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The Family Bank


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Abstract: The generation-skipping transfer tax (GSTT), a separate tax from the unified estate and gift taxes, was instituted in 1976, retroactively repealed, then passed in 1986, as what might be considered a supplement to the basic unified transfer tax system. The generation-skipping transfer tax was repealed for most of 2010 and then retroactively applied at the eleventh hour for 2010 with a $5,000,000 exemption and a 0% tax rate. For 2011 and 2012, the exemption amount is $5,000,000 with a 35% tax rate. Given that a basic purpose of the estate tax is to impede the build-up of massive family fortunes by imposing a significant tax on the accumulated wealth each time it passes to the next succeeding generation, the fruits of the transfer tax system are reduced to the extent that a generation is skipped when property is passed. Thus, the GSTT was instituted as a measure to avoid the loss of tax revenues resulting from such generation-skipping transfers. However, through leveraged use of the estate owner's lifetime GSTT exemption, allocated to gifted assets likely to grow substantially in value over time (e.g., gifts of premiums to a life insurance trust), the GSTT can be permanently avoided with respect to all benefits derived by succeeding generations, regardless of the extent to which trust assets may grow in value over several decades.

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What is a Family Bank?

The "family bank" is an exciting financial planning technique for the accumulation of substantial wealth within a trust, set up to benefit a given family through several generations—without *diminution 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. Based upon its potential for compound 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 35 percent 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 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.

The Role of Life Insurance

As explained in more detail below, life insurance policies

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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.[1]

Understanding the Generation-Skipping Transfer Tax

Perhaps the most important tax planning element in the creation of the family bank is avoidance of the generation-skipping transfer tax, since this tax is potentially applicable, at a rate equal to the highest estate tax rate, to the value of any interest acceded to in the future by any grandchild of the grantor or member of a generation subsequent to the grandchildren's generation.[2]

The generation-skipping transfer tax, although a separate tax from the "unified" estate and gift taxes, was instituted in 1976, retroactively repealed, then passed in 1986, as what might be considered a supplement to the basic unified transfer tax system. The generation-skipping transfer tax was repealed for most of 2010 and then retroactively applied at the eleventh hour for 2010 with a $5,000,000 exemption and a 0% tax rate. For 2011 and 2012, the exemption amount is $5,000,000 with a 35% tax rate. Given that a basic purpose of the estate tax is to impede the build up of massive family fortunes by imposing a significant tax on the accumulated wealth each time it passes to the next succeeding generation, the fruits of the system are reduced to the extent that a generation is skipped when property is passed.

In simple terms, if a wealthy individual passes property (at death or by gift during lifetime, or a combination) to his or her sons and daughters and they, in turn, eventually pass it to their children, the property will have been taxed twice by the time it arrives in the hands of the original donor's grandchildren. If the original donor passes the same property directly to his or her grandchildren, it will have been taxed only once. Thus, the GSTT was instituted as a measure to avoid the loss of tax revenue resulting from such generation-skipping transfers.

The GSTT is imposed on the value of a gratuitous transfer of property (whether by gift or at death) with respect to which an individual who is of a generation at least two generations younger than that of the transferor is given an interest. Such a recipient is referred to as a "skip person," the most common examples being grandchildren and great-grandchildren of the transferor. Thus, for example, a trust that provides for the income to be paid to the grantor's spouse for life, remainder to the grantor's surviving children, would not involve the GSTT since there is no gift to any skip person (i.e., no one more than one generation after that of the grantor). However, if the trust instead provided that upon the spouse's death, the income is to be paid to the grantor's children for life, then the remainder to the grantor's grandchildren, the GSTT would come into play. This is because the trust creates an interest in a skip person (one or more grandchildren of the grantor).

Since transfers to grandchildren can be made either directly or through trust arrangements in which the grandchild's beneficial enjoyment of the property may be deferred, the GSTT is imposed at different points in time, depending on the type of transfers. There are three types of generation-skipping transfers:

- Direct Skip. A direct skip is any transfer to a skip person that is subject to gift tax or estate tax.[3] For example, a taxable gift or a bequest to a grandchild is a direct skip.
- Taxable Termination. This involves a situation in which the original transfer created interests in more than one party, at least one of whom is a skip person and at least one is a non-skip person (e.g., income paid to the child (non-skip person) for life, remainder to the grandchild (skip person)). In such a situation the GSTT is imposed upon the date of termination of the last remaining interest held by a non-skip person, i.e., at the point when the property will pass to a skip person (with no remaining subsequent interests in any non-skip person). In the foregoing example, the GSTT would be applicable upon the death of the child.[4]
- Taxable Distribution. A taxable distribution is any distribution, other than a direct skip or taxable termination from a trust, if the distributee is a skip person.[5] For example, in a spray trust from which income or principal can be paid to children or grandchildren, any distribution to a grandchild is a taxable distribution.

A predeceased child exception provides that all direct skips, taxable terminations, or taxable distributions to or for a grandchild of the transferor (or of the transferor's spouse or former spouse) at a time when the parent of the grandchild who is the child of the transferor (or of his or her spouse or former spouse) is deceased, are exempt. [6]

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Computation of the GSTT

The GSTT is separate from, and in addition to, any estate or gift tax applicable to the property transferred to the skip person. The GSTT rate is a flat rate equal to the highest rate in the estate tax rate schedule. Because of available exclusions and exemptions, not all generation-skipping transfers are fully taxable. The amount of the generation-skipping transfer actually subject to tax is based upon a so called inclusion ratio—the mechanical technique by which the GSTT $5 million lifetime exemption amount for 2011 and 2012 is utilized.[7] In the case of a trust, these mechanics work in such a way that the extent to which the current value of an interest received from a trust is taxed is dependent upon the extent to which the original transferor's exemption amount was allocated to the gifts into the trust at the time they were made and based upon the property values at that time. (See example below.)

Effect of Gift Tax Exclusion upon GST Taxability

It is important to realize that a lifetime gift that creates an interest in a skip person is potentially subject to GSTT even though the gift qualifies as excludable from gift taxation. In other words, not all gifts that are excludable from gift taxation (by reason of the $13,000 (as indexed) gift tax annual exclusion) are excludable from the operation of the GSTT. For example, if a donor were to make a gift of $26,000 to a Crummey trust from which the donor's child and grandchild have Crummey powers and an income interest, each beneficiary would effectively be receiving a $13,000 gift, each of which would qualify for the $13,000 annual per donee exclusion from gift tax. However, the periodic distributions of income from the trust to the grandchild would be taxable distributions, subject to GSTT, with no GSTT benefit having been derived from the fact that the original gift was excluded from gift tax.

There are, however, certain limited situations in which gifts qualifying for gift tax exclusion are also excluded from GSTT. [8] To the extent that a gift directly to a skip person (a "direct skip") would qualify for the $13,000 gift tax annual exclusion, it also qualifies for exclusion from GSTT. A gift that qualifies for gift tax exclusion as a direct payment of educational or medical expenses of a skip person also qualifies for GSTT exclusion. A gift to a trust, which qualifies for the annual $13,000 gift tax exclusion, is GST tax-free if the trust is for the exclusive benefit of one individual who is a skip person, and the trust assets will be includable in such skip person's gross estate if the trust has not terminated before his or her death. Where the aforementioned requirements are not met, it is necessary to allocate an appropriate amount of the GST exemption, as discussed below, to annual exclusion transfers in order to exempt future generation-skipping transfers.

GSTT Exemption

Each individual (transferor) is allowed an exemption from tax for up to $5 million or more in GST transfers for 2011 and 2012.[9] The exemption amount will be indexed in $10,000 increments beginning in 2012. The exemption is generally 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.

In the case of a married couple who makes a lifetime gift and elects gift-splitting, each spouse will be deemed to have made one-half of the gift and each will be entitled to an exemption. The GSTT exemption is not portable[10], that is, trusts may still be necessary to ensure that neither spouse's GSTT exemption is wasted.

In the case of an outright gift directly to a skip person (e.g., a cash gift to a grandchild), the GSTT is applicable as of the date of the gift, and the GST exemption is allocated dollar for dollar to the amount received by the skip person (to the extent the transfer would otherwise be taxable). At the time a transfer is made, a taxpayer wishing to preserve his or her available exemption amount for anticipated future transfers may elect to have the exemption not apply to the current transfer.

The mechanics for utilization of the exemption are more complicated with respect to interests given to skip persons through trusts in which non-skip persons also hold interests. In essence, the allocation of GST exemption is made as to the value of property going into the trust—not to the value of interests eventually received by the skip person upon a subsequent taxable termination or taxable distribution.

Example: G creates a trust in 2011 by transferring $500,000 in marketable securities. The trust provides for the income to be paid to G's child, C, for life, and upon C's death, the principal is to be distributed to G's grandchild, GC. Since an interest is created in a skip person, a GSTT would be payable when the skip person, GC, receives the trust property upon C's death. However, when G makes the initial transfers of securities to the trust, $500,000 of the $5,000,000 GST exemption is allocated to this transfer. Because an available exemption has been allocated to 100 percent of the gift into the trust, all future GSTs out of the trust will have a zero inclusion ratio and, thus, the entire trust is, in effect, exempted from GSTT; no portion of any future distribution to a skip person will be taxed.[11]

Assume that when C dies, 35 years later, the trust property then passing to GC has increased in value to $4 million. This is a "taxable termination," but because the inclusion ratio is zero, no portion of the $4 million will be taxable. If G had elected not to allocate any of the GST exemption to the gift into the trust, the entire $4 million would be taxable. With an applicable tax rate of 35 percent or more, the tax savings from an allocation of GST exemption to achieve a zero inclusion ratio can be very substantial.

An additional example, with detailed comparative computations, is set forth below.

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

As illustrated by the foregoing example, 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 GSTT 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.[12] 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. [13] 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 GSTT 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 GSTT 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 GSTT 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 GSTT 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 2011, 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).

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In recent years twenty-six states and the District of Columbia have modified or effectively eliminated the rule against perpetuities for trusts in those states.[14] 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.

Conclusion

The foregoing examples 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.

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.[15]

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.

See Appendix A (below) for an example of potential growth and tax savings.

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[1]See Appendix A for an example of potential growth and tax savings.
[2]See IRC §§2601-2663.
[3]IRC §2612(c).
[4]IRC §2612(a).
[5]IRC §2612(b).
[6]IRC §2612(c)(2).
[7]The inclusion ratio is equal to 1 minus the "applicable fraction." IRC §2642(a). The numerator of the applicable fraction is the GST exemption amount allocated to the property transferred. IRC §2642(a)(2)(A). The denominator of the applicable fraction is the value of the property transferred (with adjustment for a charitable deduction with respect to such property, and death taxes chargeable to and actually recovered from that property) IRC §2642(a)(2)(B).
[8]IRC §2642(c).
[9]IRC §2631(a).
[10]The Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 introduced a new concept of portability for estate planning. The executor of a deceased spouse's estate may transfer any unused estate tax exemption to the surviving spouse.
[11]As explained in footnote 7, the "inclusion ratio" is equal to 1 minus the "applicable fraction." In this case the applicable fraction is $500,000/$500,000, or 1. Thus, the inclusion ratio is 1 minus 1, or zero.
[12]Under certain circumstances, it may even be desirable to allocate GST exemption to an insurance trust where skip persons hold only contingent interest. This will depend on the complexion of the case.
[13]This example assumes that there are eight *Crummey* powerholders in the trust. Therefore, G remains the "transferor" of the trust property for purposes of the generation-skipping transfer tax. Under certain circumstances a *Crummey* powerholder who lapses his power to withdraw may become the "transferor" for GSTT purposes. The principle is set forth in the following example: G transfers $10,000 to a new trust providing that the trust income is to be paid to G's child, C, for C's life and, on the death of C, the trust principal is to be paid to G's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 45-day period following the transfer. Thereafter the power lapses. C does not exercise the withdrawal right. The transfer by G is a completed transfer for gift tax purposes and, thus, G is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right (the so-called *Crummey* power), C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of the gift tax. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5,000 or 5 percent of the value of the trust property, G remains the transferor of the trust property for purposes of the generation-skipping transfer tax.
[14]See, for example, Wisconsin Statute Section 70016(5) 0999; South Dakota Codified Laws Section 43.5-8 (1997); Delaware Code Ann. Tit. 25 Section 503(a) (Supp. 2000); Alaska Stat. Section 34.27.100; New Jersey Stat. Ann. Section 46:2F-9 (West Supp. 2002); Ohio Rev. Code Ann. Section 213108(B) (West Supp. 2003); Maryland Code Ann. Estates & Trusts Section 11-102(0) (2001); Florida Stat. Ann. Section 689.225 (West 2003); Arizona Rev. Stat. Ann. (A) (1) Section M-2901 (West Supp. 2002); Missouri Ann. Stat. Section 456.236 (West Supp. 2003); Nebraska Rev. Stat. Sections 76-2001 (1996 and Supp. 2002); Colorado Rev. Stat. Sections 15-11-1102.5 (2006); Maine Rev. Stat. Ann. Tit. 33, Sections 101 (West 1964); Rhode Island Gen.; Nevada Rev. Stat. Session 111.1031 (see Nev. Rev. Stat. Ann. 2 Sections 111.103-1039 (Michie Supp. 2004)).
[15]If Congress does not take any action before 2013, the GST exemption amount will revert to $1,000,000 (as adjusted for inflation) in 2013.

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Appendix A - The Benefits of GSTT Planning

Assumptions:

- Trust grows at 6.5% annual rate (for simplicity model assumes no withdrawals).
- 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.

	GST Exempt “Family Bank” (Inclusion Ratio = 0)	No Allocation of GST Exemption (35% tax rate)	No Allocation of GST Exemption (55% tax rate)
Initial amount funded by grantor	**$1,000,000**	**$1,000,000**	**$1,000,000**
Value after children’s generation	5,831,617	5,831,617	5,831,617
Minus: GST taxes*	0	(2,041,066)	(3,207,389)
Net Value	**5,831,617**	**3,790,551**	**2,624,228**
Value after grandchildren’s generation	34,007,759	22,105,043	15,303,493
Minus: GST taxes*	0	(7,736,765)	(8,416,921)
Net Value	**34,007,759**	**14,368,278**	**6,886,572**
Value after great-grandchildren’s generation	198,320,237	83,790,299	40,159,853
Minus: GST taxes	0	(29,326,605)	(22,087,919)
NET DISTRIBUTION TO GREAT-GREAT GRANDCHILDREN:	**$198,320,237**	**$54,463,694**	**$18,071,934**

* Note that the GSTT operates to impose a tax on the privilege of transferring property when there is a generation skipped with respect to the collection of the estate tax. In the above example, no estate tax is collected as property passes through each intervening generation (since trust assets are owned by an irrevocable trust), thus, attracting the GSTT. But, because the GST exemption is allocated dollar for dollar to the initial gift to the trust (as depicted in the left column) with a resulting exclusion ratio of 0, the GSTT is 0.