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LEGAL UPDATES

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Exploring Trust Account Exposure to Bank Failure

Service

Private Wealth

Professionals

JENNIFER CHAMBERS-SMITH
CHATTANOOGA:
423.755.2678
JENNI.CHAMBERSSMITH@HUSCHBLACKWELL.COM

DUGAN DELP
PHOENIX:
480.824.7963
PHOENIX:
480.824.7890
DUGAN.DELP@HUSCHBLACKWELL.COM

Prompted by recent news coverage detailing the collapse of Silicon Valley Bank and Signature Bank New York, some of our clients have asked us the question: *What is my exposure in the event of bank failure?* In response to this question we have set forth below a brief overview of the risk posed by bank failure and some advantages of housing assets in deposit accounts owned by revocable and/or irrevocable trusts.

In summary, deposit protection is maximized when accounts are housed at institutions insured by the Federal Deposit Insurance Corporation (FDIC) and are appropriately titled to a revocable or irrevocable trust, because trust accounts are afforded additional protection based upon the number of beneficiaries.

I. Overview

The primary purpose of the FDIC is to supply deposit insurance to depositors in U.S. commercial banks and savings banks. When the FDIC insures a bank, it means the federal government is willing to insure up to a certain account balance for each depositor.

Eligibility. In order to qualify for FDIC insurance, the deposits must be housed in an account at a financial institution that is insured by the FDIC.

Coverage. The FDIC provides only limited account coverage for a depositor's balance at any insured institution. The general rule is that the FDIC will insure up to $250,000 per depositor per FDIC-insured institution. As explained in further detail below, when an account is owned by a revocable or irrevocable trust, the deposits may be analyzed separately from the depositor's personal accounts, resulting in increased coverage.

Takeaway: Deposits are vulnerable to loss due to bank failure if they (1) are in accounts housed at institutions that are not insured by the FDIC or (2) have balances in excess of the coverage limits per FDIC-insured institution.

II. Revocable Trusts

A revocable trust is a substitute to a Last Will and Testament that is designed to own personal use assets, like bank accounts, real estate, business interests, etc. There are no tax consequences of owning assets in a revocable trust, and like a Will, a revocable trust states where your assets will go at your death. Unlike a Will, a revocable trust provides planning for periods of lifetime incapacity; it avoids the slow, expensive, and public court process called "probate" that is required for a Will upon death. As an added benefit, deposit accounts owned by a revocable trust may receive greater FDIC coverage than deposit accounts owned by an individual.

Revocable trusts are not the only probate-avoidance tools. Depositors may also avoid probate on certain deposit accounts by titling accounts to the depositor as trustee for (ATF) or in trust for (ITF) one or more beneficiaries. Alternatively, a single or joint account may have a transfer-on-death (TOD) or payable-on-death (POD) designation to one or more beneficiaries. Accounts with ATF, ITF, TOD, and POD designations are so-called "informal" revocable trust accounts and are treated the same for FDIC insurance purposes, though they lack certain benefits of a formal revocable trust.

Eligibility. In order to qualify revocable trust assets for FDIC insurance, the assets must be deposited in an account housed at an FDIC-insured institution and appropriately titled in the name of the trust. For "informal" revocable trust accounts, the beneficiaries must be named in the institution's deposit account records. Note that if an account has a TOD or POD designation to the depositor's revocable trust (or the depositors' joint revocable trust), rather than one or more individual beneficiaries, it will be treated as a formal revocable trust account.

Coverage. On April 1, 2024, the rules regarding coverage of revocable and irrevocable trusts are changing (see Section IV below). Prior to such change, the general rule is that each depositor's revocable trust account is insured up to $250,000 per "unique primary beneficiary."

A "primary beneficiary" in this case is anyone entitled to an interest in the trust assets upon the death of the last grantor. For a single-grantor revocable trust, "primary beneficiary" includes both the life estate interest of a surviving spouse and the ultimate beneficiaries.

The $250,000 amount is available for each beneficiary per depositor (*i.e.,* for a joint revocable trust, multiply the coverage amount by two), but the same beneficiary can only be counted once per depositor; therefore, the same depositor cannot increase the coverage amount by creating several revocable trusts or several revocable trust accounts at the same institution.

For trusts with primary beneficiaries entitled to equal shares (or less than six primary beneficiaries entitled to unequal shares), each depositor is covered up to the number of primary beneficiaries multiplied by $250,000. For trusts with six or more unequal primary beneficiaries, the calculation is more complicated, but accounts will be insured at least up to $1,250,000 in aggregate balances. More complex beneficiary structures may require a more detailed analysis.

Example 1: Husband and wife have 6 children. The couple has $4,000,000 in a deposit account titled to their revocable trust at an FDIC-insured institution and have no other accounts at that bank. Their revocable trust provides that the assets continue for the survivor's lifetime after the death of the first spouse to die, then divide into equal shares for the children at the surviving spouse's death.

Depositors ("Owners")	Unique Primary Beneficiaries	Available Deposit Insurance Per Beneficiary	Amount Insured	Amount Uninsured
2	6	$500,000	$3,000,000	$1,000,000

Example 2: Husband and wife have 3 children. Husband has $1,010,000 in a deposit account titled to his revocable trust at an FDIC-insured institution and no other accounts at that bank. The revocable trust provides a life estate for Wife if she survives Husband, then divides the remaining assets into equal shares for the children at the surviving spouse's death.

Depositor ("Owner")	Unique Primary Beneficiaries	Available Deposit Insurance Per Beneficiary	Amount Insured	Amount Uninsured
1	4	$250,000	$1,000,000	$10,000

Takeaway: In addition to the estate planning advantages, like probate avoidance, owning deposit accounts in a revocable trust may provide additional protection against a possible bank failure.

III. Irrevocable Trusts

When the grantor of a revocable trust dies, it becomes irrevocable. A trust can also be expressly declared irrevocable by the grantor. An individual may create an irrevocable trust for several reasons—most commonly to own appreciating assets outside of one's taxable estate and to minimize estate taxes when transferring wealth to future generations.

Eligibility. Just like accounts owned by revocable trusts, accounts owned by irrevocable trusts must be housed at an FDIC-insured institution and properly titled in the name of the irrevocable trust to be eligible for FDIC insurance coverage independent of the accounts owned by the depositor personally. Also like with the revocable trust analysis, the coverage applies to the aggregate of all irrevocable trusts created for the same beneficiaries by the same grantor(s).

An additional threshold requirement for deposit accounts owned by irrevocable trusts is that the depositor has relinquished his or her interest in the deposited assets. Any assets in which the grantor retains an interest are considered the grantor's personal deposits and will not be treated as part of the irrevocable trust.

Coverage. The FDIC will insure deposits up to $250,000 of "non-contingent trust interests" per beneficiary, and up to $250,000 of "contingent trust interests" total per irrevocable trust. The amounts are cumulative, so to the extent an irrevocable trust account holds irrevocable trust assets comprising of both contingent and non-contingent trust interests, the FDIC would separate the funds and perform a separate analysis.

Whether trust interests are considered "contingent" or "non-contingent" depends on if the value of the interest can "be determined without evaluation of contingencies other than life expectancy," per 12 C.F.R. § 330.1(m). In other words, if a beneficiary's ability to receive distributions is limited by the discretion of the trustee or any conditions—like achieving a certain education level or maintaining employment—the interest is considered contingent.

Many of the estate planning benefits of irrevocable trusts are derived from the fact that each beneficiary has only a contingent beneficial interest in the trust estate. In such cases, the irrevocable trust's deposit accounts will be subject to a maximum FDIC coverage of $250,000, regardless of the number of beneficiaries. This is the rule until April 1, 2024.

Example 3: Benny has two children. Grandma creates an irrevocable trust for Benny and gifts $500,000 to it. In the trust agreement, Grandma relinquishes any rights to the trust assets and provides that the Trustee may distribute assets to or for the health, education, maintenance and support of Benny and his descendants in the Trustee's discretion.

Depositor ("Owner")	Beneficiaries	Contingent or Non-Contingent?	Amount Insured	Amount Uninsured
1	3	Contingent – Trustee has discretion over distribution of all funds	$250,000	$250,000

Takeaway: An irrevocable trust account balance at least up to $250,000 is covered by FDIC.

IV. Future Rule Change

Effective April 1, 2024, the FDIC rules regarding insurance coverage of revocable and irrevocable trusts are changing. Following the change, revocable and irrevocable trusts will be treated the same, creating consistency and increasing clarity in the analysis of FDIC coverage.

In summary, each grantor's deposits will be insured up to $250,000 per beneficiary—whether the trust is revocable or irrevocable, and regardless of whether the beneficiary's trust interest is considered "contingent." However, there will be a maximum coverage amount of $1,250,000 per depositor at each FDIC-insured institution, even if the account is owned by a trust with more than 5 beneficiaries.

Takeaway: Beginning on April 1, 2024, FDIC coverage of some revocable trusts may be restricted, but FDIC coverage for irrevocable trusts will be increased.

Contact us

If you have questions regarding banking risk in the context of trust and estate planning, please reach out to our Private Wealth team with questions about your specific situation and future planning needs.