



FIFTH THIRD BANK

Lending in Trusts- Can or Should a Trustee issue loans to beneficiaries?

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Authority to make loans

- For any trustee administering irrevocable trusts, it is not uncommon to be asked at some point to lend trust funds to a trust beneficiary.
- How should a trustee react when asked to make a loan to a trust beneficiary?
- Does the trustee have the authority, even if not set forth in the trust terms, to issue a loan to a beneficiary?

Authority to make loans

- Under what circumstances should a trustee consider making a loan?
- Does it make a difference whether the beneficiary is a current or remainder beneficiary?
- Should the loan be made with terms comparable to that of a commercial transaction?
- What happens if a beneficiary defaults on a loan?

Authority to make loans

- One source of guidance and authority for trustees is the American Law Institute's "Restatement of Trusts" Second and Third Editions.
- The Restatement (Second) of Trusts §255 (1959) provides: "If the trustee makes an advance or loan of trust property to a beneficiary, the beneficiary's interest is subject to a charge for the repayment of the amount advanced or lent."

Restatement (Third) of Trusts

- The Restatement (Third) of Trusts §50 (2003) comment d(6) provides: “Sometimes a beneficiary requests funds for a purpose that falls within the reasonable discretion of the trustee but which the applicable standard would not require the trustee to furnish. If the trustee is reluctant for some reason to make the requested distribution, and particularly if the trustee’s concern is one of impartiality, the trustee has discretion to make a loan or advance to the beneficiary. The loan need not qualify as a prudent investment under §90 (Restatement Third, Trust (Prudent Investor Rule § 227)). It is a form of discretionary benefit, and may be made at a market rate of interest or a low or no interest; and funds may be advanced with recourse only against the beneficiary’s interest, without personal liability.”

Uniform Trust Code

- The Uniform Trust Code addresses the authority of the trustee to make loans at §816 (18):
 - “Make loans out of trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances, and the trustee has a lien on future distributions for repayment of those loans...”
- Neither the UTC or the Restatement differentiate between current and remainder beneficiaries but rather authorize a trustee to make loans to “a beneficiary”.

Possible protocol

- Trustees should consider developing a protocol with regard to the issuance of loans from trusts so that they can fairly address the requests in light of trustee authority and their fiduciary duty to the trust's beneficiaries.
- From the trustee's perspective, consider the risks associated with lending funds to any beneficiary, such as a contingent remainder beneficiary, whose interest does not vest. In that case, the trustee has made a loan to a person who may not actually end up as a beneficiary.

How to treat loans

- Should every loan be considered an investment decision? Neither the Uniform Trust Code or the Restatement (Third) of Trusts impose that requirement upon the trustee.
- However, it certainly behooves any trustee to develop a process by which requests for loans can be evaluated so that there is a consistent and defensible approach applied in each case.

Possible Protocol

- Consider the following three alternatives that might be applied when asked to lend trust funds to a trust beneficiary:
 - Loans from irrevocable trusts may be considered for current permissible principal beneficiaries as an alternative to an outright distribution.
 - Loans from irrevocable trusts may be considered an investment by the trustee.
 - Loans might be undertaken as a part of an overall family or estate planning technique.

Alternative to an outright distribution

- Loans from irrevocable trusts may be considered for current permissible principal beneficiaries as an alternative to an outright distribution.
 - The loan should be evaluated under the same discretionary distribution standard available to that beneficiary as for an outright principal distribution.
 - The trustee may charge a competitive or nominal interest rate or no interest rate at all but should consider the income tax and or GST tax ramifications when making that decision.
 - The trustee may want to make any future distributions to the borrowing beneficiary subject to a lien for repayment of the outstanding loan.
 - In the event that the trustee decides to “forgive” the loan, that action constitutes another discretionary action by the trustee subject to further review.

Investment alternative

- Loans from irrevocable trusts may be considered an investment by the trustee.
 - The loan should be handled as an arms-length transaction.
 - The borrower must be evaluated similarly to any commercial transaction.
 - The terms of the loan must be competitive with commercial lenders.
 - Collateral for the loan should be encouraged.

Investment alternative

- It is recommended that any trustee consider the following basic questions:
 - Would the beneficiary be able to obtain the loan in the market?
 - Are the terms of the loan between the trustee and beneficiary similar to or very different than those available from a third party in the marketplace?
 - Will the loan cause a concentrated position of assets? If so, does the trust expressly waive the duty of diversification or otherwise allow for holding that particular concentration?
 - Is the interest rate higher or lower than the rate of return on the assets prior to the loan?
 - Could other current beneficiaries or remainder beneficiaries complain that the assets should have been invested in something more productive or more liquid? If so, are there clear purposes of the trust that allow deviation from the “more prudent” investment due to the benefit that the loan affords to the beneficiary?

Estate planning alternative

- Loans might be undertaken as a part of an overall family or estate planning technique.
 - When multiple trusts exist as a part of an overall estate plan for a family there may be a need to borrow funds from one trust to ensure liquidity exists in another trust.
 - An example of such a circumstance might be when funds are needed to make premium payments on an insurance policy held in an ILIT – funds might be loaned from another trust within the same family.

Loans as a last resort

- Details regarding the protocol to be applied in each case might vary but application of this three-pronged approach gives the trustee reasonable flexibility.
- Because of the inherent conflict of interest and the administrative burden of monitoring compliance with the loan terms, the trustee should thoroughly explore other possibilities before considering a loan to a beneficiary.
- When an outright distribution is not appropriate and a loan is being considered, the trustee should carefully consider the issues and ramifications that a loan to a beneficiary can involve.

Additional considerations

- Any time a loan is considered be sure to address the ultimate question: what if the beneficiary defaults? Can the loan be forgiven and treated as an outright distribution or must the trustee seek to recover the funds from that beneficiary?
- If a loan is made to one of a group of beneficiaries, will more beneficiaries seek the same treatment?
- Finally, while other beneficiaries may see the establishment of a promissory note as a receivable on the trust's statements, should the trustee also obtain their consent?

Loan example #1

Loans for estate planning purposes

- Bill Isaiah is a current Private Bank client. Corporate Trustee currently serves with Bill's wife, Chrissy, as Co-Trustee of an irrevocable trust created by Bill for the benefit of some of his descendants (the "GST Trust"). The sole assets of the GST Trust are cash and Bill's guest house located in Sarasota, Florida.
- In 2014, Bill created the Isaiah 2014 Irrevocable Survivorship Insurance Trust (the "ILIT"), which holds a second to die insurance policy on the lives of Bill and Chrissy having a death benefit of approximately \$5.5 million. Corporate Trustee is the sole trustee of the ILIT.

Loan example #1

- Each year since the inception of the ILIT, the GST Trust has loaned to the ILIT \$45,000, which is the amount required to pay the annual premium on the life insurance policy owned by the ILIT.
- The GST trust terms provide under “General Management Powers”, that the trustee "in the Trustee's individual capacity, may engage in a sale, loan, mortgage, or other encumbrance, or other transactions with the trust notwithstanding any apparent conflict of interest."

Loan example #1

- Further, under Florida law a trustee may “make loans out of trust property, including, but not limited to, loans to a beneficiary on terms and conditions that are fair and reasonable under the circumstances, and the trustee has a lien on future distributions for repayment of those loans.”
- Corporate trustee has determined that the trustee may make a loan as a part of overall family or estate planning technique in place for the settlor or settlor's family.
- The terms of the loans are such that they will be repaid once the ILIT receives the policy proceeds.

Loan example #2- Extension of existing loan to current beneficiary

- Philip Rath restated his revocable trust in 2001 and died shortly thereafter.
- Corporate Trustee serves as co-trustee with surviving spouse, Carolyn of the Residuary Trust.
- The Trust terms provide that Grantor's spouse is entitled to all income and she and Grantor's four children are permissible distributees of trust principal.
- The trustees may distribute principal to Grantor's issue for education, health, maintenance and support.

Loan example #2- Extension of existing loan to current beneficiary

- Son, Philip, Jr. has requested a loan from the trust in order to assist him in managing his insurance agency which provides his sole source of support for him and his family.
- Son Philip, Jr. was issued a loan from the trust in 2005 for \$225,000 at a rate of 5% with a maturity of April 2020.
- Philip Jr. has been making regular payments of \$1900 per month and the loan is secured by shares of stock in Philip, Jr.'s insurance agency. The loan balance at maturity is \$51,000.

Loan example #2- Extension of existing loan to current beneficiary

- When the loan was set to mature, the beneficiary was in a position to continue to make the monthly payments but was unable to pay off the remaining principal balance due on the loan.
- Corporate co-trustee and individual co-trustee agree to renew the loan for a period of 3 years at the same rate and terms.
- Could the trustees forgive the loan as a form of outright distribution to Philip, Jr.?

Loan example #3-loan to company

- Roland Ward established a revocable trust that was not funded until his untimely death, at the age of 65.
- Corporate trustee and son Kevin serve as co-trustees of the Ward Family trust.
- A primary asset of the trust is Roland's interest in his own company, Maxie Inc. which is involved in litigation as a result of Roland' death.
- Once Roland's estate administration is concluded, his trust will be divided into three shares for each of his three children and each trust will be administered for them for their lives.

Loan example #3- loan to company

- Son Kevin runs his father's company, Maxie Inc. and, due to the ongoing litigation, the company is struggling to meet payroll demands and "keep the lights on."
- Son Kevin has therefore requested that Corporate Trustee of Roland's trust make a loan to Maxie Inc. for \$800,000 to cover expenses through the end of the year with repayment expected in the first quarter of the new year when certain outstanding contracts owed the company are expected to be paid.

Loan example #3

- The law governing the trust’s administration authorizes a trustee to: “make loans out of trust property, including loans to a trust beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances. The trustee has a lien on future distributions for repayment of loans made under this subdivision.”
- If the trustee grants the loan, then the loan would be to an entity rather than a trust beneficiary. The entity, however is an asset of the trust.

Loan example #3

- A loan to secure a trust's assets is within the authority of any trustee.
- However, a loan to an entity will most likely also benefit others who are not trust beneficiaries (the other owners of the entity).
- Should the trustee insist on security for the loan? Should the loan terms be based upon an arms length transaction?
- Should the beneficiaries be made aware of and consent to the loan?

Loan example #4- an alternative investment

- Carl Ham created a trust that, at his death provided for discretionary income and principal payments to his spouse pursuant to a HEMS standard – with the trustee considering her other resources.
- The trust terms also authorized his daughter and minor granddaughter discretionary access to income from the trust if the spouse did not need or use all the trust's income.

Loan example #4

- The trust terms specifically provide that the trustee:
 - may make loans to any of my descendants, to my probate estate, to my wife's probate estate, or to any other trust established by me or by my wife. These loans may be made without security and without interest.
- On the basis of that provision, settlor's daughter requests a large loan from the trust in order to pay off her husband as a part of their divorce.

Loan example #4

- At the surviving spouse's death, the trust is distributable in accordance with the spouse's limited testamentary power of appointment or in default, outright to the daughter if she survives her mother.
- If the daughter dies before her mother then the balance of the trust is set aside for the granddaughter in further trust.

Loan example #4

- Daughter asks for a loan that is unsecured, with interest charged at the short-term AFR rate, without any payments of interest until the loan is paid off which will occur, probably, when she sells the marital home in the next year and a half.
- Her mother, the surviving spouse, is in favor of the loan and her daughter, the settlor's granddaughter is living with her and will benefit from the financial assistance that could be provided to the daughter.

Loan example #4

- Can the trustee make the loan to the daughter?
 - Recall the trust terms that specifically authorize a loan to any of the settlor's descendants
- Should the trustee make a loan to the daughter?
 - She is not currently eligible for principal distributions so if she does not repay the loan the trustee cannot re-characterize the loan as an outright distribution
 - Given the terms of the loan, it cannot really be considered a reasonable alternative investment

Loan example #4

- Who could be harmed if a loan is extended to the daughter and she does not repay the loan?
- What if the surviving spouse chooses to designate other individuals as remainder beneficiaries of the trust?
- What if the daughter does not survive her mother and the granddaughter becomes the remainder beneficiary – would the trustee have to seek to recover the loan from the daughter's estate?

An inherent conflict of interest?

Any loan to a trust beneficiary inherently places the trustee in a conflicted posture with respect to the borrower:

- The trustee is a fiduciary with duties to the borrower as a beneficiary;

but also

- The trustee is a creditor with a duty to collect from the beneficiary as a borrower.

Key Take Aways

Key take-aways on loans to beneficiaries:

- Because of the inherent conflict of interest and the administrative burden of monitoring compliance with the loan terms, ***the trustee should generally thoroughly explore other possibilities before considering a loan to a beneficiary.***
- And when an outright distribution is not appropriate and a loan is being considered, the trustee should be sure to ***think through the issues and ramifications that a loan to a beneficiary can involve.***

Questions?

Thank you