WEALTH MANAGEMENT **ADVISOR**

Spousal lifetime access trusts

HOW COUPLES CAN LOCK IN GIFT AND ESTATE TAX EXEMPTIONS

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How couples can lock in gift and estate tax exemptions

Many affluent married couples planning their estates face a dilemma: Although they'd like to take advantage of the record-high federal gift and estate tax exemption — $12.06 million per person for 2022 — before it disappears, they're not yet ready to part with significant amounts of wealth. One strategy that may offer the best of both worlds is the spousal lifetime access trust (SLAT). This trust type makes it possible for couples to leverage the current exemption amount while retaining access to trust assets.

Shielding assets from taxes

A SLAT is an irrevocable trust that one spouse creates for the benefit of the other. The grantor spouse uses his or her gift tax exemption to shield the gift from taxes and, provided the trust is designed properly, its assets will be kept out of both spouses' taxable estates.

Typically, the beneficiary spouse is the current beneficiary of the trust. Any remaining assets pass to the couple's children or other heirs, although it's possible for the children to be current beneficiaries as well.

To qualify for the gift and estate tax exemption, the donor spouse must give up all rights to the trust assets. Nevertheless, the donor retains *indirect* access to them through the beneficiary spouse. The safest way to provide such access is by appointing an independent trustee with discretionary authority to make distributions to the beneficiary. It's also possible for the beneficiary to act as trustee, but in that case distributions must be limited by an "ascertainable standard," such as amounts necessary for the beneficiary's health, education, maintenance or support.

HIS AND HER SLATS

One way to reduce the risk of losing a spousal lifetime access trust's (SLAT's) benefits if the beneficiary spouse dies is for each spouse to establish a SLAT for the benefit of the other. Even if the beneficiary of one trust dies, the donor spouse can retain access to the other trust.

However, careful planning is critical to avoid the reciprocal trust doctrine. Under that doctrine, the IRS can "uncross" the trusts — and include their assets in both of the donors' estates — if it concludes that they're so similar that the economic effect is about the same as if the spouses had each created trusts for their own benefit.

To avoid this result, work with your advisors to be sure that the two SLATs are sufficiently different that they can't be viewed as a quid pro quo for each other. There are several potential ways to do this, such as creating the trusts at different times or including powers in one trust (such as a special power of appointment) that aren't included in the other.

Funding the trust

To preserve a SLAT's tax benefits, donor spouses must fund the trust with separate property. Contributions of jointly owned or community property can be included in the beneficiary spouse's taxable estate, so it may be necessary to transfer, retitle or partition property before funding the trust. After the trust has been funded, its assets can't be commingled with marital assets.

Ideally, you should fund a SLAT with assets you expect to appreciate in value. That's because once assets are transferred to the trust, all future appreciation is removed from your estate (and bypasses your spouse's estate), allowing you to leverage the current exemption.

Suppose you transfer assets worth $5 million to a SLAT, and their value grows to $12 million in 10 years. That appreciation in value avoids taxation in your estate, even though you used less than half of your exemption amount, and regardless of how much the exemption may have shrunk since you made the gift. Avoid contributing assets that may depreciate in value over time. If you do, you risk wasting a portion of your exemption.

Reviewing other potential issues

Because the benefits of a SLAT depend on indirect access to its assets through the beneficiary spouse, you risk losing those benefits if you get divorced or your spouse dies. So it's a good idea to build some protections into the SLAT. For example, you might:

- Make benefits available only to a current spouse, not former spouses, or
- Provide that the trust terminates, or the beneficiary spouse ceases to be a beneficiary, in the event of divorce.

A common technique for mitigating the risk of death is for each spouse to create a SLAT for the other (see "His and her SLATs" on page 2). Also, some states have enacted SLAT-friendly laws that allow donor spouses to become beneficiaries after the death of beneficiary spouses.

Also consider potential income tax implications. The tax basis of assets transferred at death is "stepped-up" to their market value, minimizing or eliminating capital gains when your heirs receive them. Assets transferred to a trust, however, retain the donor's basis, which can result in a significant capital gains tax bill when the assets are sold. So, it's important to weigh a SLAT's potential estate tax savings against its potential income tax costs.

Don't wait

The increased gift and estate tax exemption is scheduled to "sunset" at the end of 2025. At that point, it will return to its previous level of $5 million (adjusted for inflation). It's also possible that Congress will reduce the exemption amount earlier than that. So, if gift and estate taxes are a concern, the sooner you act to preserve the current exemption with a SLAT or other vehicle, the better. Be sure to work with experienced advisors to ensure your SLAT is designed and implemented properly. ■

Tips for TIPS investors

Protecting your savings from rising inflation

Inflation can reduce the buying power of your savings. Although there's nothing you can do to change inflation rates, you might want to consider investing in Treasury Inflation-Protected Securities (TIPS). Like other Treasury bonds, TIPS are a relatively low-risk investment, backed by the full faith and credit of the U.S. government. But unlike other bonds, they also are designed to provide some protection against inflation.

How they differ from other bonds

Like other Treasury bonds, TIPS are U.S. government debt securities that pay a fixed rate of interest every six months until they mature. Currently, TIPS are issued in five-, 10- and 30-year terms. If you hold a bond to maturity, the principal (or "par value") will be returned to you. What's unique about TIPS is that the par value is adjusted annually to reflect inflation (or deflation), as measured by the consumer price index (CPI).

> **In the event of deflation, you'll never receive less than the original par value.**

Suppose you buy $10,000 worth of 10-year TIPS and hold them to maturity. If the CPI rises by 3% per year, then the TIPS' par value also increases 3% per year, reaching $13,439 by year 10. In addition, while the interest rate is fixed, interest payments increase (or decrease) as the par value changes. Assuming the TIPS in our example pay 1% interest, the annual interest payments would start at $100, increase to $103 after one year, $106 after two years, and so on. Ultimately interest payments in this example would reach $134.39.

After TIPS have matured, you'll receive their adjusted par value. But in the event of deflation, you'll never receive less than the original par value.

Risks to recognize

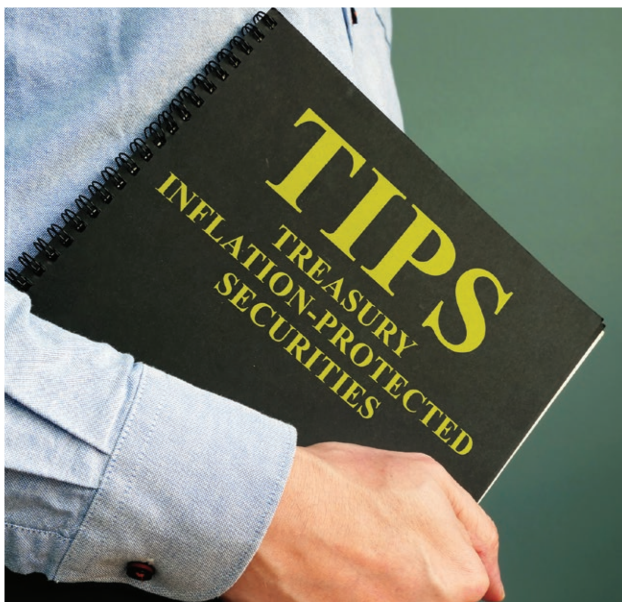
Inflation protection can be a significant benefit. But TIPS also present several risks you should be aware of, including:

Underperformance when inflation is low or negative. TIPS tend to underperform other types of Treasury bonds in times of low inflation or deflation. A good way to evaluate TIPS is to look at the breakeven rate. Typically, traditional Treasury bonds pay higher interest than TIPS. So for TIPS to outperform those bonds, the inflation rate would have to exceed the gap between those interest rates. For example, if interest rates for traditional bonds are 2.5% higher than those of TIPS, then inflation would need to exceed 2.5% for TIPS to be the better choice.

Liquidity risk. TIPS generally are less liquid than other Treasury bonds because their secondary market (where investors and brokers buy and sell securities) is less active. Plus, in periods of low or negative inflation, selling TIPS before maturity can result in a loss.

Taxes on phantom income. Earnings on TIPS are subject to federal income taxes (although they're typically exempt from state and local taxes). These earnings include not only interest

payments, but also any increases in par value to keep pace with inflation. This can result in phantom income taxes — or taxes on income that you haven't yet received. One way to avoid this is to hold TIPS in an IRA or other tax-advantaged account.



Higher personal inflation rates. The CPI is based on average prices for a "basket" of goods and services intended to reflect aggregate U.S. consumer spending. Depending on your spending patterns, your personal inflation rate may be higher than the national average. In that case, TIPS wouldn't keep pace with how fast prices are rising for you.

Hedging your bets

TIPS typically earn modest returns. But in times of rising prices, they can be useful for hedging against inflation threats. Just be sure you're aware of the risks before you invest, and talk to your financial advisor about other potential investments that offer inflation protection. ■

If you have household help, you probably have tax obligations

If you directly employ a nanny, housekeeper, cook, gardener, health care assistant or other employee in your home, it's critical that you stay on top of your tax obligations (commonly referred to as the "nanny tax"). Here's a quick overview of what household help employers need to withhold and file with the IRS.

Nuts and bolts

Specific tax obligations vary depending on the type of tax. For example, you aren't required to withhold federal income taxes (or state income taxes in most cases) from a household employee's pay, unless the employee asks you to withhold and you agree. In that case, have the employee complete Form W-4 and then withhold income taxes on both cash and noncash wages (other than certain meals and lodging).

With FICA (payroll) taxes, withhold amounts for Social Security and Medicare if your household employee's cash wages reach a specified threshold ($2,400 for 2022). If you meet the threshold, pay the employer's share of Social Security taxes (6.2%) and Medicare taxes

(1.45%) on the cash wages, but not on meals, lodging or other noncash wages. In addition, withhold the employee's share of these taxes (also 6.2% and 1.45%), although you may opt to pay the employee's share rather than withholding it from his or her pay. Note: You may need to withhold additional Medicare tax if you pay an employee more than $200,000 in a calendar year.

There's no FICA tax liability for wages you pay to certain family members or to household employees under the age of 18 if working for you isn't their principal occupation. A student who babysits on the side would be one example.

Additionally, you must pay federal unemployment tax (FUTA) if you pay total cash wages to household employees (other than certain family members) of $1,000 or more in any quarter in the current or preceding calendar year. A 6% tax rate applies to the first $7,000 of an employee's cash wages, although credits for state taxes reduce that rate to 0.6% in most cases. Ask your tax advisor about possible state tax responsibilities.

Using Schedule H

Unlike businesses, you generally don't need to file quarterly employment tax returns for household employees. Instead, report household employment taxes on Schedule H of your personal income tax return. But if you own a business as a sole proprietor, you may add the taxes for household employees to the deposits or payments you make for your business employees and include household employees on certain IRS forms, such as Forms 940 and 941.

Even if you report household employment taxes on Schedule H, you may want to pay the tax throughout the year, either via quarterly estimated tax payments or by increasing withholding from your wages. Otherwise, you'll have to pay the tax when you file your return and may be subject to penalties for underpayment of estimated tax. Also, file Form W-2 if you're required to withhold FICA taxes or have agreed to withhold income taxes for a household employee.

Your advisor can help

People working in your home aren't necessarily household employees. You generally aren't required to withhold or pay taxes for independent contractors such as occasional babysitters who work for many different families. However, the rules for distinguishing between employees and contractors are complicated. Also, employers can be subject to additional obligations that include complying with minimum wage and overtime requirements, and documenting immigration status. Your tax advisor can help you with these issues. ■

Can kids use a Roth IRA? Yes!

If you're looking for ways to teach your kids about financial planning and want to give them a head start on building a retirement nest egg, take a look at Roth IRAs. Contributions to a Roth IRA can't exceed an individual's earned income, so your child must have some earnings from an after-school or summer job. But, subject to that limit, anyone can contribute to a Roth IRA on the child's behalf.

Contributions and withdrawals

Here's why Roth IRAs work so well for kids. Although contributions aren't tax deductible, qualified withdrawals are tax-free. This makes Roth IRAs advantageous for people who will likely be in a higher tax bracket when they're ready to withdraw funds. Most kids are in the lowest tax bracket, which means tax deductions aren't worth much to them. But the benefits of tax-free withdrawals, when their income is likely to be much higher, are significant.

Roths are advantageous for people who will likely be in a higher tax bracket when they're ready to withdraw funds.

Contributions to a Roth IRA can be withdrawn tax- and penalty-free at any time. Earnings withdrawn before age 59½ generally are subject to a 10% penalty. Because kids have many decades before they will reach retirement age, the power of compounding can help them generate meaningful savings even with relatively modest, but early, contributions.

To take an example, Emma is 12 years old and earns $1,200 per year babysitting. Her parents set up a Roth IRA for her and contribute $100 per month over the next 10 years. Even if Emma never makes another contribution to the Roth IRA, by the time she turns 62 the account will have grown to more than $250,000 (assuming a 7% rate of return).

Flexible tool

Roth IRAs can give kids a big head start on retirement saving, but they also offer flexibility. For example, because contributions can be withdrawn any time without penalty, your children can use their accounts to help pay college tuition, buy a house or even start a business. ■

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