Trust Loans to Beneficiaries: A Topic of Interest

For estate planning practitioners, loans are a versatile tool which can be utilized to accomplish a broad range of goals. The ongoing interest rate environment has generated many unique opportunities, as the Applicable Federal Rate ("AFR" – the IRS-mandated minimum interest rate for intrafamily lending) sits at or near historical lows. While intrafamily loans are a popular mechanism to facilitate wealth transfer, loans also frequently come into play in the trust context. In many cases, trustees can expect to receive requests for loans from irrevocable trusts to one or more beneficiaries. While useful in appropriate situations, loans in the trust context require careful consideration in order to avoid pitfalls and ensure the settlor's original intent is respected.

BENEFICIARY BORROWING

A loan can often serve as an alternative means by which a beneficiary may enjoy the assets of the trust, and there are a variety of reasons why a beneficiary loan might be appropriate.

In situations where the dispositive provisions of the trust cannot accommodate an outright distribution, a loan can provide a mechanism for beneficiaries to access trust funds in a time of need. Each time a distribution is made to a particular beneficiary, the trust assets (and thus the interests of the other beneficiaries) are diminished. Trustees owe a duty of impartiality – they must act in favor of all beneficiaries equally. While every individual beneficiary has different needs, allocating a disproportionate amount of assets to one over another can be problematic. By virtue of the simple fact that a loan is subject to repayment, it can be used to grant access to trust resources without depleting the principal, preserving the trust corpus for continued growth and enjoyment by others.

Having a trust as a lender can be advantageous. The minimum interest rates on loans to beneficiaries (as established by the IRS) are generally much lower than what a commercial lender would offer. A beneficiary obtaining a mortgage loan from their trust, as opposed to a commercial bank, generally could enjoy a substantially discounted rate of interest. The savings that would accumulate over the life of such a loan could amount to a substantial financial benefit, while never requiring a distribution.

Loans can also serve as a means of furthering the original intent of the settlor. Trusts are created for a variety of reasons, one of which is to control beneficiary access to substantial financial assets. Settlors seek to protect family wealth from creditors and to prevent misuse by beneficiaries who are not prepared to manage a large inheritance. However, even a spendthrift beneficiary may experience a legitimate, unforeseen need for trust resources. While granting a distribution request based on such circumstances may not be contrary to the spirit of the settlor's wishes, a trustee may nevertheless be restricted from doing so by the language of trust. Here again, a loan could serve as a sort of safety valve, providing an alternative means of accessing trust funds for appropriate purposes.

IMPORTANT CONSIDERATIONS

While a loan to a beneficiary can be a versatile tool, any lending relationship must be assessed carefully by all parties to avoid potential issues. Below are some of the considerations which could be pertinent in establishing loans to trust beneficiaries.

THE BIFURICATION EFFECT

As with some other states, Delaware law permits the "bifurcation" of trustee duties. This allows for the creation of a "directed trust" structure, in which certain duties that are traditionally held by a trustee, such as distribution decisions or the management of trust investments, are allocated to other co-fiduciaries, commonly known as "advisers." [1].

[1] *See 12 Del C. § 3313.*

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The advisers holding these responsibilities, in turn, direct the trustee in carrying out the powers that fall within their purview.

Jurisdictions like Delaware have seen an increase in the prevalence of directed trusts, where trustees typically take on a purely administrative role. Often, the trustee has no responsibility for investments, and is instead directed in the management of trust assets by an appointed investment direction adviser. This development has given rise to the question of whether beneficiary loans fall within the category of "investment decisions," under the authority of the investment direction advisor, or instead remain a non-investment matter, for which the trustee is responsible. The answer has not always been straightforward.

When a directed trustee receives a request for a loan to a beneficiary, their first action will likely be to review the portion of the trust document that pertains to lending and borrowing. Assuming the trust does not explicitly prohibit the loan (in which case no further analysis is needed), the trustee will attempt to determine which party holds the decision-making authority to make loans from the trust. In order to avoid ambiguity, this responsibility is often purposely assigned to a specific party, whether it be the investment direction adviser, the trustee, or some other powerholder.

If the trust language is unclear or silent on the topic, trustees will look for statutory guidance. Under 12 Del. C. § 3313(d), the term "investment decision" includes the powers to borrow and lend "for investment purposes." In recent years, this provision was amended to clarify that "the power to lend for investment purposes shall be considered an investment decision only with respect to loans other than those described in § 3325(19)b. and c."

§ 3325(19)b. describes beneficiary loans that are "made in lieu of a distribution amount that could have been made currently to or for such beneficiary under the terms of the governing instrument, not made in excess of such amount, and the fiduciary creates a reserve for the potential liability."

§ 3325(19)c. describes beneficiary loans that are "made to or for the benefit of another trust of which such beneficiary is also a beneficiary, provided the requirements of paragraph (19)b. . . . are satisfied."

Thus, by default, a loan that is made to a beneficiary (or another trust for the benefit of such beneficiary) in place of a distribution that would have been permissible under the trust is not clearly an "investment decision." This may place decision-making authority for such loans under the purview of the trustee (rather than the investment direction adviser). As "investment purposes" may be interpreted in a number of ways, many trustees take a conservative approach and ensure that the amount of any beneficiary loan be clearly authorized, both as an investment decision and a distribution decision. In this way, the trustee (or other individual authorized to exercise distribution discretion) will have reviewed the matter thoroughly, should there ever be a request from the beneficiary to forgive the loan.

Worth noting, however, is the opening sentence of § 3313(d), which contains the following phrase: ". . . unless the terms of the governing instrument provide otherwise." Regardless of what the statute provides, practitioners and settlors are free to draft trust instruments in a way that explicitly assigns authority over loans (regardless of form or function) to the party of their choosing.

Even more specific provisions may also be included, detailing which beneficiaries may take loans, upon which terms, and for which purposes. There may be requirements related to interest rates or security. Some provisions provide instruction as to how and when action should be taken to collect outstanding debts. These provisions are often seen as a welcome guide by fiduciaries as they carry out their responsibilities. Lending provisions can be a critical component of any trust document, as they can even affect the taxability of the trust.[2] Thus, they are often carefully crafted.

[2] *See, e.g., I.R.C. § 675(2).*

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FUNCTIONAL FORMALITIES

The creation of a loan necessarily entails documentation, as well as adherence to certain formalities. It is important to remember that a loan is not the same as a distribution, and it should not have the appearance of a distribution.

The terms of a loan are typically laid out in a promissory note, which serves as the governing document for the transaction, as well as evidence of the debt. Notes are generally executed by the borrower, and typically provide (at a minimum) the principal amount, interest rate, payment obligations, maturity date, default provisions, details of security (if any), and any other pertinent aspects of the agreement. In situations where the debt is secured by real estate or other assets, there may be additional formalities required, such as the recording of a mortgage or deed of trust. Properly documenting the transaction in this way provides evidence of the debt, ensures that the transaction is accounted for accurately, and helps to avoid future disputes. As mentioned above, trustees have a duty to deal impartially with the beneficiaries, and the administration of loans must reflect that. Well-drafted debt instruments assist trustees in adhering to this important responsibility.

INTEREST

Interest is a key consideration for any loan, and it is no different for beneficiary loans. On a monthly basis, the IRS publishes its ruling on the Applicable Federal Rates (AFR).[3] In nearly all cases, loans to beneficiaries carry interest rates that meet or exceed the AFR for the applicable month. The use of a sub-AFR interest rate is generally considered to be a below-market loan. A below-market loan in the trust context can be problematic, as the difference between the loan's interest rate and the AFR rate is generally treated as a distribution from the trust to the borrowing beneficiary.[4] Use of the AFR rates avoids this scenario. Ultimately, determination of the interest rate, as with the other terms of loan, falls within the purview of the person authorized under the trust to make such a determination.

As with other estate planning matters, planning for beneficiary loans in the trust context is complex and requires consultation with qualified professionals. Commonwealth Trust Company, a Delaware qualified trustee, is experienced in working with closely with attorneys and their clients to ensure their trust is administered correctly and efficiently, as it was intended.

ANDREW L. WINTERS, TRUST COUNSEL
COMMONWEALTH TRUST COMPANY

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[3]*The Index of Applicable Federal Rates Rulings can be found at: https://apps.irs.gov/app/picklist/list/federalRates.html.*
[4]*See I.R.C. § 7872*

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