

# Building ILIT flexibility with a SLAT

One of the time-honored strategies for wealthy clients to plan for the Federal estate tax is the use of an irrevocable trust to hold life insurance, best known as an ILIT (irrevocable life insurance trust). Properly designed, an ILIT can hold whatever amount of life insurance is needed for meeting estate liquidity needs, without inflating the value of the estate. The ILIT does not pay the estate tax; instead, it is designed to acquire assets from the estate, paying the estate cash that can then be used to pay estate taxes. The assets are then distributed or administered as the trust dictates, for the beneficiaries.

For a married couple, the unlimited marital deduction allows the estate tax on a couple's assets to be postponed until the second death. In addition, with portability, the second spouse can utilize any portion of the first spouse's unused estate tax exemption at death. Frequently, life insurance is used to plan for estate liquidity. Effective ILIT planning for a married couple involves planning for both deaths, to keep the trust assets out of both spouse's estates.

Couples planning for a potential estate liquidity need may use a single-life insurance policy or a survivorship (second-to-die) policy in an ILIT, depending on their objectives. The choice of which policy is needed also affects the design of the trust, as explained below.

An ILIT is typically designed to provide liquidity 20 or 30 years into the future; yet, in the past 25 years, the Federal estate tax has ranged from having an exemption as low as \$600,000 (in 1997) to being repealed (briefly), to its current status in 2022 of a \$12,060,000 exemption per person. For many who established ILITS more than 10 years ago, increases to the estate tax exemption have made an ILIT appear unnecessary. Meanwhile, growing cash values are "trapped" inside the trusts, out of reach to those who established them.

There are several ways an ILIT can be designed to offer flexibility for changing circumstances. For example:

- To provide for future children, the trust can be for the benefit of all the grantor's children, born and unborn, as well as future step-children, and adopted children.
- To address concerns as to potential marital discord, the trust can state that in the event of a divorce, the former spouse is to be treated as having predeceased the grantor. It may also define "spouse" as the individual to whom the grantor is married at the time a distribution is to be made.
- To allow for certain changes that do not affect the irrevocability of the trust, the trust can allow for decanting, in those states that allow it.
- To provide access in the event of a repeal or change to the Federal estate tax, or a change in circumstances, the trust can provide a spousal lifetime access provision. Trusts with this provision are known as spousal lifetime access trusts (SLATs).

## What is a SLAT?

A SLAT is an ILIT that names the spouse of the grantor as a beneficiary, and that allows certain distributions to the beneficiary spouse during that spouse's lifetime. Even though the spouse could then turn around and give amounts distributed back to the grantor, a properly designed SLAT feature can provide the spouse certain distributions without pulling the assets back into the estate of the grantor or the spouse.

The appeal of the SLAT feature is, in part, the result of dramatic changes in the Federal estate tax in recent decades. Many couples who faced a potential Federal estate tax when the exemption was \$1 million (as recently as 2003) funded their ILITs with cash value life insurance that has grown over time. Yet with the increases in the estate tax exemption, their net worth might now be unlikely to trigger a need for estate liquidity, even with the scheduled change in 2026.<sup>1</sup> Couples of moderate wealth with significant and growing cash values in their ILIT could understandably wonder if the ILIT has become unnecessary and the assets could be put to better use.<sup>2</sup>

**Example:** Shelby and Pat are in their mid-40s and have a net worth of \$9 million, which includes a company valued at \$8 million. If their deaths occurred in 2022, they would not face a Federal estate tax liability. However, they anticipate growth in the company, and they realize the Federal estate tax could look very different in the future. In addition, they realize that if the company dropped in value, they could want access to cash values in the trust.

Shelby and Pat's estate planning attorney designs their ILIT as a SLAT, with Pat as grantor, and a second-to-die policy. An independent, third-party trustee is named, with discretion to make distributions to Shelby. This plan gives Shelby access to cash values in the future if the company loses value or if they do not expect to need the trust for estate tax purposes. If the company continues to grow and the life insurance is needed to provide estate liquidity, they can use it for that purpose.

## It's all about control

The popularity of the SLAT feature also arises from the reality that even couples with high levels of wealth can be uncomfortable with a complete loss of control over the assets in the ILIT.

There are several considerations that must be navigated in order to keep the SLAT assets outside both spouse's estates. The most consequential may be whether to name the spouse as trustee of the trust. It is possible to name a spouse to be both a trustee and beneficiary; however, the ability to do so without pulling the trust assets into the spouse's estate is subject to very narrow standards.

- If the trust will hold a second-to-die policy, naming the spouse as trustee creates an incident of ownership. This would result in the death benefit being included in the spouse's estate. As mentioned, it is very common to fund an ILIT with one second-to-die policy; so, in such a scenario, naming an independent, third-party trustee could address the incidents of ownership issue.
- If the life insurance in the ILIT will be a single-life policy on the grantor, the spouse could be named as both trustee and as a beneficiary, but the spouse's access would need to be limited to distributions that satisfy an "ascertainable standard."<sup>3</sup> Otherwise, a spouse who is trustee and who has unlimited access to the trust assets would have estate inclusion. If the couple's objective is for the spouse to have more liberal access to trust assets without estate inclusion, having an independent third party trustee may be helpful.
- Gifts to any SLAT should be made from the separate property of the grantor spouse. If a gift is made from joint or community property (e.g., a joint checking account), the beneficiary spouse becomes a grantor, resulting in estate inclusion.<sup>4</sup> Additionally, spousal gifts that are subject to a "Crummey power" can result in the spouse becoming a grantor.<sup>5</sup>
- Spouses should avoid implementing nearly identical SLATs for each other. Under the reciprocal trust doctrine, the two trusts may be "un-crossed" for tax-purposes resulting in estate inclusion of the trust assets.

Some life Insurance policies are available with a Chronic Illness Death Benefit Advance Rider (CIDBAR). This rider typically provides the advance payment of death benefits under a life insurance policy because of the occurrence of the insured's chronic illness. Receipt of a chronic illness benefit under this rider will reduce the death benefit of the policy. CIDBAR is not a long-term care policy or rider.<sup>6</sup>

A SLAT can be funded using life insurance that includes a CIDBAR. If the life insurance in the ILIT will be a single-life policy on the grantor, the spouse (not the grantor) could be named as a beneficiary. Therefore, if the insured experiences a chronic illness, the ILIT trustee won't be compelled to exercise the CIDBAR benefit and make distributions to the insured. However, the trustee could have the discretion to exercise the CIDBAR benefit and make distributions to the trust beneficiaries (spouse and children), who could then choose to use the accelerated benefits to assist the chronically ill insured. The ILIT trustee must operate carefully to stay within the parameters outlined in the trust document.

From a practical standpoint, the impact of an unexpected death of either spouse on the SLAT design must also be considered. If the grantor spouse passes away while gifts are still being made, a plan is needed for funding the trust without the beneficiary spouse having to become a grantor.<sup>7</sup> Conversely, if the couple has a need for spousal access to the trust, the death of the beneficiary spouse could essentially cut off the access the grantor indirectly had to the trust assets.

## Next Steps

Long term planning with irrevocable trusts can be accomplished with flexibility for changing circumstances. In a volatile political environment, it can be particularly difficult to predict the future need, especially for couples on the borderline between having or not having a Federal estate tax. A SLAT can be a useful design feature to allow for more flexibility in an ILIT, by keeping open the potential for access to cash values growing in the trust. Business owners facing a potential estate tax are encouraged to discuss this feature with their local estate counsel.

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<sup>1</sup> The current Federal estate tax exemption amount is scheduled to revert to \$5 million, plus indexing for inflation, beginning after December 31, 2025. This is expected to result in an exemption of roughly \$6 million per spouse, unless changes are made by Congress.

<sup>2</sup> For strategies to unwind or change an ILIT, see “Rethinking your ILIT in times of change,” [BB12115](#).

<sup>3</sup> For example, the distributions could be limited to those necessary for the spouse’s health, education, maintenance and support (known as a “HEMS” standard).

<sup>4</sup> It is possible to address this issue by having each spouse create a trust that provides spousal access to the beneficiary spouse. But care must be given to avoiding the use of two identical trusts. When trusts between two individuals have identical (or near identical) provisions, the IRS may apply the reciprocal trust doctrine. This could result in both trusts being ignored, as lacking any economic effect. Trusts having different provisions and powers, and even dates, could help avoid this outcome.

<sup>5</sup> A “Crummey power” (i.e., power to withdraw the gift within a specified time period, which lapses when the time has elapsed) is often utilized so that the \$16,000 per individual gift tax exemption amount can be treated as a present interest gift for each beneficiary. However, the lapse of the power makes the recipient a grantor. To avoid the spouse becoming a grantor, a spousal gift to an ILIT in which the spouse is a beneficiary should be limited to the greater of \$5,000 or 5% of the trust assets. The lapse of such a power will not trigger grantor status.

<sup>6</sup> The primary difference between CIDBAR and long-term care insurance is the status of a qualifying condition. While the trigger language is similar requiring the inability of two of six activities of daily living (bathing, continence, dressing, eating, toileting and transferring) or severe cognitive impairment, CIDBAR requires the impairment be permanent, which is generally not a requirement for long-term care. In addition, benefits under a long-term rider qualify for tax-beneficial treatment as health benefits under Section 7702(B) of the Internal Revenue Code (IRC). Benefits from CIDBAR are characterized as life insurance death benefits under 101(g) of the IRC. While CIDBAR benefits are intended to qualify for tax-advantaged treatment under 101(g) of the IRC, there may be situations in which benefits are taxable.

<sup>7</sup> This is because if the beneficiary spouse makes gifts to the trust, that creates grantor status and pulls the assets into the estate of the beneficiary spouse. Sometimes term insurance on the grantor spouse is used inside the trust for this purpose, to provide funding to replace gifts the grantor spouse would have made until the survivorship policy can become self-sustaining.



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