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Unpack the Potential of the Trust to Beneficiary Interest-Free Loan

A strategy for fighting inflation.

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Wealthy families and their advisors strive to provide for the efficient and appropriate use of family capital. Many families use intrafamily loans to make capital available to family members, family entities and trusts for their benefit. The historically low interest rates that supported these transactions, however, have now been supplanted by rapidly rising interest rates brought about by inflation. This has dramatically increased the burdens associated with traditional loan structures, causing many clients and their advisors to review and consider alternatives. Let's unpack potential planning opportunities of interest-free loans from a trustee to a trust beneficiary while addressing common misconceptions with respect to the complex tax provisions that govern the treatment of loans with below-market interest rates.

When Useful

Interest-free loans from a trust to a beneficiary are useful in a number of situations. Consider, for example, the following hypothetical. Able is a young adult beneficiary of a significant irrevocable family trust. Able and Beatrice, his spouse, wished to purchase a home and wanted to access trust resources to do so. The trustee, however, was reluctant to purchase residential real property and was adamant about maintaining the separate nature of the trust assets. The trustee refused to make a significant distribution to Able or to pledge trust assets to guarantee a third-party loan. It was uncomfortably clear that Beatrice wasn't a trust beneficiary. The trustee ultimately employed a common solution: The trustee loaned Able and Beatrice the funds to purchase the home. The loan was made when the applicable federal rate (AFR) was near historic lows and was secured by a mortgage. This structure worked well for Able and Beatrice as it allowed them to

own their home jointly as husband and wife with rights of survivorship—like many Americans—and share the appreciation in the value of their home. The loan appropriately balanced wealth stewardship and family obligations.

The family soon grew, along with the need for a larger, more expensive home. Able and Beatrice approached the trustee for financing assistance only to find that current interest rates were much higher than the rate on their previous loan. Able and Beatrice simply didn't have the cash flow to satisfy the annual interest obligation and other inflexible promissory note terms. The trustee considered making a loan to Able on an interest-free basis.

IRC Section 7872

Congress enacted Internal Revenue Code Section 7872 to codify the gift and income tax treatment of certain below-market rate loans.[1] This legislative action was in response to *Dickman v. Commissioner*.[2] In *Dickman*, the U.S. Supreme Court held that interest-free demand loans between family members resulted in gifts for federal gift tax purposes, concluding that the right to use money is a property interest, that the gratuitous transfer of the right to use money is a transfer of property for gift tax purposes and that the value of the taxable gift is the reasonable value of the use of the money.[3] This holding came after years of unsuccessful Internal Revenue Service challenges to interest-free and below-market loans.[4]

IRC Section 7872 applies to certain loans in which the amount of interest that would have been payable on the loan at the AFR exceeds the amount of interest actually payable (a below-market loan). When applicable, Section 7872 treats forgone interest on a

below-market loan as transferred from the lender to the borrower and subsequently retransferred from the borrower to the lender. The character of the first transfer depends on the relationship between the lender and borrower and the purpose of the loan. For example, under Section 7872, the deemed transfer of forgone interest from a lender to the lender's employee would likely be characterized as compensation, while the deemed transfer from a lender to the lender's son would likely be characterized as a gift. In the case of a demand loan, the transfer of forgone interest from lender to borrower and the subsequent transfer from borrower to lender are deemed to occur on the last day of each calendar year that the loan is outstanding.[5] In the case of a term loan, other than a gift loan, the lender is deemed to transfer to the borrower on the date the loan is made an amount equal to the excess of the amount loaned over the present value of all payments required to be made under the loan.[6] The below-market term loan is thereafter treated as having original issue discount (OID) under IRC Section 1272, essentially requiring the lender to ratably recognize the forgone interest over the term of the loan.[7] In the case of a gift loan that's also a term loan, for gift tax purposes, the lender is deemed to have transferred to the borrower on the date the loan is made an amount equal to the excess of the amount loaned over the present value of all payments required to be made under the loan. For income tax purposes, however, the lender is treated as having transferred and received an amount equal to the forgone interest on the last day of each year.[8]

Congress intentionally provided that Section 7872 applies only to below-market loans that fall within six enumerated categories defined in the statute (subject to certain de minimis exceptions): (1) gift loans, (2) compensation-related loans, (3) corporation-shareholder loans, (4) loans in which one of the principal purposes of the arrangement is the avoidance of federal tax (tax-avoidance

loans), (5) loans the interest arrangements of which have a significant effect on any federal tax liability of the lender or borrower, to the extent provided in the Treasury regulations (significant effect loans), and (6) loans to qualified continuing care facilities.[9] Only three of these categories apply to the subject trust to beneficiary loan—gift loans, significant effect loans and tax-avoidance loans.

Gift loans. Gift loans are below-market loans in which the forgoing of interest is in the nature of a gift.[10] The Joint Committee on Taxation's Explanation of Section 7872 states:

In general, there is a gift if property (including foregone interest) is transferred for less than full and adequate consideration under circumstances where the transfer is a gift for gift tax purposes.[11]

As a general matter, trustees don't make gifts and the gift tax rules don't apply to treat transfers from a trustee to a beneficiary as a gift. Treasury Regulations Section 25.2511-1(g)(1) provides that the gift tax applies "only to a transfer of a beneficial interest in property" and further provides that "[a] transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee. . . ."[12] When a trustee lends money to a trust beneficiary, the trustee is merely permitting the beneficiary use of property in which the beneficiary already has a beneficial interest. If the trustee distributed cash to the beneficiary instead of making a loan, the resulting transfer to the beneficiary wouldn't be characterized as a gift but rather as a trust distribution. Accordingly, an interest-free or other below-market loan from a trust to a beneficiary shouldn't be characterized as a gift loan.

Significant effect loans. Section 7872(c)(1)(E) provides regulatory authority to extend Section 7872 to below-market loans not otherwise subject to Section 7872 if the interest arrangements have a significant effect on the federal tax liability of the borrower or lender. The proposed regulations under Section 7872 don't exercise this power.[13] The proposed regulations specifically state that: "[n]o transaction will be treated under the regulations as a significant effect loan earlier than the date that future regulations under section 7872(c)(1)(E) are published in proposed form."[14] Therefore, until proposed regulations addressing significant effect loans are issued, an interest-free loan from a trust to a beneficiary shouldn't be characterized as a significant effect loan subject to Section 7872.

Tax-avoidance loans. Section 7872 provides that a below-market loan is a tax-avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any federal tax by either the borrower or the lender.[15] This is a question of fact. The Joint Committee on Taxation's General Explanation of Section 7872 states that tax avoidance is a principal purpose of the interest arrangement if it's a principal factor in the decision to structure the transaction as a below-market loan instead of a loan requiring payment of interest equal to or exceeding the AFR. The proposed regulations under Section 7872 use similar language and further provide that the purpose for entering into the transaction (for example, to make a gift or to pay compensation) is irrelevant to determining whether a principal purpose is the avoidance of federal tax.[16] In other contexts, courts have found that "a principal purpose" doesn't require the prohibited purpose to be the only purpose, but rather that the prohibited purpose "weighed heavily."[17] Of course, in general terms and particularly with respect to estate-planning transactions, the principal purpose of a

transaction isn't tax avoidance if the purpose is to claim tax benefits in a manner consistent with the IRC and Congressional intent.[18]

The IRS has provided little guidance with respect to below-market tax-avoidance loans. In 1989, the IRS advised that a refundable deposit paid to an insurance company by a policy holder was held to be a tax-avoidance loan.[19] The insurance company emphasized the tax advantage to the policyholders of paying for homeowner's insurance by making non-interest-bearing refundable deposits in lieu of insurance payments. The benefit to the policy holder was the avoidance of tax on the forgone interest used to satisfy nondeductible insurance. This advice revoked prior guidance to the taxpayer that the deposits wouldn't be subject to Section 7872 until issuance of proposed regulations related to significant effect loans.[20] Outside of this guidance addressing commercial exploitation of a tax-avoidance loan, we weren't able to find any other instances in which a below-market loan was held to be a tax-avoidance loan.

There are circumstances under which structuring a loan from the trust to the beneficiary as an interest-free loan may provide a tax benefit. For example, if the beneficiary paid interest to the trust, the trust would be subject to income tax on the interest income. An interest-free loan that's not subject to Section 7872 avoids this tax. Although in this sense every interest-free loan may appear to be a tax-avoidance loan, such loans are often tax neutral because the borrower would otherwise be entitled to a tax deduction for the interest paid. Treasury regulations don't require Section 7872 interest imputation when one of the principal purposes of the loan isn't the avoidance of tax, and the borrower is able to show that the lack of interest on the loan doesn't have a significant tax effect on the lender or borrower.[21] For example, a trust beneficiary would be entitled to a tax deduction for the payment of interest on a properly

structured loan from the trust to the beneficiary for the purchase of a residence or investments.[22] As a discretionary beneficiary of the trust, the beneficiary could receive a distribution of that interest income, in which case the beneficiary would report the interest income on their income tax return and offset that income with the corresponding deduction, in which case there's no significant tax effect to the trust or the beneficiary.

Characterization of an interest-free loan as a tax-avoidance loan is a question of fact. In many cases, the circumstances may support a finding that the arrangement isn't tax motivated. Perhaps the trustee simply wants the beneficiary to have use of the loaned funds without having to be concerned about investing the funds in a way that provides liquidity for annual interest payments—for example, to purchase an illiquid asset like a home. Perhaps an interest-bearing loan would negatively impact the ability of the beneficiary to qualify for a third-party loan arrangement or support a family business. The trustee may also want to avoid the administrative and compliance burdens of collecting interest on a loan to a beneficiary, especially in cases in which the beneficiary is a mandatory income beneficiary or regularly receives most or all of the trust income.

In our hypothetical, the loan to Able is consistent with the reasons for which the trust was established, and the structure adheres to the grantor's principal goal of a controlled devolution of family wealth among descendants. Even if the trustee dispensed with the loan and distributed to Able the funds to purchase the home, that trust distribution, in and of itself, wouldn't attract additional tax. Likewise, if the trustee instead purchased the home, any subsequent use of that home by Able also shouldn't result in an additional tax. Moreover, as described above, in this case, the loan arrangement would be tax neutral because Able would otherwise be entitled to a mortgage interest deduction for interest paid. Finally,

when the trust lends money to Able, the trustee is merely permitting Able to use property in which he already has a beneficial interest, and this arrangement is readily distinguished from *Dickman* and Congressional intent in the establishment of Section 7872. Although the promissory note doesn't bear interest, the interest-free loan arrangement between the trustee and Able is neither motivated by donative intent nor established with the principal purpose of avoiding a federal tax.

An interest-free loan arrangement may be appropriate in light of specific facts and circumstances. While not free from doubt, in many cases, the facts and circumstances will reasonably support a conclusion that an interest-free loan from a trust to a beneficiary isn't subject to Section 7872.

Reducing the Risk

In some cases, the terms of the trust instrument may be flexible enough to permit changes to the instrument that would avoid the risk of the IRS successfully taking the position that an interest-free loan from a trust to a beneficiary is subject to Section 7872. Suppose, for example, that the terms of Able's trust were changed to give him the annually exercisable right to withdraw all trust income, as that term is defined in Section 643(b). If Able has that right, Section 678(a) would cause him to be treated as the owner of the trust's income. As owner, the payment of interest by him to the trust and the return of that interest to him by the trustee would be ignored for income tax purposes. Section 7872, therefore, would have no application to the loan. If it would be undesirable to give Able the right to withdraw all of the trust's income, it may be possible to separate the trust into two separate trusts, one consisting of the loan made to Able, and the other consisting of the balance of the trust's assets.

OID

A discussion of interest-free loan arrangements isn't complete without reference to the complex provisions that govern the tax accounting for debt instruments. These rules generally require compensation for the use of money and establish the framework for its coordinated taxation. The rules measure interest and characterize that interest as qualified stated interest or OID, or some combination. The OID tax rules under Section 1272 and related sections are intended to identify and tax deferred interest income and force borrowers and lenders to recognize that income in the appropriate time periods.

Most advisors carefully structure intra-family promissory obligations to avoid imputed interest by providing for the payment of annual interest at the governing AFR. The OID rules simply don't apply to interest-free money loan arrangements that aren't subject to Section 7872. The analysis starts with determination of the amount of OID under
Section 1273, which provides that OID is equal to the excess of the "stated redemption price at maturity" over the "issue price."[23] Under Section 1273(a)(2), the "stated redemption price at maturity" is the sum of all payments under the note except for qualified stated interest. For an interest-free loan, this will be the initial loan amount. Under Section 1273(b)(2), the "issue price" for a money loan is the initial loan amount.[24] Therefore, the excess of the stated redemption price at maturity over the issue price is zero, and there's no OID. With respect to money loan arrangements, OID rules aren't applicable, and Congress relies on
Section 7872 to require appropriate deemed payments and the imputation of interest.

Implementation

Unlike a traditional loan bearing interest at a fair market rate, establishment of an interest-free loan requires the trustee to deliberate with respect to the appropriateness of the arrangement and the purposes for which trust income or principal is payable to the beneficiary. The interest-free loan arrangement must be properly documented to ensure that it's accorded treatment as a loan and not as a trust distribution. In fact, a number of court cases have construed transactions that are nominally documented as loans as other than loans,[25] and interest-free arrangements may test the traditional boundaries of lending arrangements.

The trustee must establish an interest-free lending arrangement within the authority granted by the trust instrument or in accordance with administrative provisions of the state law governing the trust. These rules generally require the trustee to administer the trust property in a prudent and impartial manner. Some trust instruments may have specific provisions authorizing interest-free loans. As a result of fiduciary constraints, interest-free promissory notes may include terms that differ from traditional loans, including: (1) relatively short-term periods that provide the trustee an opportunity to review and make frequent independent decisions regarding the arrangement, (2) penalty provisions to ensure compliance, (3) provisions that convert the arrangement to an interest-bearing note in certain circumstances, and (4) provisions that provide for maturity of the note on the death of the beneficiary or certain other beneficiary-related circumstances. The trustee should be careful to ensure that the special terms of an interest-free loan arrangement comply with governing law and satisfy the beneficial interest requirements of the trust instrument.[26]

Reporting/Compliance

The reporting of an interest-free loan arrangement requires special attention. As described above, an appropriate interest-free loan between a trustee and a trust beneficiary shouldn't result in taxable income, and no income reporting should be required. Conservative taxpayers may avoid the risk of some tax penalties by disclosing the nature of the transaction on Form 8275-R. Give consideration to state and local tax compliance as the rules may differ from federal rules. Finally, the trustee should disclose the loan to beneficiaries on fiduciary accounting reports in accordance with the governing trust instrument and administrative law.

Irrevocable taxpaying trusts compute taxable income at the trust level and provide for the allocation of that taxable income between the trustee and its beneficiaries. This system of fiduciary taxation doesn't create additional tax, it merely determines which taxpayer is responsible for a tax payment. Although the allocation of a trust's taxable income between a trust and its beneficiaries is beyond the scope of this article, that allocation is based in part on the distribution of trust property to the beneficiary. We're not aware of any instance in which Section 7872 imputed interest on an interest-free loan has been deemed "paid, credited or permanently set aside" for characterization as a trust distribution deduction under Section 661.[27]
Furthermore, a trust isn't required to claim a distribution deduction under Section 661, although Chief Counsel has advised that the impact of not claiming a distribution deduction doesn't shift the incidence of taxation but rather subjects the income to taxation by both the trust and the beneficiary.[28]

Market Adjustments

Historically, high rates of inflation and corresponding interest rate increases have dramatically altered the burdens associated with

traditional intra-family loan structures. These profound market adjustments have a significant impact on existing structures and new transactions, causing many clients and their advisors to review and consider alternatives. In the right circumstances, the trustee to beneficiary interest-free loan may be an ideal solution that promotes family harmony while appropriately balancing stewardship obligations with beneficiary needs.

Endnotes

1. *See* Staff of the Joint Committee on Taxation, 98th Cong., "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," at pp. 528-9 (Comm. Print 1984).

2. *Dickman v. Commissioner*, 465 U.S. 330 (1984).

3. *Ibid.*, at pp. 338-44 (1984).

4. *See*, *e.g.*, *Dean v. Comm'r*, 35 T.C. 1083 (1961); *Hardee v. United States*, 708 F.2d 661 (Fed. Cir. 1983).

5. Internal Revenue Code Section 7872(a).

6. IRC Section 7872(b). The present value is determined by reference to the applicable federal rate on the date of the loan. Section 7872(f)(1).

7. Section 7872(b).

8. Sections 7872(a) and 7872(d).

9. *See supra* note 1 and Section 7872.

10. Section 7872(f)(3).

11. *See supra* note 1, at p. 529.

12. Treasury Regulations Section 25.2511-1(g)(1).

13. Proposed Regulations (Prop. Regs) Section 1.7872-4(f) was reserved for this purpose.

14. Preamble to Prop. Regs. Aug. 20, 1985, Fed. Reg. Vol. 50, No. 161, at p. 33554.

15. Section 7872(c)(1)(D); U.S. House, Committee of Conference Report, Deficit Reduction Act of 1984 (H.Rpt. 98-861), at p. 1019 (Washington: Government Printing Office 1984).

16. Prop. Regs. 1.7872-4(e).

17. *See* Kevin M. Keyes and Jonathan R. Zelnik, *Federal Taxation of Financial Instruments and Transactions* (1997, Supp. 2022) at 11.02(3)(d)(i) (discussing *Santa Fe Pac. Corp. v. Central States, Southeast, Southwest Areas Pension Fund*, 22 F.3d 725 (7th Cir. 1994)).

18. As U.S. Supreme Court Justice Learned Hand observed:

[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs

that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here, was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of [estate] taxes, as it certainly was.

19. *Helvering v. Gregory*, 69 F.2d 809, at p. 810 (2d Cir. 1934) (citations omitted), *aff'd*, 293 U.S. 465 (1935).

20. Technical Advice Memorandum (TAM) 8952001.

21.TAM 8831004.

22. Section 7872(i)(1)(C) and Treas. Regs. Section 1.7872-5T(b)(14) and (c)(3).

23. Married couples filing jointly, single taxpayers and heads of households can deduct interest with respect to qualifying mortgages of up to $750,000 (2022), and a married taxpayer filing separately may deduct up to $375,000 (2022). IRC Section 163. The investment interest deduction is generally available for interest paid on loans used to buy property that will produce investment income—interest, dividends, annuities or royalties—or that's expected to appreciate in value. The investment interest deduction is limited to investment income, but any excess investment interest deduction may be carried forward to a future tax year. Section 163.

24. IRC Section 1273(a)(1).

25. Note that the issue price and original issue discount analysis would be different with respect to an interest-free installment

purchase transaction of property.

26. *See, e.g., Wood Preserving Corp. of Baltimore, Inc. v. U.S.*, 347 F.2d 117 (4th Cir. 1965); *Jaeger Auto Fin. Co. v. Nelson*, 191 F. Supp. 693 (E.D. Wis. 1961); *Dixie Diaries Corp. v. Comm'r,* 74 T.C. 476 (1980); *Gooding Amusement Co. Inc. v. Comm'r,* 23 T.C. 408 (1954); Internal Revenue Service Notice 94-47. *See also Bohan v. U.S.*, 456 F.2d 851 (8th Cir. 1972).

27. The Biden administration's *General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals* proposes to treat loans from trusts as trust distributions, noting that such trust loans allow a taxpayer to "divorce their ability to benefit from trust assets from the receipt of income for tax purposes" thereby allowing them to "inappropriately avoid income and GST taxes."

28. Under IRC Section 662, a trust beneficiary reports as taxable income a ratable share of the amount specified in IRC Section 661 that's paid, credited or required to be distributed to the beneficiary. An amount is properly paid if it's authorized by the governing instrument and applicable local law and common law principles. *See*, *e.g*., Revenue Ruling 71-335. To be paid, there must be an actual payment, which is a question of fact. *McCauley v. United States*, 61-1 U.S.T.C. Section 9108 (E.D. Ark. 1960). Amounts that are credited to a beneficiary are also treated as distributions, but Treasury regulations are silent as to its meaning, simply stating, "An amount which is credited . . . is included in the gross income of a beneficiary whether or not it is actually distributed." Treas. Regs. Section 1.662(a)-3(a). To be properly credited, an amount must be subject to immediate enjoyment by the beneficiary. *See Freuler v. Helvering*, 291 U.S. 35, at p. 42 (1934).

29. ECC 201016073.

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