The grantor spouse uses some or all of their available unified federal gift tax exemption and estate tax exemption (often referred to as the "unified credit") to fund the trust with the grantor's assets, typically naming the spouse as the lifetime beneficiary and other third parties such as the grantor's descendants as remainder beneficiaries. Because the grantor's spouse is given a beneficial interest in the SLAT (usually a lifetime interest in trust income, principal, or both), the grantor can potentially benefit indirectly from SLAT distributions to the grantor's spouse during the marriage.[2] When set up properly, any appreciation to the assets of the SLAT after the date of transfer from the grantor to the trust is excluded from the grantor's taxable estate at death.

> "Given the uncertainty of this tax environment, a SLAT may be a beneficial estate planning tool to lock in use of the currently higher unified credit for those married couples whose combined exemptions are likely to exceed the available exemptions if the current exemption 'sunsets' at the beginning of 2026."

In 2024, the unified credit and the generation-skipping transfer tax exemptions are each $13.61 million per person.[3] However, absent legislative action, these amounts will automatically be reduced by half at the end of 2025.[4] Given the uncertainty of this tax environment, a SLAT may be a beneficial estate planning tool to lock in use of the currently higher unified credit for those married couples whose combined exemptions are likely to exceed the available exemptions if the current exemption "sunsets" at the beginning of 2026. A grantor could also preserve some of the grantor's currently increased generation-skipping transfer tax exemption by naming the grantor's grandchildren or subsequent descendants as beneficiaries of the SLAT.

Some concern existed that if a grantor funded an irrevocable trust prior to 2026 using their increased unified credit, and at the time of the grantor's subsequent death the federal estate tax exemption was less than what existed at the time of the trust's funding, the Internal Revenue Service (IRS) could "claw back" that difference into the grantor's taxable estate. In response to this concern, the IRS issued final regulations (often referred to as the "anti-clawback" regulations) clarifying that certain types of lifetime transfers from a person to an irrevocable trust (like SLATs) made prior to December 31, 2025, that used the then-existing unified credit will not be "clawed back" into the grantor's taxable estate at death, thereby permitting limited continuing benefits of the current increased unified credit as to certain specified transfers, even if the exemption amounts decrease after 2025.[5]

Note, however, that the IRS is currently considering proposed "anti-abuse" regulations that identify certain types of transfers for which the "anti-clawback" regulations would not be applicable.[6] If finalized and enacted, these additional proposed "anti-abuse" regulations

should be carefully reviewed by the drafting attorney to determine their applicability to those specific assets being considered to fund the SLAT.

Issues to Address When Establishing a SLAT

Three overriding considerations an estate planning attorney should analyze and discuss with the client before establishing a SLAT include (1) avoiding application of the reciprocal trust doctrine (if each spouse will be establishing their own SLAT), (2) addressing whether a marital agreement would be useful and appropriate given the grantor's specific circumstances, and (3) considering how the trust agreement and its specific provisions will operate in the event of a marriage dissolution. In addition, the estate planning attorney may want to consider whether it would be beneficial to structure the SLAT as an intentionally defective grantor trust (IDGT), and whether the advantages of an IDGT outweigh the potential risks to the grantor spouse in the event of a divorce.

Avoiding Application of the Reciprocal Trust Doctrine

If both parties to a marriage are interested in establishing and funding separate SLATs, the potential application of the reciprocal trust doctrine should be addressed. Under the reciprocal trust doctrine, the IRS could assert that separate spousal SLATs that have substantially similar terms and are essentially part of the same transaction should be treated as if each grantor had settled the trust for that grantor's own benefit.[7] The result could be that the appreciated assets each grantor spouse transferred to their SLAT would be included in their respective taxable estates at their deaths.[8] This would defeat the purpose of establishing the SLATs in the first place.

Including different dispositive provisions in the SLATs and/or settling the SLATs at different times are frequently used techniques to reduce the risk that the reciprocal trust doctrine will apply. Some such differing provisions used, whether in combination or separately, include (but are not limited to) naming different beneficiaries, including different types of powers of appointment; funding the SLATs with assets of different types and values; and naming a different combination of primary and successor trustees.[9]

Using Marital Agreements

If one or both parties to an existing marriage will be establishing a SLAT, it may be beneficial for the parties to enter into a marital (or "postnuptial") agreement that stipulates how a spouse's interests in the SLATs will be treated in a dissolution of marriage proceeding should the parties later divorce.[10] While most states have adopted a version of the 1983 Uniform Premarital Agreements Act, Colorado is one of only a few states to adopt a version of the 2012 Uniform Premarital and Marital Agreements Act, which treats premarital and marital agreements almost identically.[11] As a result, the treatment of *marital* agreements still varies widely from state to state, with many states having different—and often more difficult—standards of enforceability than for premarital agreements.[12]

While it is common for one attorney to prepare a SLAT for each spouse, this attorney should typically not also represent both spouses in connection with the marital agreement and should strongly recommend that one of the spouses retain separate legal counsel.[13] In many circumstances, it may be best for this attorney to recommend that both spouses each retain separate legal counsel in relation to preparing and reviewing the marital agreement.

In a Colorado dissolution of marriage proceeding, the court will set apart to each spouse their respective separate property, and must "equitably" divide marital property between the spouses after considering all relevant factors, including the "economic circumstances of each spouse at the time the division of property is to become effective."[14] A spouse's separate property includes all property acquired before the marriage, as well as any property acquired

during the marriage by "gift, bequest, devise, or descent."[15] However, any increase in value to a spouse's separate property during the marriage is marital property.[16]

Under current Colorado law, a beneficial interest in a SLAT or other irrevocable trust may be subject to treatment as either property or an economic circumstance in the event of a dissolution of marriage under Colorado law.[17] However, this involves a complicated and fact-specific analysis that depends, among other things, on whether the spouse has an interest in the trust's income and/or principal; whether the interest is mandatory (e.g., the trustee *must* distribute all net income to spouse) or discretionary (e.g., trustee *may* distribute principal to spouse in trustee's sole discretion); whether the spouse is a current or remainder beneficiary; and what contingencies are built into the trust (e.g., spouse is entitled to one-half of trust principal only if and when spouse reaches age 50). Expert witnesses are often required to opine as to both the character of the spouse's trust interest (including whether the interest constitutes property versus an economic circumstance, and, if the interest is property, whether it constitutes separate property, marital property, or a combination of the two), as well as the value of the various interests. Consequently, the court's final determinations can often be unpredictable.

A grantor of a SLAT will typically give their spouse a lifetime interest in the trust's income, principal, or both. The terms of the SLAT will stipulate whether these interests are mandatory or discretionary, and may specify whether the spouse's interest in the trust continues or terminates in the event of a divorce. Should the spouse's beneficial interest in the SLAT continue even after a dissolution of marriage, this may impact not only the division of marital property but also spousal maintenance and child support.[18]

In furtherance of the estate tax avoidance purposes of a SLAT, the spouse is typically not named as the remainder beneficiary. Assuming the beneficiary spouse does not have a remainder interest, a spouse's interest in a SLAT that continues after a divorce and provides for either (1) mandatory distributions of income or (2) discretionary distributions of income or principal should typically not be treated as a property interest. However, under applicable Colorado statutory and case law, this continuing interest would generally constitute an economic circumstance of the spouse that the court can consider when determining how to equitably divide marital property.[19] In addition, a spouse's beneficial interest in trust income could impact both spousal maintenance and child support.[20]

For the reasons addressed above, if the grantor's spouse will continue to hold beneficial interests in the SLAT after a dissolution of marriage, a marital agreement that clearly establishes how a spouse's interest in a SLAT will be treated in the event of a divorce could be a useful tool to avoid unnecessary costs and complications. Note, however, that under Colorado law, the terms of a marital agreement will be unenforceable by a Colorado court if and to the extent such terms impact a child's right to support or otherwise violate public policy.[21]

Specific Drafting Considerations in Anticipation of a Possible Future Divorce

Several key provisions discussed below address concerns with how a spouse's beneficial interests in a SLAT may be treated if the parties divorce.

Definition of spouse. The definition of spouse contained in the trust agreement will determine whether a former spouse will remain a trust beneficiary after a dissolution of marriage proceeding.[22]

One approach to identifying the spouse in the trust agreement is by using the current spouse's name. The trust agreement may or may not contain a provision to the effect that the current spouse's beneficial interests in the SLAT are contingent upon the current spouse remaining legally married to, and not legally separated from, the grantor during the grantor's life.

Another approach to consider is to define the spouse as the person to whom the grantor is married at the time that either the trustee takes an action or a trust provision becomes operative or applicable. Under this scenario, if the grantor initially establishes the trust while married to one spouse but subsequently remarries, the grantor's new spouse would then have a beneficial interest in the SLAT. Such a provision would potentially allow the grantor to continue to indirectly benefit from SLAT distributions to the subsequent spouse.

Beneficial interests of the grantor's descendants in a SLAT. In addition to addressing the spouse's beneficial interests in a SLAT in the event that the grantor and spouse divorce, consideration should also be given to the possible impact on someone holding beneficial interests in trusts other than the grantor's spouse, if that beneficiary should themself later become involved in a divorce proceeding. As discussed above, such beneficial interests could be treated as property or an economic circumstance by the court.[23] Specifically, the interest of a remainder beneficiary could be deemed separate property, so the increase in value to this property during the parties' marriage would then be deemed marital property.[24] Interests subject to the discretion of the trustee would potentially be treated as economic circumstances and could affect the division of marital property, spousal maintenance, and/or child support for grantor's descendants.

Drafting strategies to potentially avoid treatment of beneficial interests in trusts as property or economic circumstances in the event of a dissolution of marriage. Various provisions and drafting approaches have been used to address the risk that a beneficial interest in an irrevocable trust such as a SLAT would be treated as the property or an economic circumstance of the beneficiary. However, the impact of such provisions is a new and developing area of the law with little available statutory or case law authority to provide guidance. Therefore, the practitioner should exercise independent discretion in determining the operation of such or similar provisions on the treatment of beneficial interests in irrevocable trusts as property or an economic circumstance in a dissolution of marriage proceeding, and whether their application as to spousal rights would be contrary to public policy.

As noted above, a beneficiary's discretionary right to income or principal may be deemed an economic circumstance of the beneficiary in a dissolution of marriage proceeding. One

technique sometimes used to seek to avoid this result is to include trust provisions that prohibit the trustee from making discretionary distributions of income and/or principal to the interest holder if a dissolution of marriage proceeding is initiated. If the holder of such a beneficial interest is also the trustee, another option sometimes used to avoid the trustee-beneficiary's beneficial interest being treated as a property interest and/or an economic circumstance is to remove the interest holder as trustee in the event of commencement of a dissolution proceeding (or even before such time). This may occur upon the resignation of the trustee-beneficiary or under the express terms of the trust. Limiting a trustee-beneficiary's distribution rights to an ascertainable standard is another possible basis to avoid the beneficiary's interest being treated as an economic circumstance. Such a standard is routinely included to avoid the trust being included in the trustee-beneficiary's taxable estate, though in practice it is often disregarded.

Another approach sometimes suggested is to use choice-of-law provisions to avoid application of the laws of states like Colorado that are more inclined to treat beneficial interests in trust as property or an economic circumstance in a dissolution of marriage proceeding. However, it seems that Colorado courts will most likely rule that Colorado law applies when determining the effect of beneficial interests in trusts held by a spouse, even if the trustee and the trust assets are not subject to the jurisdiction of the Colorado court in which a dissolution of marriage proceeding is pending.

Using generation-skipping trust provisions in most instances should avoid a non-remainderman lifetime beneficiary (typically a spouse) being treated as having a property interest. However, circumstances surrounding the trust's creation, administration, or operation may provide grounds for challenging this conclusion.

Structuring a SLAT to Operate as an IDGT

A SLAT could further reduce a grantor's taxable estate if it contains provisions causing it to be an IDGT. An IDGT is a type of irrevocable trust drafted in such a way that it is deemed a grantor trust for income tax purposes only (i.e., the trust's income is attributable to the grantor rather than the trust, while the trust operates as a standard irrevocable trust in all other respects, including for estate tax purposes). As a result, the grantor is responsible for paying the income taxes, thereby further reducing the grantor's taxable estate while allowing the trust's assets to grow income-tax free. Under current law, the grantor's payment of the SLAT's income taxes will typically not be treated as completed gift by the grantor (which would have the undesirable result of further reducing the grantor's unified gift and estate tax credit or causing gift tax liability to the grantor).[25]

Drafting for IDGT status. A trust is deemed to be an IDGT as to the grantor if its terms include at least one of the powers or interests identified in IRC §§ 671 to 677.[26] However, the drafting attorney must exercise caution to ensure the power/interest included in the SLAT does not unintentionally cause the trust to be deemed a grantor trust not only for income tax purposes, but estate tax purposes as well (which would defeat the purpose of the SLAT).

One of the IRC powers most commonly included in irrevocable trusts for purposes of qualifying the trust for IDGT status is to give the grantor the ability to reacquire trust property by substituting other property of equivalent value in a nonfiduciary capacity (also referred to as a "swap" power).[27] While used primarily to ensure IDGT status, this power can have the added benefit of offering increased flexibility to the grantor.

Depending on the trust structure, an estate planning attorney can provide the grantor with certain powers that can later be released if the grantor no longer wants to bear the income tax burden associated with the power.[28]

Potential complications of IDGTs in the event of divorce. While imputing an IDGT SLAT's income to the grantor spouse may be mutually beneficial to the spouses during their marriage, this arrangement poses a significant risk to the grantor spouse if the spouses divorce in the future. Under such circumstances, would the grantor spouse continue to be liable for taxes on income from which the grantor no longer receives any direct or indirect benefit? Due to recent changes in the law, the answer is unclear.

IRC § 672(e), commonly known as the "spousal unity rule," is a definitional and rules code section applicable to IRC §§ 671 to 679 which imputes to the grantor any "power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest . . . ." In the context of an irrevocable trust such as a SLAT in which the grantor's spouse typically holds an interest in the trust's income, this imputes income tax liability on a grantor spouse for any income payable from a trust to the spouse.[29] The wording of this law appears to leave open the possible interpretation that a grantor could continue to be liable for tax on the income payable from a trust to a *former* spouse. However, until recently there was no need to address this concern because IRC § 682, which was in effect until December 31, 2018, overrode specific provisions of IRC § 672(e), thereby effectively assigning income tax liability to the former spouse (who is entitled to the trust's income distributions) while maintaining the grantor trust status of the trust.[30]

The 2017 Tax Cut and Jobs Act repealed IRC § 682.[31] After the repeal of IRC § 682, in cases where a former spouse remains a trust beneficiary after a marriage dissolution, there is now the open question as to whether the spousal unity rule under IRC § 672(e) continues to apply after the marriage dissolution, even if no other grantor trust sections are applicable.[32] IRS Notice 2018-37 states that the Department of the Treasury and the IRS intend to address this issue; however, over five years have passed without such guidance.[33]

Two differing conclusions have been suggested in response to this question. The first is that, after a dissolution of marriage, the spousal unity rule under IRC § 672(e) no longer applies.[34] Under this interpretation, (1) the grantor would not be liable for income tax on trust income distributed to a former spouse, and (2) if no other grantor trust sections are applicable, having a former spouse remain a trust beneficiary after a marriage dissolution will not result in grantor trust status.

The second possible conclusion is that the spousal unity rule under IRC § 672(e) uses language that looks at the identity of the

grantor's spouse at the time of trust creation, so based on the plain language of the IRC, a marriage dissolution cannot end the application of IRC § 672(e).[35] Under this approach, if a former spouse is still a trust beneficiary after a marriage dissolution, the grantor is liable for income taxes on income distributions to the grantor's former spouse.

A discontinuation of payments from a SLAT to a prior spouse under the terms of a SLAT (or possibly under the terms of a marital agreement that produces such a result) can avoid the likely undesirable possibility of the grantor being liable for the income tax on trust income paid to the prior spouse.

Conclusion

For clients with substantial estates, SLATs can preserve the benefit of currently increased federal estate and generation-skipping tax exemptions before their scheduled sunset in 2026. In addition to the general considerations regarding use of SLATs (including the tax ramifications of the reciprocal trust doctrine and a grantor's liability for taxes on trust income), Colorado law gives rise to some special considerations, including the use of marital agreements and the drafting of specific provisions to address spousal rights of persons holding beneficial interests in SLATS, as well as other types of irrevocable trusts. CL



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NOTES

1. The term "grantor" is used in this article to refer to the person who created a trust; some trust agreements may instead use the term "settlor" or "trustor."

2. *See* Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis With Forms*, § 6.06 (Spousal Limited Access Trusts) (5th ed. Thomson Reuters/WG&L 2013).

3. *See* IRS Rev. Proc. 2023-34.

4. 2017 Tax Cut and Jobs Act, P.L. 115-97.

5. *See* Zaritsky, "Treasury Proposes Anti-Abuse Regulations for Clawback of Basic Exclusion Amount," 49 *Est. Plan.* 36 (July 2022).

6. *See id.* Such regulations were still proposed as of the writing of this article.

7. *See* Johns et al., eds., *Orange Book Handbook: Colorado Estate Planning Handbook* at § 30.3.8. (CLE in Colo., Inc., Supp. 2022).

8. *See id.*

9. *See, e.g., id.*

10. *See* Goffe et al., "When Estate Planning and Marital Agreements Collide (Part 1)," 68(5) *Prac. Law.* 26 (Oct. 2022); Goffe et al., "When Estate Planning and Marital Agreements Collide (Part 2)," 68(6) *Prac. Law.* 20 (Dec. 2022).

11. Uniform Law Commission, https://www.uniformlaws.org/committees/community-home?CommunityKey=2e456584-938e-4008-ba0c-bb6a1a544400.

12. For example, in California, spouses are subject to "the general rules governing fiduciary relationships" in contracting between themselves, which imposes "a duty of the highest good faith and fair dealing on each spouse, and neither shall take any unfair advantage of the other." Cal. Fam. Code § 721.

13. American College of Trust and Estate Counsel (ACTEC) commentary on MRPC 1.7: "A lawyer is almost always precluded from representing both parties to a premarital agreement or other matter (such as a marital agreement) with respect to which their interests directly conflict to a substantial degree."

14. CRS § 14-10-113(1) and (1)(c).

15. CRS § 14-10-113(2)(a).

16. CRS § 14-10-113(4).

17. *See* Deffenbaugh and Kirch, "How Powers of Appointment Affect Irrevocable Trust Remainder Interests in Dissolution of Marriage Proceedings: Four Approaches," 48 *Colo. Law.* 48, 49 n.3 (Dec. 2019); Deffenbaugh and Kirch, "Measuring the Value of Trust Interests in Dissolution of Marriage Proceedings," 51 *Colo. Law.* 38 (Mar. 2022), https://cl.cobar.org/features/measuring-the-value-of-trust-interests-in-dissolution-of-marriage-proceedings.

18. *See* Deffenbaugh and Kirch, "Measuring the Value of Trust Interests in Dissolution of Marriage Proceedings," *supra* note 17.

19. *See In re Marriage of Guinn*, 93 P.3d 568 (Colo.App. 2004) (the mandatory income interest in an irrevocable trust was not property of the beneficiary spouse); *In re Marriage of Jones*, 812 P.2d 1152 (Colo. 1991); *In re Marriage of Rosenblum*, 602 P.2d 892 (Colo.App. 1979) (a discretionary interest in income and/or principal distributions from an irrevocable trust was not property of the beneficiary spouse, but was an economic circumstance to be considered by the court). The *Guinn* court did not address whether a beneficiary's mandatory income interest would be an "economic circumstance" to be considered by the court, as the parties in that case apparently did not raise that issue. However, under the Colorado appellate authority of *Jones* and *Rosenblum*, it is logically consistent that if a beneficiary spouse will continue to have a mandatory income interest in a SLAT (when the beneficiary spouse does not also have a remainder interest), such interest would be an economic circumstance to be considered by the court.

20. CRS §§ 14-10-114 and -115.

21. CRS § 14-2-310(2)(a), (e).

22. *See* Johns, *supra* note, 7 § 30.3.9 (regarding definition of spouse in an irrevocable life insurance and impact of marriage dissolution).

23. *See* Deffenbaugh and Kirch, "Measuring the Value of Trust Interests in Dissolution of Marriage Proceedings," *supra* note 17.

24. *See id.*

25. *See* Johns, *supra* note 7, § 29.4.1.

26. *E.g.*, IRC §§ 675(2) (power to borrow without adequate interest or security), 675(4)(C) (general powers of administration—power to reacquire trust corpus by substitution), and 674 (power to control beneficial enjoyment).

27. *See* Johns, *supra* note 7, § 29.4.5; IRC § 675(4)(C).

28. *See* Johns, *supra* note 7, §§ 29.4.5 and 29.4.6.

29. "[A] grantor shall be treated as holding any power or interest held by [] any individual who was the spouse of the grantor at the time of the creation of such power or interest . . . ." IRC § 672(e)(1).

30. *See* ACTEC, Comments of American College of Trust and Estate Counsel on Application of Code §§ 672(E)(1)(A), 674(C), 674(D), 676 and 677 After the Repeal of Code § 682, dated July 2, 2018, pursuant to Notice 2018-37, 2018-18 I.R.B. 392, released on April 13, 2018 (ACTEC Comments) at pp. 1–4.

31. 2017 Tax Cut and Jobs Act, *supra* note 4.

32. *See* ACTEC Comments, *supra* note 30 at 1–4.

33. IRS Notice 2018-37, Guidance in Connection with the Repeal of Section 682. Such guidance had not been provided as of the writing of this article.

34. *See* ACTEC Comments, *supra* note 30 at 6.

35. *See id.* at 4.