Lifetime Credit Shelter Trust

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This sophisticated irrevocable trust commonly referred to as a Lifetime Credit Shelter Trust, Spousal Lifetime Access Trust or "Rainy Day" Trust, is an advanced technique often used by families who may be subject to estate tax and/or are interested in asset protection. It is particularly useful for families wanting to capitalize on the increased estate tax exemptions available until 2026.

Introduction

Currently, you can give away up to $11.7 Million during your lifetime without incurring gift tax – this is known as your **Lifetime Gift Tax Exemption.**[1] This $11.7 Million exemption is available until January 1, 2026, when the current law will greatly reduce the exemption amount to $5 Million. A significant advantage of Lifetime Gift Tax Exemption gifts is that all appreciation after the time the gift is made accrues to the benefit of your family without being subject to estate tax on your death.

In addition to the Lifetime Gift Tax Exemption, you can also give up to $15,000 per year to as many different people as you want without using up your Lifetime Gift Tax Exemption or incurring gift tax – this is known as the **Annual Gift Tax Exclusion**. For example, if you have three children, you can give each child $15,000 per year, or a total of $45,000 per year. Together with your spouse you can give up to twice that amount, or $30,000, to each child for a total of $90,000 without gift or estate tax consequences. From an estate tax perspective, you save 40% on every dollar that you give away, so in this example, the immediate estate tax savings is $36,000 ($90,000 X 40%).

Effectively combining your Lifetime Gift Tax Exemption and Annual Gift Tax Exclusion can transfer significant amounts to your family free of all transfer taxes – gift, estate and generation skipping transfer (GST) tax. Unfortunately, there are four main problems with a simple, direct gift program:

- First, because direct gifts to children or grandchildren are often spent right away, there is no long-term benefit. While you might be reducing potential estate taxes, no lasting financial benefit to your family is created.
- Second, making a large gift directly to a child exposes the value of the gift to estate tax on your child's death.
- Third, gifts made directly to your children or other recipients are subject to claims of potential creditors, which may include divorcing spouses.
- Fourth, once the gift is made, you no longer have access to it if you need it in the future for unforeseen reasons.

Because of reluctance to gift assets caused by any one or more of these factors, unnecessary estate tax is paid on amounts retained. To overcome these drawbacks of direct gifts, you can make gifts to a properly drafted irrevocable trust rather than directly to individual beneficiaries. By doing so, the value of all gifts, *including all subsequent appreciation*, is still excluded from the donor's taxable estate but the assets are retained and managed by a trustee (which may be the donor's spouse); excluded from each beneficiary's estate for estate tax purposes; protected from most creditor's claims against the individual beneficiaries; and the donor retains access to the

[1] It is important to remember that any amount of your Lifetime Gift Tax Exemption that you use reduces the amount of your Estate Tax Exemption (currently $11.7 Million) available at your death. For example, if you make a lifetime gift of $2 Million, then the Estate Tax Exemption available at your death will be reduced to $9.7 Million.

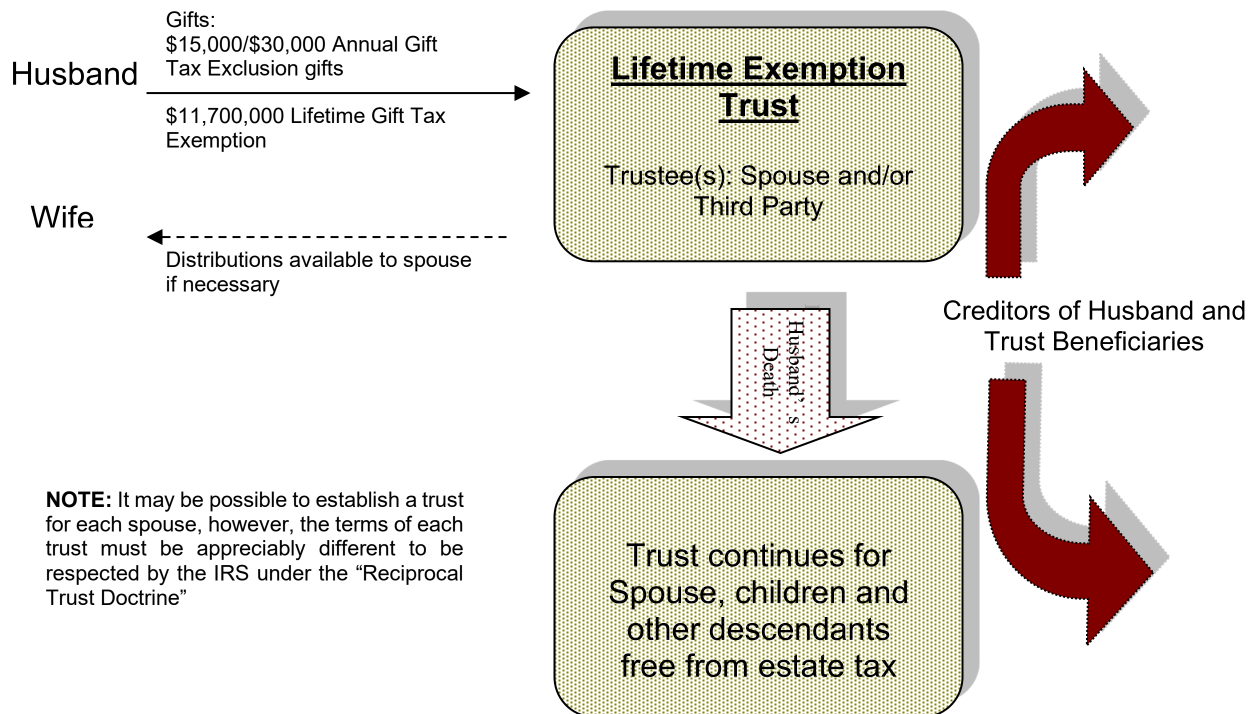
trust assets through the donor's spouse as a beneficiary, if necessary. It may even be possible for you to borrow money from the trust on very favorable terms or to give a trusted third party the power to distribute trust assets back to the donor if absolutely necessary.

How a Lifetime Exemption Trust Works

First, you create an Irrevocable Trust for the benefit of your spouse, children, and any descendents. Next you gift, or otherwise transfer assets, to the trust. Your spouse, a professional trustee, or another family member will serve as the trustee and will have the discretion to make distributions to the beneficiaries.[2] If your spouse serves as trustee, your spouse will retain control of the management and investment of the trust assets and also how, if at all, the trust assets are distributed to the beneficiaries. Until your spouse's death, he or she can receive distributions from the trust if required. After your spouse's death, the assets will continue in trust for the benefit of your children and their families. However, none of the assets in the trust will be included in either your or your spouse's estate for estate tax purposes and the assets in trust will have a high level of protection from any unforeseen creditors (see Figure 1).

FIGURE 1

Spousal Lifetime Access Trust (trust)



You will not want to use the assets in the trust unless absolutely necessary because the assets in the trust are out of your estate for estate tax purposes, so you should first use assets that are subject to the estate tax (this is why these trusts are sometimes referred to as "Rainy Day Trusts"). However, if you ever need the assets in the trust, you will be able to access them either through distributions to your spouse, borrowing from the trust or giving a third party the power to "appoint" the assets back to you.

[2] If your spouse or another beneficiary is the trustee, the distributions must be limited to distributions for "health, education, maintenance and support." These are called "Ascertainable Standards," and because distributions are limited to these standards, the trust assets will not be includible in the estate of your spouse. In addition, there are several other important tax and state trust law considerations that must be considered if your spouse will be the trustee, which will add some additional complexity to the trust.

How Assets are Transferred to a Lifetime Exemption Trust

Assets are transferred to the trust through gifts.[3] This can be in the form of a Lifetime Gift Tax Exclusion gift (e.g. up to $11.7 Million) and/or in the form of Annual Gift Tax Exclusion gifts. For example, If you and your spouse have three children, then you can transfer $90,000 per year into the trust ($30,000 X 3 = $90,000). You may also have grandchildren and spouses of children but without the trust arrangement, you may be hesitant, for various reasons, to make direct gifts to these family members. However, since the gifts are in trust rather than made directly, your concerns should be eliminated – allowing you to *greatly expand your gifting program*. For example, if your three children are all married and each have two children, you can transfer up to $360,000 of Annual Gift Tax Exclusion gifts in trust ($30,000 X 12 beneficiaries) instantly saving $144,000 in federal estate tax ($360,000 X 40%) each year you make the gift. Upon the death of you and your spouse, the trust assets can be managed for the primary benefit of your children, even though you used their spouses and your grandchildren to increase the amount of Annual Gift Tax Exclusion gifts that you made while living.

Unfortunately, it's not as simple as that. In order to get the benefit of the Annual Gift Tax Exclusion, the trust beneficiaries must have access to their portion of the gift. If they do not have access, then that year's gift will fail to qualify for the Annual Gift Tax Exclusion and will instead count against your Lifetime Gift Tax Exemption (and also your Estate Tax Exemption at death). To avoid this result, you must give each beneficiary the ability, for at least 30 days, to withdraw their gift and spend it as they choose. This ability is often referred to as a "Crummey Withdrawal Right" after the court case that legitimized the practice. In reality, beneficiaries rarely exercise their withdrawal powers, because their parent would probably not continue to make gifts to them if they did. Although the failure to withdraw the assets (also know as a "lapse") is treated as a gift by the beneficiary to the other beneficiaries of the trust, the trust can be designed to ensure that the lapse also qualifies for the Annual Gift Tax Exclusion. Finally, after the 30 day withdrawal period lapses, the gifts are property of the trust and generally cannot be withdrawn by the beneficiaries. The assets are invested by the trustee, and may be distributed to any beneficiary of the trust according to the terms of the trust.

Don't Forget About Gifts to Your Spouse

You should not forget to make gifts to your spouse when making Annual Gift Tax Exclusion gifts to the trust. Normally, gifts made from one spouse *directly* to the other spouse are free from gift tax regardless of amount, so the Annual Gift Tax Exclusion is irrelevant. However, to make a gift to your spouse in the trust rather than directly to your spouse you must use the Annual Gift Tax Exclusion. Again, this adds to the complexity. Under very complex rules relating to the gift and GST tax treatment of the lapse of a withdrawal power, your spouse's withdrawal power cannot be greater than 5% of the trust assets or $5,000. Under these rules, you can maximize the Annual Gift Tax Exclusion gift to your spouse by making a Lifetime Gift Tax Exclusion gift of at least $300,000 which would allow your spouse to have the maximum Annual Gift Tax Exclusion withdrawal power of $15,000 ($300,000 X 5% = $15,000). If you do not make an initial gift of at least this amount, then your spouse's withdrawal power will be limited to the greater of 5% of the trust assets at the time of the gift or $5,000.

What Benefits Will a Lifetime Exemption Trust Produce Over Time?

As previously discussed, a husband and wife with three children can make Annual Gift Tax Exclusion gifts of up to $90,000 each year to the trust. In addition, the donor can make a gift to his or her spouse of up to an additional $15,000 per year. This gifting, over time, will produce significant estate tax savings as a large amount of value will compound outside of your estate.

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[3] In addition to gifts, money or assets can be transferred to the Lifetime Credit Shelter Trust through loans or installment sales which may further increase the usefulness of the Lifetime Credit Shelter Trust.

The following table shows how this works:

Annual Gift Tax Exclusion Gifts				
Year of Trust	Number of Trust Beneficiaries (including Spouse)	Gift Made to Trust at Beginning of Year	Value of Trust Assets at End of Year	Estate Tax Savings
1	4	$ 95,000[4]	$ 101,650	$ 40,660
2	4	$ 95,000	$ 210,416	$ 84,166
3	4	$ 95,000	$ 326,795	$ 130,718
5	4	$ 95,000	$ 584,563	$ 233,825
10	4	$ 95,000	$ 1,404,442	$ 561,777
20	4	$ 95,000	$ 4,167,192	$ 1,666,877
30	4	$ 95,000	$ 9,601,939	$ 3,840,776

This example assumes 7% annual growth and an estate tax rate of 35%. This will produce $124,955 of estate tax savings over a five-year period and as the trust grows, so does the estate tax savings *and* the value of assets protected from creditors of the beneficiaries. So much so that by year 30, about $9,027,000 will be in the trust, resulting in approximately $3,159,324 in estate tax savings. Actually these savings will likely be greater, because (1) the Annual Gift Tax Exemption is likely to increase in future years, and (2) you will likely have additional gift recipients in later years of the trust in the form of grandchildren, great-grandchildren, etc.

These results are greatly enhanced if we add additional Crummey Withdrawal Rights by adding grandchildren and spouses of children. Returning to the previous example, assume that each of your children are married and have two children:

Annual Gift Tax Exclusion Gifts				
Year of Trust	Number of Trust Beneficiaries (including Spouse)	Gift Made to Trust at Beginning of Year	Value of Trust Assets at End of Year	Estate Tax Savings
1	13	$ 365,000	$ 390,550	$ 156,220
5	13	$ 365,000	$ 2,245,951	$ 898,380
10	13	$ 365,000	$ 5,396,014	$ 2,158,406
20	13	$ 365,000	$ 16,010,790	$ 6,404,316
30	13	$ 365,000	$ 36,891,660	$ 14,756,664

Again, this example assumes 7% annual growth, and an estate tax rate of 40%. However, the estate tax savings over a five-year period of $898,380 is significantly greater than the $233,825 savings from the previous example. Again, the differences are significantly greater as the trust grows. So much so that by year 30, about $36,900,00 will be in the trust, resulting in approximately $14.8 million in estate tax savings!

[4] The gift to your spouse is limited to $5,000 under the 5% or $5,000 limitation discussed above.

Finally, using even some of your Lifetime Gift Tax Exemption, results in even more dramatic results:

Annual Gift Tax Exclusion Gifts PLUS Lifetime Gift Tax Exemption Gift								
Year of Trust	Number of Trust Beneficiaries (including Spouse)	Gift Made to Trust at Beginning of Year		Value of Trust Assets at End of Year		Estate Tax Savings	
1	N/A	$	3,000,000	$	3,210,000	$	1,284,000
1	13	$	365,000	$	3,600,550	$	1,440,220
5	13	$	365,000	$	6,453,606	$	2,581,443
10	13	$	365,000	$	11,297,468	$	4,518,987
20	13	$	365,000	$	27,619,843	$	11,047,937
30	13	$	365,000	$	59,728,425	$	23,891,370

Continuing the assumed 7% growth and an estate tax rate equal to 40%, the estate tax savings over a five year period is $2,581,443 and again, the differences are significant as the trust grows over longer time periods.

Plan to Pay the Income Tax

A Lifetime Exemption Trust is structured to be excluded from your estate for estate tax purposes, but it is still treated as yours for *income tax* purposes. This may seem strange. It may also seem undesirable at first glance. That is why this type of trust is often called "defective" – meaning that it works for estate tax planning but not for income taxes. As odd as this might seem, it is actually a great opportunity. Here is why – someone has to pay the income tax on the investment income of the trust assets. There are three possibilities under the tax law: (1) the trust; (2) the beneficiaries; or (3) the creator, or 'grantor,' of the trust.

Option 1: Paid by the Trust. If the Trust pays the tax, it will pay at the highest income tax bracket after earning only $13,050 (2021) of income per year – which may not be too bad if both the Grantor and all beneficiaries are also in the top marginal income tax brackets or if the capital gain rates are the same for trusts and beneficiaries as they are currently. However, if the Trust pays the income tax, it affects the growth of the trust assets and erodes the estate tax benefits by reducing the value of trust assets passing to the family.

Option 2: Paid by the Beneficiaries. For the most part, income earned by the trust is passed through to the beneficiaries in proportion to the distributions each beneficiary receives from the trust. This income is then taxed to the beneficiary rather than the trust. However, the trust must actually make a distribution to the beneficiary defeating the estate tax, asset management and asset protection features of the trust. It also depletes the amount available to the grantor's spouse.

Option 3: Paid by the Grantor. As long as the trust is "defective" it is considered a 'grantor' trust for income taxation. This means that the grantor pays the income tax. The IRS has ruled that payment of the income tax by a grantor is not a taxable gift to the trust. Therefore, assuming that someone must pay the income tax, why not make additional tax free gifts to the trust through payment of applicable income taxes to further enhance the estate tax and asset protection features of the trust? Even if this income tax burden is too onerous in any given year, a well drafted trust gives the grantor the ability to make distributions to the spouse to aid in the payment or even "turn off" the grantor trust status.

Therefore, the trust will initially be taxed as a "defective" grantor trust. It is important for you to understand that you will be responsible for the income tax attributed to trust assets, however, you should also see the tremendous benefit this provides.

Summary

As you can see from the tables, there is a substantial benefit gained by using a Lifetime Exemption Trust as part of your estate plan. Depending on your life span and the amount of money you are able to gift, you will be able to move substantial value outside of your estate free from expensive estate, gift and GST tax. You will also be able to give your family significant asset protection for assets held inside the trust. Finally, you get all of this while still being able to access the funds inside the trust through your spouse as long as your spouse is living or though other mechanisms.

This is a great strategy for families with assets that may be subject to the estate tax, however, it does involve a thorough analysis of income, estate, gift and GST tax matters as well as state trust law. It is also important to properly operate the trust after creation and to file appropriate gift and income tax returns as required. Therefore, it is important to review and consider all of these matters in the context of your overall estate plan and carefully draft and implement the trust with experienced advisors, if you decide to use this technique.

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