WHAT IS FAMILY BANK?

The "family bank" is simply an irrevocable trust designed to create a pool of wealth that can benefit a family through multiple generations without diminution at each generational level by the normal wealth transfer taxes; i.e., the gift tax, estate tax and generation-skipping transfer tax. It is referred to as a family "bank" because, like a bank, the trust is a prime resource for the funding of the particular needs of the various beneficiaries in successive generations; including funding business ventures, purchasing real estate or providing family distributions to fund educational expenses. Based upon its potential for compound, estate and gift tax free growth of asset value over several decades for the benefit of a particular family, the "family bank" is sometimes referred to as a "dynasty trust." Because one of the principal planning elements is the avoidance of the generation skipping transfer (GST) tax, a family bank is also sometimes referred to as a "GST exempt trust."

How It Works

The basic concept is quite simple: The founder of the trust (the grantor) causes a trust to be created and transfers assets to the trust. The trust instrument spells out in detail who the beneficiaries are to be, their respective rights to benefits, how long the trust is to remain in existence, and what happens to trust assets when it terminates, several generations later. The principal challenges to achieving optimum long-term results are the following:

- avoiding or minimizing gift and/or estate tax on assets transferred into the trust.
- avoiding or minimizing the generation skipping transfer tax potentially applicable with respect to distributions received by trust beneficiaries who are two generations or more younger than the original grantor's generation
- structuring the trust to last as far into the future as possible, to benefit as many successive generations as possible, without violating the rule against perpetuities, if applicable.

Potential Long-Term Benefits

With the maximum marginal rate for the unified (gift and estate) transfer tax at 55 percent (declining in future years but not below 45 percent prior to the one-year repeal in 2010), and the generation skipping transfer tax at a flat rate equal to the maximum estate tax rate, the impact of these taxes when passing family wealth to each succeeding generation is obviously quite substantial. By avoiding these taxes through a family bank arrangement, the value of assets ultimately received by the original grantor's distant future descendants can be several times greater than would result if the assets were passed directly, outside of the trust, to each next succeeding generation. Click here for illustrated example of the Family Bank.

The Funded Family Bank helps avoids tax uncertainty through the Irrevocable Trust

Recent tax law changes are providing disturbing uncertainty for estate planners, and clients given the on-again-off-again-on-again status of future estate, gift and generation-skipping transfer (GST) taxes. As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001, these taxes are scheduled for gradual reduction over the next several years, with total repeal in 2010, and full reinstatement in 2011 (at

2001 tax levels). It is almost universally believed that this obviously irrational schedule of changes will be further revised at some future point. All of this, of course, places estate plans at risk of becoming out of date as the rules continue to change. This state of affairs warrants a re-examination of the "family bank" or "dynasty" trust as a vehicle for multi-generational family wealth transfer without regard to transfer taxation.

An important strategy for elevating an estate plan above the vagaries of a shifting set of tax rules is the irrevocable trust. Among other important benefits, the transfer of assets during lifetime to an irrevocable trust for the benefit of the grantor's heirs will provide transfer tax certainty: the transfer will be subject to gift tax when made, but the amount of the available exclusions, exemption and tax rate will be computable with certainty as part of the planning process. (By contrast, if the subject assets are retained by the grantor or placed in a revocable trust, the eventual income tax/transfer tax burden, and the net amount available to the heirs, will be dependent upon conditions existing as of the date of death, including the then value of the assets-and the then state of the estate tax and GST tax rates and exemptions.)

Assets held in an irrevocable trust are not subject to estate tax upon the death of the grantor. The GST tax is also not applicable at that point unless a grandchild or great grandchild accedes to a current interest upon the grantor's death. Thus, the trust may continue for the current benefit of the surviving spouse and the children, and the future benefit of subsequent generations, without regard to the state of the transfer tax law as of the grantor's death. The need for constant updating of an estate plan, as the law changes-and the risk of unexpected death prior to updating-are eliminated with respect to assets removed from an estate by lifetime transfer to an irrevocable trust.

Of course, the irrevocable trust is not a panacea. The element which is critical to estate tax avoidance-absence of control by the grantor-is precisely the factor that makes such trusts objectionable to some estate planning clients. However, the new reality of instability in the estate tax rules now becomes an added factor which could tip the scale in favor of the irrevocable trust, despite the control issue: at least the tax consequences will be predictable. And proven techniques are available to mitigate the loss of control.

How Long Can Transfer Taxes Be Avoided This Way?

If, at the time of the irrevocable trust grantor's death, the current income interests in the trust are acceded to by the grantor's children, and not by any grandchildren (or members of any generation below that of the children), there will be no transfer tax triggered by the grantor's death. However, the GST tax will come into play any time that a member of a generation two or more generations below that of the grantor (e.g., grandchildren and great grandchildren) accedes to a current interest in the trust.

On the other hand, even the GST tax may be permanently avoided if the trust is made GST tax exempt through application of the available GST tax exemption. Thus, transfer taxes can be avoided through several generations, as long as the GST-exempt trust is allowed under state law to remain in existence--and in some states such trusts are allowed perpetual life.

$1 Million Lifetime GST Tax Exemption

Each individual (transferor) is allowed an exemption from tax for up to $1 million or more in GST transfers. The GST exemption amount for years prior to 2002 is $1 million, as adjusted for inflation in years subsequent to 1997. As of 2001, the inflation-adjusted amount is $1,060,000. For the years 2002 and 2003, this amount is subject to further adjustment for inflation. The exemption amount is scheduled

to increase to $1.5 million in 2004, $2 million in 2006 and $3.5 million in 2009 [I.R.C. §2631(a)]. The exemption is automatically allocated to generation skipping transfers made during the transferor's lifetime until the entire available amount is used up. Any unused balance is applied to any generation-skipping transfers made at death.

It is important to note that the allocation of GST exemption is made as to the value of property going into the trust at the time of the gift -not to the value of interests eventually received by the skip person upon a subsequent taxable termination or taxable distribution.

The Role of Life Insurance

As explained in more detail below, life insurance policies present a unique opportunity to create a multimillion dollar initial funding source for the family bank, with potentially no gift tax costs, through careful planning of gifts for the payment of annual premiums and leveraging of the GST exemption.

Importance of Leveraged Use of GST Exemption in Establishing the Insurance - Funded Family Bank

It is generally advantageous to elect to allocate GST exemption to any transfer to a trust from which a skip person is likely to receive benefits in the future. Substantial appreciation in value over a prolonged time period can be sheltered from GST tax by allocation of GST exemption to 100 percent of the gifts into the trust. One of the most important applications of this principal is the creation of a family bank through leveraged use of GST exemption in a life insurance trust. It is generally desirable to allocate GST exemption to any transfer to a life insurance trust in which a skip-person holds a vested interest. If the interest in the insurance policy proceeds ultimately to be received by the skip-person is expected to be substantially more than the premium payment going into the trust (as is likely to be the case because insurance death benefit proceeds usually greatly exceed premium input), allocation of the exemption to the premium payment gifts will ultimately free the transfer to the skip-person from the tax, while using up an exemption amount which is only a fraction of the otherwise taxable amount. This leveraging of the exemption may be illustrated by the following example:

Example: G establishes an irrevocable life insurance trust, which acquires a $5 million policy on the life of G. Upon G's death, the proceeds are to be held by the trustee with the income to be paid to G's child, C, for life, and on C's death, the corpus is to be distributed to G's grandchild, GC. Each year, for 20 years, until G's death, G contributes $40,000 to the trust for the payment of premiums. Each such year a portion of G's GST exemption is allocated to the $40,000 gifts. G dies, survived by C and GC, and the $5 million insurance proceeds are paid to the trust. Since a grandchild of G holds an interest in the trust, the GST tax comes into play, and GC, the grandchild, is a skip-person, but the tax is not imposed until C dies. At C's death a "taxable termination" occurs, and the GST tax would be applied to the value of GC's interest. Assuming no appreciation or decline in value of the $5 million insurance proceeds during the years that the income was paid to C, the taxable transfer to GC will be $5 million. Because GST exemption was allocated to 100 percent of all gifts into the insurance trust (a total utilization of $800,000 of exemption over the 20 years before G's death), the inclusion ratio will be zero; thus 100 percent of the transfer out of the trust to the skip-person (the entire $5 million) is effectively exempted. If the trust were to have continued for one or more additional generations, no GST tax would ever be applicable, regardless of how much the assets of the family bank may have eventually grown, because the trust was at all times 100 percent GST tax exempt.

Duration of a Family Bank

The ultimate duration of a family bank may be limited by a "rule against perpetuities" statute in the state whose law governs the trust. The rule against perpetuities, established centuries ago as part of English Common Law, was intended to prevent an owner from effectively tying up real property ownership forever. The rule, as originally adopted in almost all U.S. states, applies to personal property as well as real estate. Although often complicated in its application to specific factual situations, the rule in general invalidates the creation of a trust unless by its terms the trust must terminate no later than 21 years plus a period of gestation (i.e., 9 months) after the death of a designated party who is alive at the time the trust is established. For example, if at the time that G creates a trust in 2001, he has any grandchildren, he could specify that the trust will end 21 years after the death of the youngest of those grandchildren. If his youngest grandchild at the time of establishing the trust was only 1 year old, and that grandchild lives to age 80 or more, the trust could remain in existence for more than 100 years (21 years after the death of the designated grandchild).

In recent years a growing list of states (including Alaska, Delaware, South Dakota, Wisconsin, Idaho, and Maryland) have effectively eliminated the rule against perpetuities for trusts in those states. These jurisdictions have apparently made this change in order to encourage trust business in their states. Thus, it now appears that a family bank/dynasty trust may be established to last in perpetuity for the benefit of infinite future generations, but only if the trust has sufficient nexus with one of these states (as specified in the state's own statutes) to qualify for governance by that state's trust law.

Asset Protection Element in Certain States

Of the handful of states that have eliminated the rule against perpetuities, some (egs.,Alaska and Delaware) have also adopted legislation enabling the establishment of so-called domestic assets protection trusts. This is a form of irrevocable trust designed to protect assets from potential creditors' claims, while at the same time allowing the trustee to make discretionary distributions of assets back to the grantor (without triggering inclusion of the trust assets in the grantor's gross estate under one of the "strings-attached" provisions (i.e., Code §§2036 or 2038)). Domestic asset protection trusts were the subject of last July's Current Comment 01-16. If the intended federal tax effect of the asset protection element of these state trust laws eventually stands up to potential IRS scrutiny, the combination of asset protection and perpetual existence, make the establishment of a family bank in one of these states potentially very attractive. The grantor of the trust need not be a resident or otherwise connected with the state; however, it is generally required that the designated state have a substantial connection to the trust, such as the location of trust administration, domicile of the trustee, or location of trust assets at the time the trust is established.

Conclusion

The foregoing examples and the detailed computations in the illustration below demonstrate the astounding tax savings which can be achieved through well planned use of the GST exemption, leveraged to shelter a growing asset pool from transfer taxes over several decades and through several generations.

Through this technique, an individual or couple can establish a "family bank" for the benefit of succeeding generations, potentially as far as great-great-grandchildren--or even in perpetuity in certain states--with potential for long-term compounded growth of the "bank's" assets, undiminished by estate, gift or generation-skipping transfer taxes, as benefits pass through successive intervening generations.

As discussed above, the irrevocable trust and life insurance have taken on new importance in an environment of an estate tax law that has built-in changes and is likely to be subject to material, but unknown, future revisions. The traditional reluctance of individuals to lose control over their wealth during their lifetime by an irrevocable transfer will, of course, remain. However, techniques are available to provide significant measures of personal financial security and limited continuing control over ultimate disposition, even after an irrevocable transfer. These include naming of a spouse or other family member as a beneficially interested trustee with discretionary authority to distribute funds to him or her self limited by an ascertainable standard.

Other techniques involve the law of certain states that have adopted trust legislation which permits the establishment of trusts whose assets are protected from the creditors of the grantor, but permit the trustee to make discretionary distributions of assets back to the grantor. Such trusts offer another potential avenue for mitigation of the loss of access to monies placed in an irrevocable trust for estate planning purposes (See Current Comment 01-16).

If the carryover basis at death approach is ultimately retained in the Code, life insurance takes on considerable new importance as a vehicle for avoidance of income taxes. Thus, life insurance takes on considerable importance: both as a vehicle for passage of wealth free of the burden of a possible future carryover basis regime, and simultaneously as a funding vehicle for an irrevocable trust seeking to leverage the transfer tax exemptions in a way that "guarantees" success in wealth transfer planning.

THE BENEFITS OF GST TAX PLANNING

Assumptions:

- Trust earns income at 6.5% annual rate, all of which is reinvested.
- 55% federal estate tax rate.
- Each generation dies 28 years after the death of the respective parent.
- $1 million of the transferor's exemption amount was allocated to the initial transfer creating the "Family Bank," and thus, the GST-exempt trust has an inclusion ratio of zero.