Intrafamily Loans vs. Trust Loans

Two methods for providing financial help to a loved one

If a relative needs financial help, you can offer an intrafamily loan. However, if it's not properly executed, such a loan can carry substantial negative tax consequences. Also, if you lack liquid assets, an intrafamily loan may not be possible. +

If the family member needing financial assistance is also the beneficiary of one of your trusts, he or she may have the option to borrow money from the trust. Let's take a closer look at intrafamily loans and trust loans.

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.

Trust loans

It may be possible for a trust beneficiary to obtain a loan from your 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),
- 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.

Before taking action, 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.

The trustee has the final say

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.

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.

Consider your options

The decision to make an intrafamily loan or a trust loan can be complicated. For the former, you must take into account the current AFR and whether you have liquid assets. For the latter, you must determine whether your trust allows loans. Before taking action, talk to your estate planning advisor. He or she can determine the best option based on your circumstances.