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SPOUSAL LIFETIME ACCESS TRUSTS: PITFALLS FOR THE UNWARY COUPLE

By **Tish McDonald** | Partner, King & Spalding
Emily Newton | Partner, King & Spalding
Seth Euster | Associate, King & Spalding

A spousal lifetime access trust ("SLAT") is an increasingly popular asset protection tool in high-net-worth estate planning. Although SLATs can be highly effective, they present two key pitfalls that may undercut their intended benefits. This article examines those risks and highlights the importance of careful estate planning to mitigate them.

Introduction

A SLAT is an irrevocable trust created by one spouse (the grantor) for the primary benefit of the other spouse (the primary beneficiary) and often also for descendants of the spouses (remainder beneficiaries). A SLAT is an attractive asset protection tool because the grantor can remove assets committed to the trust (and any future earnings and appreciation) from his or her taxable estate, up to the individual lifetime estate and gift tax exemption. Properly documenting this contribution often requires the help of a valuation professional, particularly when the trust is funded with illiquid or nonmarketable assets that are not easily valued.

Under the One Big Beautiful Bill Act, which extended the Tax Cuts and Jobs Act ("TCJA") provisions that were set to expire January 1, 2026, the lifetime estate and gift tax exemption sits at $15.0 million. This is up from the pre-TCJA exemption of $5.6 million.

A SLAT IS AN ATTRACTIVE ASSET PROTECTION TOOL BECAUSE THE GRANTOR CAN REMOVE ASSETS COMMITTED TO THE TRUST … FROM HIS OR HER TAXABLE ESTATE.

Because it takes assets out of the grantor's taxable estate, a SLAT also provides for the beneficiary spouse in the form of income, maintenance, and support. (The grantor spouse can access those benefits indirectly as well while married to the beneficiary spouse.)

Thus, a SLAT enables the grantor spouse to take advantage of the lifetime gift and estate tax exemption, shielding assets from future estate taxes, while providing income to the beneficiary spouse.

Nonetheless, even a well-intentioned SLAT can run into issues or otherwise backfire on the grantor. Two potential pitfalls inherent in a SLAT are the status of the trust's assets if the couple divorces and the risk that certain SLAT setups would cause the Internal Revenue Service to still consider the assets as part of the grantor's estate upon the grantor's death for tax purposes. Care is necessary to avoid those pitfalls.

SLATs in Divorce Proceedings

One recurring issue in litigation involving irrevocable trusts, including a SLAT, is whether to classify the trust's assets as third-party property or as marital property subject to equitable division in states that apply equitable distribution principles in a divorce.

The prevailing rule in most jurisdictions is that an irrevocable trust (like a SLAT) is an independent third party whose assets are not marital property and not subject to equitable division. For example, in *Nelson v. Nelson*, the Florida Second District Court of Appeal cited cases that deemed an irrevocable trust established by one spouse for the other as a "distinct entity" whose assets are "beyond the trial court's reach for purposes of equitable distribution."[1] Florida is an equitable distribution state.

However, because the trust was not a party to the dissolution proceedings, the court of appeals ruled that the trial court had impermissibly "adjudicated the property rights of a nonparty."[2]

A similar rule would likely apply to a SLAT in Georgia, where "property that has been conveyed to a third party is not subject to equitable division absent a showing of fraudulent transfer."[3]

Despite this general rule, the treatment of irrevocable trust assets in divorce varies significantly by jurisdiction and turns heavily on the specific facts of the case.

For instance, in *Dayal v. Lakshmipathy*, Ohio's Sixth District Court of Appeals examined whether assets in an irrevocable trust created by one spouse for the benefit of the other constituted marital or separate property.[4]

The grantor husband had created the trust to take advantage of the federal estate tax exemption, naming his wife as beneficiary and relinquishing "any interest, either vested or contingent, in the income or principal" of the trust.[5] The trust also included a provision expressly stating that any trust assets "shall be owned by [the] beneficiary … as separate property and not as community property," providing that it was "the Grantor's intent that such property is in the nature of a gift or inheritance from the Grantor."[6]

The court concluded that the transfer "constituted an *inter vivos* gift" to the wife, making the assets her separate property, and found that the trial court's classification of the assets as marital property was "against the manifest weight of the evidence."[7]

But in *Kim v. Kim*, Ohio's Ninth District reached a different result. There, the husband, himself a "self-identified estate and trust attorney," created an irrevocable trust, named his wife primary beneficiary without her knowledge, and purchased life insurance policies with marital funds. Even though the policies were held in trust, the husband "retained control over" them and borrowed against the policies' cash value during the marriage without the wife's knowledge.[8]

THE TREATMENT OF IRREVOCABLE TRUST ASSETS IN DIVORCE VARIES SIGNIFICANTLY BY JURISDICTION.

The court affirmed that the cash value of the policies was marital property, reasoning that a contrary rule "would allow a spouse to unilaterally, and without the consent or knowledge of the other spouse, move marital money out of the reach of the other spouse by merely placing it in irrevocable trust."[9]

Generally, in Ohio, the courts take a case-by-case approach, considering the intent and context of the creation of a trust as part of classifying the asset in a divorce proceeding.[10]

As is evident from the cases above, the grantor spouse incurs some risk that in the event of divorce, he or she not only will lose indirect benefits from being married to the SLAT's beneficiary (their soon-to-be ex-spouse) but also still might be required to continue to pay income taxes on the SLAT if the beneficiary spouse remains a beneficiary after divorce. That is because a SLAT is typically structured as a "grantor" trust for purposes of Internal Revenue Code Sections 671–677. Under these rules, the grantor is treated as an owner of the trust and would be required to pay income tax on trust income.[11]

To avoid these negative consequences for the divorcing grantor spouse, one may work with legal counsel to consider adding a provision that authorizes an independent trustee to make distributions to the grantor, at the independent trustee's discretion, to reimburse the grantor for the income tax liabilities of the SLAT.[12]

Another potential solution is to work with legal counsel to add a provision in the SLAT that terminates the beneficiary spouse's interest in the trust assets upon divorce.[13] Note that doing so could carry significant adverse tax consequences, from a gift tax exemption, income tax, and possibly even capital gains tax perspective, so this may be analyzed carefully with legal counsel while drafting such provisions.

Another approach is to include a provision that treats the spouse as predeceasing the grantor in the event of divorce, with remainder beneficiaries (children) becoming primary beneficiaries. Even if a SLAT contained such a clause, however, a court still might deem trust assets marital property, as in *Kim*, discussed above.[14] If spouses have not included such provisions in the trust agreement itself, there are still potential risk-mitigating solutions. Depending on the applicable state law, divorcing spouses could consider modifications to the trust, or "decanting."

Reciprocal Trust Doctrine Risks

Another potential pitfall for spouses in the use of a SLAT is unwittingly violating the reciprocal trust doctrine, which would result in the Internal Revenue Service considering the assets of the trust to be part of the grantor's taxable estate, erasing any gift and estate tax benefit from the creation and funding of the SLAT under 26 U.S.C. Section 2036.[15]

This can occur under certain circumstances when spouses create overlapping SLATs for each other. If the grantor of a trust dies and the trust violates the reciprocal trust principle, the Internal Revenue Service could "uncross" the trusts and include in the decedent's estate the value of the trust for which he or she was

the grantor spouse. At this juncture, depending on the marketability and liquidity of the assets in the uncrossed trust, a valuation professional may be needed to appraise the value of the trusts for estate tax purposes.

The canonical case in this area is Justice Thurgood Marshall's 1969 opinion in *United States v. Estate of Grace*. In *Grace*, the husband executed a trust directing the trustees to pay his wife income during her lifetime. He also gave the trustee power to invade the principal for her benefit if a majority of trustees deemed it advisable. However, 15 days later, the wife executed a virtually identical trust, naming the husband as beneficiary.[16]

The U.S. Supreme Court held that the principal of the wife's trust was includable in the husband grantor's gross estate and rejected the lower court's focus on subjective intent. Justice Marshall wrote, "Application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."[17]

In addition to comparing the economic positions of the spouses, courts also consider whether the trusts were created around the same time, whether they contain nearly identical terms, and whether they have the same trustees and remainder beneficiaries.[18] Valuation professionals can help substantiate genuine economic asymmetry between the two trusts by differentiating between the value of assets in the two trusts.

In contrast to *Grace*, in *Estate of Levy v. Commissioner*, the U.S. Tax Court examined two trusts created on the same date by a husband and wife, each funded with 12.5 shares in the same company and naming the other spouse as trustee and their son as a remainder beneficiary. Despite these similarities, the court held the trusts were *not* overly interrelated because one trust gave the beneficiary spouse a special power of appointment, and the other did not.[19]

The practical takeaway from *Levy* is that spouses who want to create a SLAT for each other's benefit can potentially avoid the reciprocal trust doctrine through deliberately structuring the trusts to operate differently.

Summary

A SLAT remains a powerful tool for high-net-worth couples looking to maximize their estate and gift tax exemptions while preserving access to trust income (at least for the beneficiary spouse). But, as described above, potential unintended consequences could undermine the reason the spouse created the trust in the first place, particularly at divorce or death. Therefore, it is essential to work with estate planning attorneys, tax advisors, and valuation professionals to avoid as much risk of things going awry as possible.

About the Authors

Tish McDonald is a partner in King & Spalding's Trial and Global Disputes practice. A Fellow of The American College of Trust and Estate Counsel, she represents trustees, executors, beneficiaries, and financial institutions in a wide range of fiduciary proceedings.

Emily Newton is a partner in King & Spalding's Trial and Global Disputes practice, where she handles fiduciary disputes and high-stakes business litigation, including antitrust matters and class actions.

Seth Euster is an associate in King & Spalding's Trial and Global Disputes practice, where he focuses on fiduciary disputes, consumer class actions, and commercial litigation.

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References:

1 Nelson v. Nelson, 206 So.3d 820-1 (Fla. 2d Dist. Ct. App. 2016).

2 Ibid., 821.

3 Gibson v. Gibson, 301 Ga. 622, 625 (2017). See also Armour v. Holcombe, 288 Ga. 50, 52-53 (2010). A divorcing spouse cannot claim equitable division of property titled to a third party without first showing a fraudulent conveyance.

4 Dayal v. Lakshmipathy, 163 N.E.3d 683 (Ohio Ct. App, 6th Dist. 2020). As with Florida and Georgia, Ohio is an equitable distribution state.

5 Ibid., 691.

6 Ibid., 687.

7 Ibid., 694.

8 Kim v. Kim, 150 N.E.3d 1236 (Ohio Ct. App., 9th Dist. 2020).

9 Ibid., 1236-7.

10 Guagenti v. Guagenti, 90 N.E.3d 297, 315 (Ohio Ct. App., 3d Dist. 2017). The court called "the case-by-case approach based upon the intent and conduct of the relevant parties with regard to the formation and the operation of the trust" the "better approach".

11 See Gould v. Commissioner, 139 T.C. 418, 435, discussing grantor trust rules under the Internal Revenue Code and explaining that "where the grantor or another person is treated as the owner of any portion of a trust, he shall compute his taxable income and credits by taking into account 'those items of income, deductions, and credits against tax of the trust'"; and Smiley v. Commissioner, T.C.M. (RIA) 2024-066, *6, n.16 (2024). "[I]ncome and deductions attributable to a grantor trust pass through the trust and must be taken into account by the grantor for federal income tax purposes." A variant on the SLAT, a spousal lifetime access non-grantor trust seeks to avoid the income tax consequences for the grantor by working around the Internal Revenue Code's grantor trust rules.

12 This may depend on which state law governs the trust agreement.

13 Nelson v. Nelson, 206 So.3d 819 (Fla. 2d Dist. Ct. App. 2016), noting that the trust instrument did "not contain a provision dissolving the Trust upon divorce."

14 Kim v. Kim, 150 N.E.3d 1236 (Ohio Ct. App., 9th Dist. 2020), describing a trust where "once the divorce is finalized ..., [the wife] will be deemed to have predeceased [the grantor] and their three children will become the primary beneficiaries" but nonetheless deeming as marital property life insurance policies held in the trust.

15 See 26 U.S.C. § 2036 providing that "the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer...by trust or otherwise, under which he has retained ... (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

16 United States v. Estate of Grace, 395 U.S. 318-9 (1969).

17 Ibid., 324.

18 See Estate of Levy v. Commissioner, T.C. Memo 1983-453, 46 T.C.M. (CCH) 910 (1983); and Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977).

19 Ibid.