Bloomberg Tax

Tax Management Estates, Gifts and Trusts Journal™

The Best Laid Plans: How Divorce Can Impact SLAT Planning and Why a Postnuptial Agreement May Be Your Best Option

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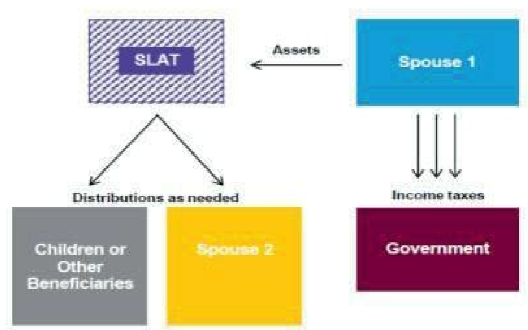
Ahead of the 2026 drop in the federal gift and estate tax basic exclusion amount, many wealthy couples are considering certain forms of trust planning to preserve use of today's higher exclusion.[1] More specifically, these couples may be contemplating moving sizeable sums into a spousal lifetime access trust (a "SLAT"). This type of trust benefits the creator's spouse while providing the trust creator (the "grantor spouse") with indirect access to the trust funds through distributions to the spouse.[2]

SLATs Have Become an Increasingly Popular Form of Trust Planning



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This article may be cited as Jennifer B. Goode, *The Best Laid Plans: How Divorce Can Impact SLAT Planning and Why a Postnuptial Agreement May Be Your Best Option,* 48 Tax Mgmt. Est., Gifts & Tr. J. No. 2 (Mar. 9, 2023).

[1] As of January 1, 2023, each U.S. citizen and permanent resident may give away during life and/or at death up to $12.92 million free of federal gift and estate tax. Barring congressional action, however, this amount will drop to approximately $6.9 million on January 1, 2026, leaving only those individuals who made a gift in excess of $6.9 million prior to 2026 with the benefit of some or all of the excess exclusion.

[2] Besides the creator's spouse, a SLAT may also benefit other named beneficiaries. Wealthy couples may even fund two SLATs, with one benefitting each spouse. However, this strategy suffers from certain limitations. First, each spouse must be able to fund the trust created by such spouse with more than $6.9 million of individually held assets to enjoy the preservation of excess exclusion. Thus, it may make more sense for some couples to fund one trust with the full basic exclusion amount, rather than attempt to preserve a smaller portion of each spouse's exclusion by creating two trusts. Second, the couple must include meaningful, economic differences between the trusts to avoid the "reciprocal trust doctrine." This doctrine was created under case law and provides that parties who create substantially identical trusts for one another are deemed to have created trusts for their own financial benefit, thereby triggering inclusion of each trust's assets in its creator's taxable estate.

HOW MIGHT A DIVORCE IMPACT SLAT PLANNING?

But what becomes of this strategy if the couple divorces? Unless the SLAT's terms provide otherwise, the beneficiary spouse will retain access to the trust's assets and may continue to serve as trustee, if appointed. Plus, the beneficiary spouse's post-divorce trust interest may result in continued grantor trust status.[3] This means that the grantor spouse will be deemed the owner of the SLAT's assets for income tax purposes and must pay the trust's yearly income tax liability from a source other than the SLAT.[4]

To address the impact of a future divorce on a SLAT, when drafting the trust, estate planning attorneys may treat the beneficiary spouse as deceased upon divorce.[5] The post-divorce SLAT would then operate under the trust provisions applicable following the spouse's death (e.g., the SLAT would continue to benefit any other current beneficiaries, such as the couple's children or more remote descendants). While this approach may avoid certain post-divorce pitfalls, it may not provide the parties with the best financial outcome.

For example, consider a recent Ohio case, *Kim v. Kim*.[6] There, a husband created a SLAT for the benefit of his wife and children and funded it with life insurance policies purchased with assets acquired during the couple's marriage. The husband later modified these policies and took loans against their cash value. At the couple's later divorce trial, Mr. Kim testified that he created the SLAT, in part, because he believed his wife to be fiscally irresponsible and that his wife would be treated as though she were deceased under the trust following their divorce.[7] Since Ohio imposes a common law property system,[8] a court must first classify a divorcing couple's property as either ''marital property'' or ''separate property'' and then divide the marital property between the spouses to achieve an equitable division based on several factors.[9] In *Kim*, the trial court held that the SLAT assets were marital property, as the husband used funds acquired during the marriage to purchase the trust's life insurance policies and retained some level of control over and use of these assets. However, the court then credited the value of the SLAT assets *solely* to the husband for purposes of the marital property's equitable division — even though he was not a beneficiary of the trust! This meant the husband's share of non-trust marital property was effectively reduced by the value of the trust assets and the wife received a larger share of their marital property outside of a trust (something the husband had originally intended to avoid). Had the wife maintained an interest in the SLAT following their divorce, the court may have been more likely to attribute to her at least a portion of the SLAT's value. Doing so would have left the husband in a better financial situation and closer to his original intent of restricting the wife's control over the couple's assets.

The potential impact on the division of a divorcing couple's marital property is not the only concern. Eliminating a beneficiary spouse's trust interest may also increase the likelihood of a court granting spousal support. A court typically awards spousal support when one party's standard of living significantly declines following the divorce, after factoring in the division of marital property and the couple's respective

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[3] *See* §672–§678. Note that §677(a) provides that a trust qualifies as a grantor trust if its income may be distributed or held for future distribution to either the trust's grantor or the grantor's spouse. While Reg. §1.677(a)-1(b)(2) provides that grantor trust status triggered by a spouse's income interest applies only during the period of the couple's marriage, it then refers to §682 as controlling in the event of a divorce and has not been updated to reflect §682's repeal under the 2017 Tax Cuts and Jobs Act. Additionally, §672(e) (adopted 15 years after Reg. §1.677(a)-1(b)(2)) provides that ''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*'' will be attributed to the grantor. Thus, §672(e) effectively overrules Reg. §1.677(a)-1(b)(2) by treating an ex-spouse's income interest as the grantor's retained interest for purposes of §677(a). *See also* George D. Karibjanian et al., *Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act,* 43 Tax Mgmt. Est., Gifts & Tr. J., No. 3 (May 10, 2018).

All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder.

[4] The Tax Cuts and Jobs Act repealed §682 that previously shifted the income tax burden to a beneficiary spouse for any income paid, credited, or required to be distributed to such spouse following a divorce, effective January 1, 2019. The IRS has announced its intent to issue regulations confirming continued application of §682 for couples who executed a divorce or settlement agreement prior to January 1, 2019, except for agreements modified after this date that waive such treatment. Notice 2018-37.

[5] Alternatively, a planner may define the term ''spouse'' to refer to the person married to the grantor at the time in question. For example, if the initial parties divorce and the grantor remarries, the term ''spouse'' would refer to the grantor's new spouse.

[6] 150 N.E.3d 1229 (Ohio 2020).

[7] The husband testified that Ohio law required the termination of the wife's beneficial interest following a divorce, but commentators have since noted that this is inaccurate. It may be that the trust terms provided for this treatment. Charles Baker and Edwin P. Morrow, III, *Special Considerations for Spousal Lifetime Access Trusts,* Ohio Prob. L.J., Vol. 32, Issue 2 (Nov./Dec. 2021).

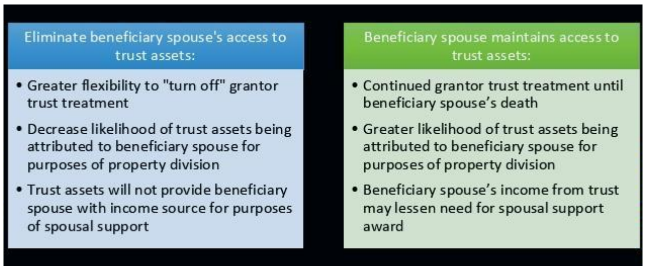
[8] Although all but nine U.S. states employ a common law property system, their respective rules vary. The balance of U.S. states utilize a community property system that divides a couple's property into ''community property'' or ''separate property'' and may provide less court discretion in dividing community property between the spouses. Am. Law Inst., *Principles of the Law of Family Dissolution,* §409 (2002).

[9] Ohio Rev. Code Ann. §3105.171. Under Ohio law, the court starts with a presumption that marital property will be divided equally between the parties and then deviates from this presumption to the extent necessary to achieve an equitable result.

ISSN 0886-3547

income sources.[10] Importantly, a beneficiary spouse's SLAT interest may function as an income source. Thus, a spouse's continuing interest may effectively supplant the need for a grant of spousal support. This could prove especially useful for a grantor spouse with sizable illiquid assets outside of the SLAT that might otherwise need to be liquidated to fund spousal support payments.

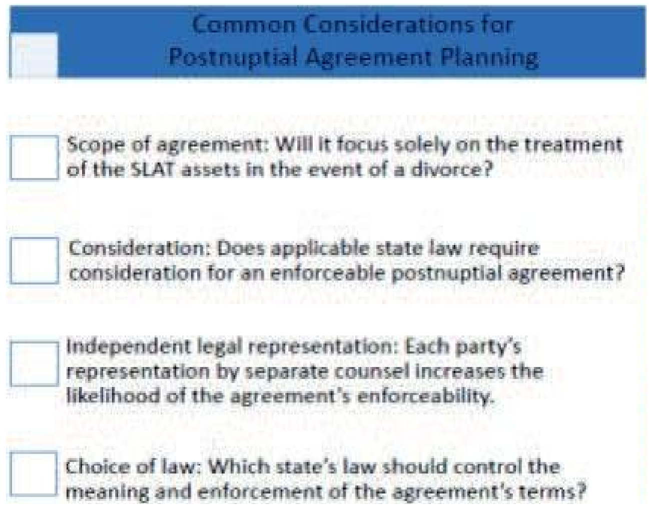
How Should the SLAT's Beneficiary Spouse Be Treated in a Divorce?



Ultimately, the traditional wisdom of terminating an ex-spouse's interest in trust may not always prove optimal. However, granting the beneficiary spouse a continuing interest — and leaving everything up to the settlement process or a court's discretion — may generate a similarly undesirable result. For instance, consider another recent case from Ohio, *Dayal v. Lakshmipathy*.[11] Here, yet another SLAT was funded by a husband for the benefit of his wife (and children) using assets acquired during marriage. This time, the wife's interest continued after divorce. However, in this case the court held that the gift of marital property to trust transformed it into the *wife's* separate property. As a result, the value of the trust assets was not considered in dividing the couple's marital property, again leaving the husband in a less than ideal financial situation. As evidenced by the *Kim* and *Dayal* cases, couples divorcing after the creation of a SLAT may experience varied results — even when determined under the same applicable law!

A POSTNUPTIAL AGREEMENT CAN AVOID AN UNDESIRABLE RESULT

In place of a restrictive trust provision or unchecked uncertainty, a couple engaging in SLAT planning may benefit from a postnuptial agreement. With this approach, they can spell out whether the trust assets will be characterized as marital or separate property and the role trust income may play in supporting the beneficiary spouse following the divorce. In general terms, a postnuptial agreement is an agreement entered into by spouses who intend to stay married but want to define certain controlling rights between them in the event of a divorce or one spouse's death. Requirements for a postnuptial agreement's enforceability vary under state law, but some common considerations are summarized below.[12]



Now, let's look at how this type of agreement might function in the context of a SLAT. Assume that Ted and Nancy, a married couple with a joint net worth of $50 million, would like to engage in SLAT planning. Having previously sold a profitable business that she created during their marriage, Nancy has $20 million in her brokerage account. The funds constitute marital property, despite being titled in Nancy's sole name. The balance of the couple's wealth comes from jointly held assets and retirement accounts, all of which constitute marital property as well.

To take advantage of her current basic exclusion amount, Nancy decides to fund a SLAT for the benefit of Ted and their children with $12.92 million of marketable securities from her individual brokerage account.[13] If Nancy and Ted later divorce and the SLAT's terms deem Ted deceased as a result, both Nancy and Ted would lose access to the securities placed in the SLAT. What's more, if a court were to divide the value of their marital property equally in a manner like that under the *Kim* case,[14] Nancy would be credited with the value of the SLAT assets despite

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[10] Am. Law Inst., *Principles of the Law of Family Dissolution,* §503 (2002).

[11] 163 N.E.3d 683 (Ohio 2020).

[12] *See* Michael A. Mosberg and Patricia Kindregan, *Ten Practice Tips for Postnuptial Agreements: Drafting Considerations and Formalities,* 52 Fam. L.Q. 277 (Summer 2018).

[13] To prevent inclusion of the trust assets in Ted's taxable estate, Nancy should refrain from funding the SLAT with property that she owns jointly with Ted.

[14] The equitable division of a couple's marital property does not always mean an equal division. However, we will assume an equal division for our purposes in the interest of simplicity.

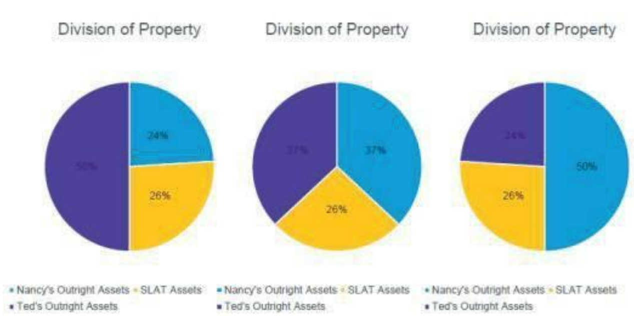
ISSN 0886-3547

her lack of access. This would leave Nancy with approximately $13 million of inaccessible trust assets and $12 million in their non-trust assets, while Ted would receive the balance of their marital property (that is, $25 million outright).

Alternatively, what if the SLAT provides for Ted's continued interest after the couple's divorce, but the court deems the trust assets Ted's separate property? Following the reasoning of the *Dayal* case, the value of the marital property to be divided between Nancy and Ted would fall to $37 million ($50 million minus the $13 million in the SLAT). If we again assume an equal division, this leaves Nancy with $18.5 million of non-trust assets. While better than the result under a *Kim* analysis, still not ideal.

Lastly, let's assume that the couple enters into a postnuptial agreement under which they agree that the SLAT assets will be deemed marital property and attributed to Ted in the event of a divorce due to a continuing beneficial interest. This leaves Nancy with the best possible outcome. She will receive $25 million in non-trust assets, while Ted will collect $12 million outright and maintain access to the $13 million in the SLAT.[15]

A Postnuptial Agreement Can Facilitate the Division of Marital Property



But what about the income tax implications of Ted's continuing interest? To address the ongoing grantor trust treatment, the postnuptial agreement could require Ted to reimburse Nancy for income taxes paid on behalf of the trust.[16] This would make Nancy whole for taxes paid on a trust to which she has no access. And, it would allow Ted to seek a desired asset allocation (including one focused on income generation) without potentially triggering Nancy's animosity due to the allocation's impact on her tax bill.[17] In addition, the SLAT could continue to enjoy the more forgiving tax brackets applied to individuals, rather than the compressed brackets applicable to nongrantor trusts.[18] This would aid in the long-term growth of the SLAT's assets — something both parties may appreciate if their children will ultimately benefit from the trust.

TAX CONSIDERATIONS OF A POSTNUPTIAL AGREEMENT

From an estate tax perspective, some practitioners have raised concerns that a postnuptial agreement might cause inclusion in the grantor spouse's taxable estate.[19] More specifically, these practitioners worry that a grantor spouse may retain the benefit of the SLAT's assets, as these assets would increase the value of the ''marital pot'' to be divided between the spouses upon divorce.[20] However, both prior case law and IRS guidance suggests that the ability of an individual to take an act of ''independent significance'' (for example, to adopt a child or pursue a divorce) that would impact the use or enjoyment of trust assets will not trigger inclusion in the individual's taxable estate in and of itself.[21]

Additionally, the policy arguments underlying inclusion of trust property in an individual's taxable estate do not support inclusion under this fact pattern. The inclusion rules in question attempt to prevent an individual from *circumventing the tax consequences* of retaining control over previously transferred assets

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[15] The postnuptial agreement should address the value of Ted's beneficial interest and attention should be paid to this agreement in crafting the SLAT's post-divorce operations. For example, if the parties intend for the full value of the trust to be attributed to Ted, they may consider allowing for broad distributions to Ted (including, potentially, a terminating distribution) and granting Ted some control over the Trustee selection process as evidence of Ted's potential access to the full value of the trust.

[16] Some practitioners suggest that the trust include an adverse party to control distributions to the beneficiary spouse in the event of divorce. However, others have noted myriad provisions that would require adverse party review to avoid grantor trust status, making this strategy highly complicated. Karibjanian, above n.3; Edwin P. Morrow, III, *Ed Morrow and Using Spousal Lifetime Access Non-Grantor Trusts (SLANTs) After the 2017 Tax Reform,* Steve Leimberg's Income Tax Planning E-mail Newsletter Archive Message #139, Apr. 13, 2018 (*see* discussion of §676).

[17] Care should be paid to the determination of the reimbursement amount, as the addition of the trust's income to the grantor spouse's adjusted gross income could have ancillary impacts, such as eliminating the applicability of certain deductions.

[18] §1.

[19] Chad Baker and Edwin P. Morrow, III, *'Till Death Do Us Part . . . or Not: Unintended Consequences of SLATs,* Ohio Prob. L.J., Vol. 31, Issue 4 (Mar./Apr. 2021).

[20] Section 2036 and §2038 provide that the value of an individual's gross estate for estate tax purposes includes any property previously transferred but in which the individual retained certain rights to income or to control the use or enjoyment of the property.

[21] Rev. Rul. 80-255; *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (''In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd.''); Baker and Morrow, above n.19.

ISSN 0886-3547

until death (that is, attempting to replicate a testamentary transfer without suffering the same tax liability). By executing a postnuptial agreement solidifying the marital property status of the SLAT's assets, the grantor spouse does not retain access to or control over the trust assets themselves. Rather, the grantor seeks a larger share of the couple's non-trust marital property — assets that will be included in the grantor spouse's taxable estate and potentially subject to estate tax. Thus, a postnuptial agreement does not unfairly deplete the grantor spouse's estate outside of the transfer tax system.

This same reasoning may forestall any concern over a reimbursement provision's impact for estate tax purposes.[22] However, we should note some uncertainty regarding the gift tax treatment of reimbursement payments. Transfers between spouses[23] qualify for the unlimited marital deduction from federal gift and estate taxes. Transfers between ex-spouses, on the other hand, are treated as an exchange for full and adequate consideration (that is, not as gifts subject to tax) where the transfers occur pursuant to (i) a written agreement addressing the settlement of marital or property rights and the couple divorces within one year before or two years after executing such agreement or (ii) a divorce decree.[24] Could a divorcing couple simply incorporate a previously executed postnuptial agreement into their divorce decree to avoid a potential taxable gift? The IRS has previously asserted that the divorce decree exception applies in this scenario only if the court has the power to disregard the postnuptial agreement's provisions and supplant its own judgment.[25] This then would undermine the whole purpose of executing the agreement!

To avoid such a Catch-22, a couple might consider leaving the court some discretion in making the grantor spouse whole for the SLAT's future income taxes. For example, under their postnuptial agreement, the couple could provide that the present value of the grantor spouse's future income tax payments on behalf of the SLAT would be attributed to the beneficiary spouse for purposes of the court's equitable division of the couple's marital property and any grant of spousal support, *unless* the court requires the beneficiary spouse reimburse the grantor spouse for such taxes. Of course, this would also require that the couple agree on a formula to value those future income tax payments based on a range of asset allocations and the beneficiary spouse's life expectancy.

Ultimately, married couples considering transferring millions of dollars into trust should carefully consider not only how these transfers will impact their finances in the event of the beneficiary spouse's death but also how a divorce can derail their individual financial goals. In doing so, they may decide that terminating the beneficiary spouse's interest best meets their needs. But this is not always clear-cut. If the couple wishes to allow the beneficiary spouse continued enjoyment of the SLAT's assets, a postnuptial agreement can provide useful parameters to help contain the fallout from a (hopefully unlikely) future divorce.

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[22] In addition to divorce serving as an act of independent significance, property transferred to the grantor spouse under the reimbursement provision would be that of the beneficiary spouse, not of the trust, and includible in the grantor spouse's taxable estate.

[23] The receiving spouse must be a U.S. citizen. §2523.

[24] §2516; *Harris v. Commissioner*, 340 U.S. 106 (1950).

[25] Rev. Rul. 60-160, 1960-1 C.B. 374. *See also* Linda J. Ravdin and Marcia C. Fidis, *Tax Aspects of Marital Agreements, Premarital and Domestic Partnership Agreements,* Premarital and Domestic Partnership Agreements (Md. State Bar Ass'n 2009).

ISSN 0886-3547