THE ESTATE PLANNER

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# Can beneficiaries borrow from a trust?

Interest rates remain extremely low, enhancing the benefits of intrafamily loans. These loans allow you to provide financial assistance to loved ones — often at favorable terms — while potentially reducing gift and estate taxes. But what about families that lack the liquid assets to make such loans? Are there other options?

One lesser-known possibility is for trust beneficiaries to borrow money from a trust. This strategy requires careful planning, however, because the trustee must consider his or her fiduciary duty to the trust and its other beneficiaries in approving and structuring such a loan.

## Benefits of intrafamily loans

An intrafamily loan can be a great way to help out your children or other family members financially while also transferring significant amounts of wealth free of gift and estate taxes. Why not simply make an outright gift? Actually, a gift is the better option, so long as your unused exemption is enough to cover it and you don't need the funds or the interest income. But if transfer taxes are an issue or if you're not prepared to part with the money just yet, a loan can be an attractive alternative.

Generally, to pass muster with the IRS, the interest rate on an intrafamily loan must be at least the applicable federal rate (AFR) for the month in which the loan is made. Otherwise, the IRS may view the loan as a disguised distribution, which can result in a variety of unpleasant tax complications.

The loan should also be documented by a promissory note and otherwise treated as an arm's-length transaction. If the borrower places the funds in investments that enjoy returns that are higher than the interest rate on the loan (not a high bar in the current environment), then the excess appreciation is, in effect, a tax-free gift. (See "Intrafamily loan example" on page 3.)

## Trust loans vs. distributions

If an intrafamily loan isn't an option, it may be possible for a trust beneficiary to obtain a loan from the trust. You might wonder why a beneficiary would borrow from the trust rather than take a distribution. There are several situations in which a loan may be necessary or desirable, including:

- The trust's terms place conditions on distributions that aren't currently satisfied,
- The borrower seeks an amount that exceeds limits on distributions imposed by the trust (an income-only trust, for example),

## Intrafamily loan example

Here's an example that illustrates an intrafamily loan's tax-saving potential. Laura, who has already used up her gift and estate tax exemption, lends $1 million to her son, Eric. The loan calls for annual payments of interest-only — at the AFR, which is 0.5% when the loan is made — followed by a balloon payment at the end of the eight-year term. Eric invests the funds in a business venture that earns a 10% annual return.

At the end of the loan's term, Eric's $1 million investment has grown, net the interest at $5,000 per year, to more than $2.5 million. After repaying the $1 million principal, he's received in excess of $1.5 million gift-tax free.

- The trust has multiple beneficiaries and the borrower seeks an amount that would be unfair to other beneficiaries if taken as a distribution, or
- A loan is preferable for tax-planning purposes.

Be sure to check whether trust loans are permissible. Many trust instruments explicitly authorize loans. But even if the trust is silent, the law in many states permits loans unless the trust expressly prohibits them.

### Handle with care

There's a critical difference between intrafamily loans and trust loans: The trustee has a fiduciary duty to manage the trust in a prudent and impartial manner. If you lend money to family members from your personal assets, you're generally permitted to structure the transaction as you see fit. However, a trustee considering a loan request must act in the best interests of the trust and all of its beneficiaries. So, for example, a trustee who approves a loan to a current beneficiary who is a bad credit risk is likely breaching his or her fiduciary duty to the remainder beneficiaries.

To fulfill this duty, the trustee needs to treat the loan as an investment of trust assets. That means the interest rate should be reasonable in comparison to other potential investments (the AFR probably isn't sufficient) and the trustee should consider steps to ensure collection, such as assessing the borrower's ability to repay and securing the loan with adequate collateral.

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Of course, if a trust loan's terms are comparable to those available from a bank, the trustee should question why the beneficiary isn't simply obtaining a bank loan. If the answer is that the beneficiary isn't creditworthy, the trustee should act in the trust's best interests by rejecting the loan request, increasing the interest rate or demanding additional collateral.

### Make your intentions clear

When setting up new trusts, it's a good idea to address loans in the trust instrument. Whether you permit them or prohibit them, saying so explicitly avoids any ambiguity down the road. Talk with your estate planning advisor for additional details.

# Taking steps to protect your will from being contested

Well-crafted, up-to-date estate planning documents are an imperative for everyone. They also can help ease the burdens on your family during a difficult time. Arguably, the most important document is your will.

Regardless of how harmonious your family may be during your life, there's always a chance that a disgruntled family member may challenge your estate plan after your death. Contests over wills typically occur if an estate plan operates in an unexpected way, such as if a large amount of assets is willed to a nonfamily member while a child receives nothing. To avoid a challenge, and the possible outcome of a judge ultimately deciding the distribution of your assets, consider these strategies.

## Communicate your wishes

Before you (and your spouse, if married) set the table for your will, discuss estate matters with close family members who likely will be affected. This may include children, siblings, adult grandchildren and possibly others. Present an outline regarding the disposition of your assets and other important aspects.

This doesn't mean you should be specific but doing so will provide a basic overview of your estate. Consider the input of other family members; don't just pay lip service to their feedback. In fact, they may raise issues that you hadn't taken into account.

This meeting — which may require several sessions — may head off potential problems and better prepare your heirs. It certainly avoids the kind of "shockers" often depicted on screen.

While it's usually best to bring issues out into the open, you don't have to provide all of the specifics. For instance, there's probably no need to publicize restrictions that may be placed on a spendthrift son or daughter.

## Fortify your will

Although there are no absolute guarantees, consider the following methods for bulletproofing your will from a legal challenge:

**Draft a no-contest clause.** Also called an "in terrorem clause," this language provides that, if any person in your will challenges it, he or she is excluded from your estate. It's a good way to thwart contests to a will.

This puts the onus squarely on the beneficiary. If he or she asserts that the estate isn't divided equitably, the beneficiary risks receiving nothing. Be aware that, in some states, this clause may be subject to certain exceptions. Contact your estate planning advisor for specifics.

**Invite witnesses.** Usually, little thought is given concerning witnesses to the will. It's often just whoever happens to be around. It might even

be staffers at the attorney's office where the will is being drawn up.

But it's far better to use witnesses who know you well, such as close friends or business associates. They can convincingly state that you were of sound mind when you made out the will. Also, choose witnesses who are in good health, preferably younger than you are and easily traceable. Finally, you may add extra witnesses for greater protection.

**Obtain a physician's note.** A note from a physician about health status is recommended for someone extremely ill or elderly. For instance, it can state that you have the requisite mental capacity to make estate planning decisions and thus will be useful in negating legal challenges.

It's important to obtain the physician's note close to the time that the will is signed. A note from several years ago will carry little weight in court.

**Draft a revocable living trust.** This trust type is often viewed as a vehicle that discourages will contests. The assets transferred to the trust are governed by the terms of the trust, not your will, giving you more flexibility.

For starters, assets in a living trust are exempted from the probate process. The trust is the owner of the assets — not you. Conversely, a will is subject to public inspection and must go through probate. In most states, the disposition of a living trust cannot be contested.

Furthermore, you retain some control over the assets during your lifetime, since you can change beneficiaries or even revoke the trust entirely. Generally, a living trust is adopted to complement your will.

## Examine all options

No matter how carefully you plan, there's the possibility of an upset beneficiary who feels he or she deserves more of your estate than you provided. To minimize the chances of your will being contested after your death, discuss your options with your attorney. ∎

*Defined-value gifts*

# Plan carefully to avoid unpleasant tax surprises

For 2021, the federal gift and estate tax exemption has reached its highest level ever. Individuals may transfer up to $11.7 million by gift or bequest without triggering federal transfer taxes, while married couples can shield up to $23.4 million from tax. This is a limited time offer, however, as the exemption amount is scheduled to drop to $5 million (adjusted for inflation) in 2026 (and Congress may decide to reduce it even sooner).

Many are considering making substantial gifts to the younger generation to take advantage of the current exemption while it lasts. Often, these gifts consist of hard-to-value assets — such as interests in a closely held business or family limited partnerships (FLPs) — which can be risky. Suppose, for example, that a business owner transfers interests to his or her children valued at $10 million. If the IRS later determines that these interests were undervalued and were actually worth $14 million,

the owner would be liable for nearly $1 million in gift taxes (plus interest and possibly penalties).

## Hedging your bets

A defined-value gift may help you avoid unexpected tax liabilities. Simply put, a defined-value gift is a gift of assets that are valued at a specific dollar amount rather than a certain number of stock shares or FLP units or a specified percentage of a business entity.

Structured properly, a defined-value gift ensures that the gift will not trigger an assessment of gift taxes down the road. The key is to ensure that the defined-value language in the transfer document is drafted as a "formula" clause rather than an invalid "savings" clause.

A formula clause transfers a fixed dollar amount, subject to adjustment in the number of shares or units necessary to equal that dollar amount (based on a final determination of the value of those shares or units for federal gift and estate tax purposes). A savings clause, in contrast, provides for a portion of the gift to be returned to the donor if that portion is ultimately determined to be taxable.

## Language matters

For a defined-value gift to be effective, it's critical to use precise language in the transfer documents. In a recent case, the U.S. Tax Court rejected an intended defined-value gift of FLP interests and upheld the IRS's assessment of gift taxes based on percentage interests. The documents called for the transfer of FLP interests with a defined fair market value "as determined by a qualified appraiser" within a specified time after the transfer.

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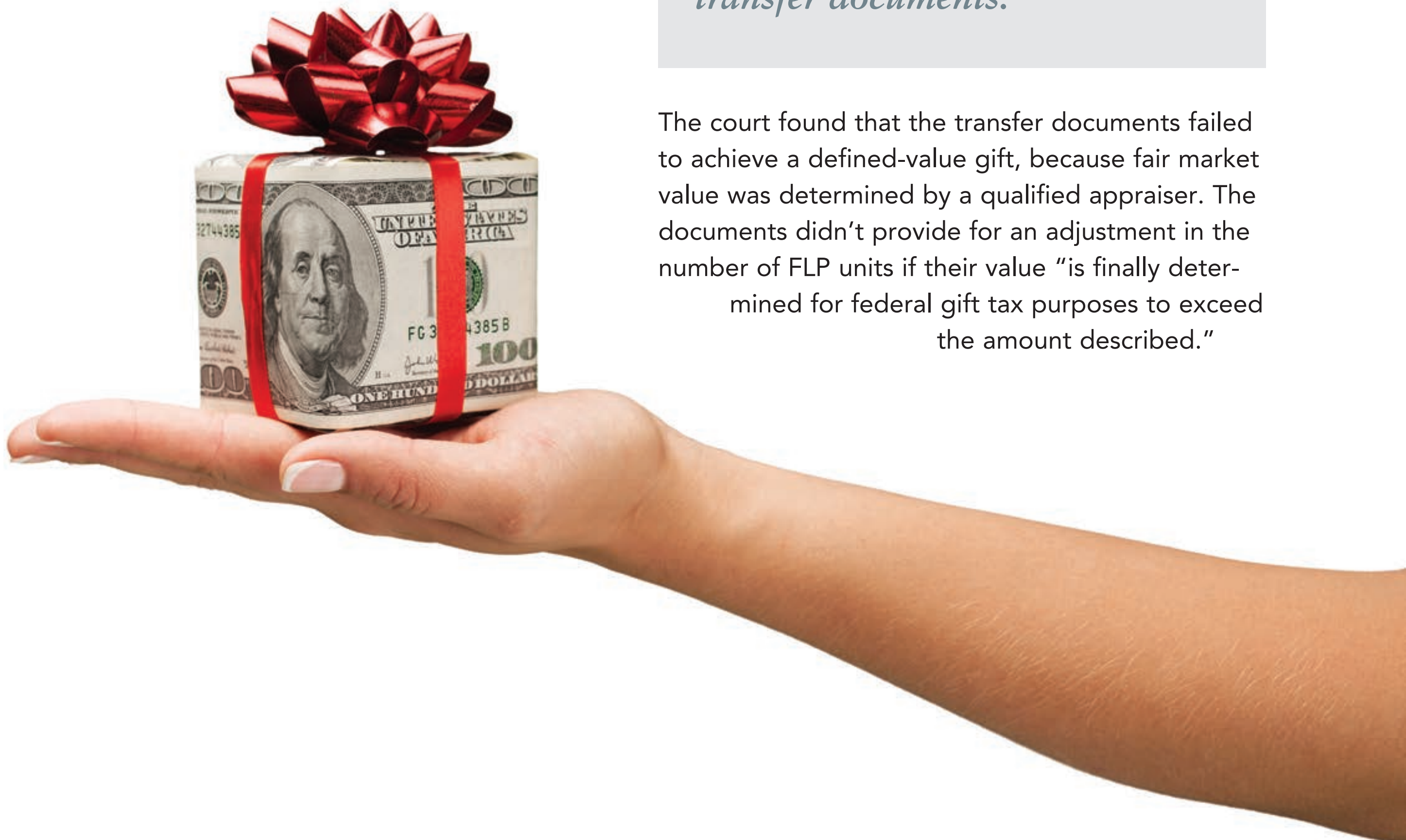
The court found that the transfer documents failed to achieve a defined-value gift, because fair market value was determined by a qualified appraiser. The documents didn't provide for an adjustment in the number of FLP units if their value "is finally determined for federal gift tax purposes to exceed the amount described."



## Use the magic words

If you plan to make substantial gifts of interests in a closely held business, FLP or other hard-to-value asset, a defined-value gift can help you avoid unwanted gift tax consequences. If you use this strategy, however, be sure to plan your gift carefully. To be effective, the transfer documents should contain specific language that provides for adjustment of the number of shares or units to convey the desired value. ▮

ESTATE PLANNING RED FLAG

## You own real estate in more than one state

One goal of estate planning is to avoid or minimize probate. This is particularly important if you own real estate in more than one state. Why? Because each piece of real estate titled in your name must go through probate in the state where the property is located.

Probate is a court-supervised administration of your estate, and if probate proceedings are required in several states, the process can become expensive. For example, your representative will need to engage a probate lawyer in each state, file certain documents in each state and comply with other redundant administrative requirements. In addition to the added expense, the process may also delay the settlement of your estate.

If you have a revocable trust (sometimes called a "living trust"), the simplest way to avoid multiple probate proceedings is to ensure that the trust holds the title to all of your real estate. Generally, this involves preparing a deed transferring each property to the trust and recording the deed in the county where the property is located. Property held in a revocable trust generally doesn't have to go through probate.

Before you transfer real estate to a revocable trust, talk to your advisor to ensure that doing so will not have negative tax or estate planning implications. For example, will transferring a residence to a trust affect your eligibility for homestead exemptions from property taxes or other tax breaks? Will the transfer affect any mortgages on the property? Will it be subject to any real property transfer taxes? It's also important to consider whether transferring title to property will affect the extent to which it's shielded from the claims of creditors.

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- Accessible attorneys who give clients priority treatment and extraordinary service.
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