**WEBINAR RESOURCE PAPER**

# How Can My Trust Help My Kid Buy a House?

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## INTRODUCTION

Advisors espouse the virtues of making gifts of assets to achieve estate planning goals for good reason. By transferring assets, high net worth clients can reduce the size of their taxable estate and remove assets that are likely to appreciate so that, as a matter of current law, the appreciation can be transferred to heirs without a transfer tax. While clients may also be motivated to make gifts by the potential for significant transfer tax savings, many clients make gifts in order to share their wealth with heirs before their death.

After funding an irrevocable trust with significant wealth, it is fairly common for a client to ask how the assets in that trust might be used to help a beneficiary to buy a house or other property. Advisors may need to guide clients through the many different options for how to handle this common transaction in order to maintain the integrity of the original planning and avoid unintended negative consequences.

In an effort to demystify the range of options from a legal, tax, and family harmony perspective, the focus of this paper will be on practical solutions advisers can bring to clients when encountering the common question: **How Can My Trust Help My Kid Buy a House?**

## I. Helping a child buy a house without using a trust.

Before delving deeper into the ways that a trust might help to facilitate a home purchase, reviewing the simpler and more common approach of helping a child to buy a house without using a trust might be useful. First, for many clients, the option of not using trust assets may be viable and perhaps makes sense to consider before tapping trust resources. Personal assets are in the client's taxable estate and reachable by the client's creditors, so using those resources first may just be the better option. If it is determined that trust assets are a preferrable approach, it will

be helpful to contrast how trust assistance compares to that of direct assistance since the direct approaches are what clients are likely familiar with. Contrasting the two may help the client understand the nuances of how trust assistance is similar or different.

One of the most common transactions in family units is for a parent (or sometimes another senior benefactor), to help a child (or other heir) buy a home. Homeownership is almost universally viewed as a positive step for a child gaining financial independence, building their own family, and more. There are a number of ways that a parent can help a child buy a home:

- Make a gift to the child to provide funds for a downpayment or more.
- Sometimes the gifts take the form of annual gifts from mother to child and child's spouse, and from father to child and child's spouse so that four times the annual exclusion can be given. In 2023, that is $17,000 x 4 or $68,000.
- Annual gifts might be spread over 2 years, e.g. gifts late in the first year and in early January of the next year, to double the amount so that perhaps $68,000 x 2 or $136,000 can be given.
- In some instances parents may loan funds to the child to help purchase a house. In such instances, although awkward, parents should have the loan secured by a mortgage in order to protect the funds, or to enable the child to qualify for a home mortgage interest deduction if interest is charged. If interest is not charged, the imputed interest rules have to be considered.
- It is very common for a third party lender, e.g. a bank providing a mortgage on the house that is the primary source of financing to request that the parents provide a gift letter confirming that the funds transferred to the child were a gift. This is done so that the lender is secure that their loan/mortgage is the only lien on the premises. Clients commonly sign these gift letters without input from their advisers, even in cases where the funds transferred were a loan and not a gift.

## II. Helping a child buy a house using a trust is a lot different – some introductory considerations.

All of this changes if the family chooses to help a child buy a house using assets in a trust. Consider:

- The annual gift considerations that are often primary to structuring how a parent helps a child buy a house directly should be irrelevant as the trust may already hold more than adequate assets.
- Note that a combination of approaches may be used and the parents might choose to make annual gifts to the child, and perhaps the child's spouse as well, to cover furniture, moving and other costs, or even to facilitate part of the purchase in addition to the financial assistance the trust provides.
- The trustee will have to make all decisions. An independent trustee may not merely rubber stamp what the parents want done. That may especially be so if the trustee is a professional or institutional trustee that understands their responsibilities and liabilities as a trustee. A trustee, for example, may have to consider the impact of helping one beneficiary on the financial security and resources thereafter available to other

beneficiaries. That concern may affect to what extent and how the trust provides assistance.

- Is there a concern with equalization? If a trust benefits three children and only one child is to buy a house now, the trustee might want to at least conceptually allocate equal amounts to assist other children, absent special circumstances. If the trust is a spousal lifetime access trust ("SLAT") with  a spouse as a beneficiary as well as children, how might the trustee weigh the needs of the spouse? What if the trust document expressly states that the spouse is to be considered as a primary beneficiary of the trust? Certainly, the trustee could have the spouse sign off acknowledging the financial transaction to assist the child with the purchase of a house, but a sign off doesn't obviate the trustee's responsibilities to the spouse as a beneficiary, the duty of loyalty to both the spouse and other named beneficiaries (i.e., not only to the child being assisted today), etc.
- Advisors need to determine which fiduciary, or perhaps even which combination of fiduciaries, must weigh in on the decisions involved. In a simple trust with just a trustee, that answer is simple, it is the trustee. But many modern trusts bifurcate fiduciary functions into two or more roles. There may be a general trustee, distributions trustee and investment trustee. If the trust buys the house for the child in whole or part, or makes a loan to the child/beneficiary for part or all of the purchase price, that transaction might appear on the first glance to be an investment decision within the purview of the investment trustee or advisor. However, is it really an investment decision if the asset is not income producing, violates the requirements or at least the prudence of diversification, etc.? Likely not (unless the trust instrument expressly makes this a decision of the investment advisor). Would this then mean the home assistance question is within the purview of the general trustee? That will depend on the trust instrument. It may in fact be within the purview of the distributions trustee. That may seem odd if the trust is purchasing the house (or an interest in it) and not actually making a distribution. But if the purpose of the transactions is to assist a particular beneficiary in securing access to live in a particular residence that may in fact be the fiduciary in charge.
- If the trust will purchase the house in whole or part, if the residence is in a jurisdiction other than where the trust has situs the interest may have to be purchased in an entity as discussed below to avoid the trust being subjected to jurisdiction in the state in which the property is located. That could undermine the legal goals for the trust plan.
- If a loan is made, is the trust a grantor trust or a non-grantor trust? If it is a grantor trust, then the imputed interest rules may apply no different than if the settlor made the loan directly to the child. This too is discussed in more detail below.

The key point is that clients may struggle with the complex tax and legal implications of a direct assist to a child buying a home. But when a trust is interposed to be part of that plan, which often can be advantageous, some complications facing individuals may no longer be relevant, but an entirely new set of considerations and challenges will become relevant and those are likely to be even less intuitive and more complex than the issues facing the individual parent helping. Practitioners will have to guide clients with both sets of rules and help select which of the various combinations and permutations of techniques suits the client's wishes and provides acceptable or perhaps even preferable legal and tax results.

## III. What about the financial implications to the child?

When the child of a high net worth client seeks to purchase a property, with or without the help of a family trust, it may be important to consider at the outset whether the child has the wherewithal to cover the carrying costs of the property involved. Too often the child may seek to have a particular home for a variety of personal reasons never having contemplated, let alone analyzed, the financial implications of owning that particular home. Practitioners may endeavor to direct the client (and trustee if one is involved) to first evaluate with the child the ongoing costs. It is not merely the mortgage which may be avoided with the gift planning under consideration but property taxes and all the various carrying costs. For an expensive home, these are likely to be more costly than for a less expensive home. While that sounds obvious, not all children/beneficiaries have really come to terms with that. If the parent and/or trust are going to have to assist to the tune of another $50,000/year for carrying and other costs for the home under consideration the legal, tax and financial implications of all of this should be evaluated before proceeding further. What will be the source of those ongoing funds? If the trust, will the trustee agree? For how long can a trustee distribute funds in that amount before the concerns over disparate treatment of other beneficiaries become problematic?

Who will own the interests in the home? If the child/beneficiary has a spouse what rights will the spouse have? Does the child have a prenuptial agreement with the spouse? If not should this discussion be revisited (although in the context of a post-nuptial agreement)? Who should mention that conversation? If the child is now seeking substantial financial assistance from the parent and/or trust perhaps the parent can mention this discussion (perhaps again bring up this discussion if it was suggested before marriage and ignored).

## IV. Evaluate how helping the child purchase a home might affect the estate plan in place.

When the child of a high net worth client seeks to purchase a property worth a significant sum, it may be important to consider how a distribution or gift of the purchase price will affect the client's overall tax planning. A cash gift is usually not the most strategic use of lifetime exemption since cash cannot be leveraged out of an estate with valuation discounts. Similarly, decreasing the value of a trust by a significant cash distribution out to a beneficiary may not be particularly advantageous, as it reduces the growth potential of the overall trust. That might be contrary to the original objectives for the trust involved. Further, the interests of other beneficiaries may be adversely affected.

Before deciding how a client might help a child purchase a home, the client should also be reminded about the asset protection benefits of the original plan. This is particularly important where asset protection had been a motivating factor for the client in putting together the plan in the first place. Simply put, if the child directly is given money to buy the house, or a low or no-interest loan, which will shift economic value from the protective envelope of the trust to the child's personal name with all the attendant divorce, lawsuit and other risks.

## V. Outright Distributions / Gifts.

The reality is that many children seeking to buy a house expect to, even may try to insist upon, owning the house outright in their own name or if married in their name and their spouse's name jointly. Regardless of the legal and tax consequences, which may be the child's wish and a decision will have to be made by the parent and/or trustee as to whether that position should be acquiesced to or not.

The path of least resistance – to make a cash gift or have a trust just make a distribution to the child so that the child could buy a house - is arguably the least appropriate option from an asset protection perspective. If the child ends up divorcing, the property might have to be sold as part of a divorce settlement. It's also possible that the ex-spouse could become the owner of the property as part of the divorce. A property owned outright by a child might also be subject to that child's other creditors.

Outright distributions to a beneficiary child from a trust may not be optimal from a tax perspective. A property owned outright by a beneficiary would potentially be subject to estate tax in the beneficiary's estate. Perhaps worse, as the threat may be greater and come sooner, is the loss of asset protection by removing the economic value from the trust.

Many irrevocable trusts involved are structured to be outside of everyone's estate. Family trusts are often established with an eye towards benefiting future generations of your family without the imposition of additional estate or generation skipping transfer tax. When funding an irrevocable trust that provides for successive life interests in multiple generations, allocating generation skipping transfer ("GST") tax exemption can avoid estate taxes when trust distributions are made to grandchildren and to each successive generation regardless of how much the trust grows. An outright distribution to a beneficiary for the purpose of enabling that child to purchase a home may undermine what was likely a primary benefit when the trust was created.

Additionally, when distributions are made from a trust, the trustee has a fiduciary obligation to consider the impact of such a distribution on all of the beneficiaries of the trust. If a trust has multiple beneficiaries, the trustee needs to consider whether a substantial distribution outright to one beneficiary is permitted in the first place.

## VI. Having a trust purchase the property for a beneficiary.

A dynastic trust can purchase the desired property and retain it in trust for as long as state law will permit. Such an ownership structure can facilitate growth outside of the client's and the child's taxable estate and perhaps protect the house from the child's divorce and creditor claims. Further, such a structure may make it easier for the trust to pay the maintenance and carrying costs for the property. Some thoughts:

1. The trust instrument should have an express provision to permit the trustee to hold personal use property. If using an institutional trustee, the advisor should determine whether such a trustee might have any issues with holding personal use property. Where an institutional trustee is preferred but is unwilling to administer personal use property, perhaps the trust might be structured as a directed trust with a person named

to be in charge of trust investment decisions (e.g. an investment director), including purchasing and holding the personal use residence. Generally, an institutional trustee may not be the most appropriate fiduciary to handle the particular issues that might arise when a trust owns a home for a beneficiary. If the trust provisions don't address these concerns it may be possible to have the trust protector act to facilitate the transactions desired or perhaps to ask the trustee to decant the trust to modify the administrative provisions of the trust so that they better facilitate the transaction. That being said, as discussed above, trustees may be concerned about equity as to other beneficiaries, the overall impact on the trust, etc. Clients often assume that since they set up the trust the trustee will do whatever they want, and that is not the case, nor should it be.

2. The terms of the trust instrument should clarify which fiduciary is responsible for administering any personal use property owned by the trust. It may be worthwhile to consider providing an individual fiduciary, such as an investment director, with the right to create rules or regulations for the use of the property.

3. To the extent that the trust separates investment and distribution functions and allows for those decisions to be made by different fiduciaries, it would be important for the draftsperson to identify with specificity which fiduciary will be responsible for the decisions to purchase and hold personal use property (or make a loan if that approach is used as discussed below). Without specificity in the trust instrument, it may not be certain whether purchasing and maintaining a home would be viewed as an investment decision or a distribution decision.

4. The trust might include specific language permitting the beneficiaries to use personal use property rent-free, but even if the trust is silent, that may be permissible. If the beneficiary were required to pay rent, there would be income tax consequences discussed below. Note that in some instances the trustee or the family itself might wish some rent would be paid by the beneficiary. That might be done to teach responsibility, to have the beneficiary feel responsible for the home as they bear some of the costs, to negate some of the inequity if only one beneficiary is presently receiving such a benefit, or even to augment the trust cash flow to meet expenses of the home.
   - If the trust were a grantor trust, the grantor would have taxable income to the extent that the rental income exceeded the expenses.
   - If the trust were a non-grantor trust, the trust would have taxable income to the extent that the rental income exceeded the expenses. If any distributions were made to the beneficiary, the beneficiary would have taxable income, possibly flowing from the rental income paid by the beneficiary.
   - Whether the trust were a grantor or non-grantor trust, the basis of the real property would have to be depreciated and eventually recaptured as ordinary income on the sale of the property.

## VII. Arranging for the trust to own the property through a Limited Liability Company (Or Other Entity) with other owners

Many trusts have situs in trust "friendly" jurisdictions, Delaware, Alaska, South Dakota, and Nevada might be the most common. If the property is located in a different jurisdiction owning real estate directly could subject a trust in a different jurisdiction to the application of the laws of the state where the house is located. That could potentially undermine the efforts to have situs in that better jurisdiction. So, if the house is in a different jurisdiction it may be advisable to have an entity purchase the house, not the trust directly. That way, the trust would only own an intangible property interest (i.e., equity in the entity) and not the underlying property. Liability issues are also often a concern. If the trust is substantial, why expose other trust assets to the potential liability of real property ownership? So, having the home isolated in a separate entity, such as an LLC, may help insulate the trust and its other assets from liability associated with ownership of real property.

Where the child and the child's spouse want to contribute some of their own money to purchase the home, perhaps it makes sense for the property to have multiple owners (e.g. the child, the child's spouse and the trust).

In such instances, perhaps using a limited liability company (LLC) to own the property could be advantageous.

### Advantages of using an operating agreement.

It would likely be useful to prepare an operating agreement for the LLC rather than default to the rules embedded in the state's LLC statute. The statutory default rules may or may not reflect the needs of the child, the child's spouse, the trust or the family. There are a number of provisions that can be added that might be beneficial.

1. The LLC operating agreement can contain rules and regulations about the use of the property. For example, the operating agreement might specify who is responsible for repairs and who can make decisions as to decorating or improvements.

2. The LLC operating agreement could contain provisions that describe how disputes among members, e.g. in the event of a divorce, might be resolved.

3. It may be advantageous to set forth provisions for acts a manager may be required to perform with third parties (e.g. express authority to acquire and finance a residence), name a successor manager, and set forth rules and regulations on the use of the property.

4. In lieu of establishing the LLC as a manager-managed entity from the start, perhaps the operating agreement will identify circumstances upon which the entity would become manager-managed and clarify procedures for appointing a manager during the pendency of the divorce proceeding until the value of each member interest might be determined and paid. The manager could have authority to execute documents, pay bills, etc., on behalf of the LLC. That may make the LLC easier to administer and allow for continuity of ownership during disruptive periods.

## Potential estate tax benefits.

The value of the LLC interests retained by the child and the child's spouse would be considered fractional interests in the underlying property, perhaps eligible for valuation discounts in the estate of either or both of the child and the child's spouse. By their very nature, fractional interests have no ready market for sale and are considered "hard-to-value" assets. As a result, such assets are generally considered to be worth less for gift and estate tax purposes than the gross value of the property.

That said, an LLC could serve substantial purposes independent of any potential for estate tax savings. Given that there is a potential for some tax benefit, advisors need to consider whether the fact that the LLC formed to hold personal use property presents any problem.

Owning a personal use property for the benefit of members of the LLC would generally not be considered to be a valid business purpose. Fortunately, as a matter of state law, it seems that an LLC does not generally need a business purpose in order to be valid even though many LLCs are formed for business purposes. For instance, section 108(b) of the current version of the Uniform Limited Liability Company Act provides that in forming an LLC it "may have any lawful purpose, regardless of whether for profit." The comment explains that "[a]lthough some LLC statutes continue to require a business purpose, this act follows the current trend and takes a more expansive approach." Thus, a purpose statement permitting the LLC "to engage in any lawful activity for which the LLC may be organize in this state" or a similar statement should suffice. Owning a personal use property would be a "lawful purpose."

The IRS has argued that an entity that lacks a business purpose should be disregarded for income tax purposes. However, the courts have rejected the IRS's position that an entity that is disregarded for income tax purposes should also be disregarded for transfer tax purposes under similar circumstances. Since a property used as the personal home of the child and the child's family would have no income tax effect, the lack of any business purpose from the ownership and operation of the home might be irrelevant.

## VIII. Insurance Considerations when the property is owned by a trust or an LLC.

When a trust or an LLC owns a home, property insurance generally must be handled differently than it often otherwise would for the typical individual purchasing homeowner's insurance for a personal residence. Who/what should be listed as insureds and additional insureds need to be examined, to maximize protection in the event of a claim. Many agents are not used to dealing with this type of clientele and do not ask the correct questions. Clients also often are unclear and do not understand that simply being insured may not be sufficient.

An advisor implementing a plan that results in property ownership by a trust or an LLC should advise the client to be certain that the property, owned by an LLC in turn owned by a trust (or owned in part by the trust, the child, etc.) is adequately and appropriately insured. Unless there's a third party lender, issues of proper insurance might be missed and could cost the client substantial losses:

1. All direct and indirect owners, including the trust and/or LLC may need to be included in any property insurance policy. In a structure where the house is owned by a trust or LLC in a different state, perhaps both the trust and the LLC should be named insureds

2. Title insurance protects the title being conveyed from the original seller to the new buyers. Third party lenders require lender title insurance up to the value of the purchase money mortgage. Generally, it is a good practice for purchasers may also be to buy owners coverage for the entire purchase price of the property.

3. The advisors should obtain copies of all insurance instruments showing the correct names of all insured and relevant parties.

Advisors might put their recommendations regarding insurance in writing. Clients need to understand the possibility of large loss if the property is not insured properly.

## IX. Having a trust make a loan to a beneficiary.

Those involved might prefer for the home to be purchased by the trust for the benefit of the child. However, the child and the child's spouse might prefer to have ownership vested in them not the trust. For the sake of harmony between the child, the child's spouse, and the child's family, or because the trustee prefers not to own a personal use asset, or for other reasons, those involved might consider the implications of having the trust loan the beneficiary money to buy the house. This way, the child and perhaps the child's spouse could purchase the property in their own names, subject to a note owed back to the trust. That note may be secured by a mortgage to protect the trusts interests and support the beneficiary claiming a home mortgage interest deduction if the loan carries interest (it may be interest free, low interest, or market rate).

## Consider terms of favorable beneficiary loans.

The typical loan structure often provides for favorable terms, e.g. no interest, to a beneficiary, low interest at AFR, repayment terms structured to match the beneficiary's earnings, etc. Even a favorable loan arrangement arguably protects the purchase money for transfer tax and divorce protection, even if the underlying property were still subject to division as part of a divorce settlement. However, it is advisable that if that is a concern for the family that local matrimonial counsel should review the documentation and terms.

Advisors should likely discuss the benefits and disadvantages of using a demand loan, which would give the trustee the ability to call the note at any time but otherwise defer repayment due from the beneficiary. While the beneficiary is happily married and unencumbered by significant debt and until the property is sold, the note might remain in deferment. Upon the sale of the property or significant creditor risk, the note can be called and paid off.

Alternatively, perhaps the trust might issue a loan with a long repayment period with low or no interest due annually. For example, a typical loan might have a term of 30 years with a balloon principal payment at maturity and no interest payments due.

There are a myriad of variations of how these terms can be handled and practitioners should endeavor to address the legal and tax ramifications of the approach that is to be used and suggest alternative approaches if advisable.

## Ensure that the terms of the trust are appropriate.

The trust instrument should ideally incorporate specific provisions allowing for loans to be made to the beneficiary with favorable terms, although that may not be necessary to support a low or no interest loan to a beneficiary. The trust might provide for a trust protector with specific authority to direct the fiduciary to make loans. Following is wording that the draftsperson might consider including in trust agreements that may be used for this purpose:

> To direct the Distributions Trustee (not the Investment Trustee) to make loans to any beneficiary or trust for a beneficiary or family entity at an interest rate that is less than the minimum rate required by applicable federal income tax law or even at zero interest, or that the loans to a beneficiary bearing interest at the minimum interest rate required by applicable federal income tax law shall be within the purview of the Investment Trustee and not the Distributions Trustee (when the Investment Trustee is not the settlor or spouse of the settlor), or to direct the Distributions Trustee to purchase or fund the purchase of a residence or part thereof for a beneficiary, and the Distributions Trustee shall have no liability for such loan…

## Be sure to follow the formalities of making a loan.

Clients must be careful not to skip the formal requirements of making a loan or else the transaction could be deemed to be a distribution. If the loan is at an interest rate less than an

arm's length rate it may be more important to have other indicia of a real loan carefully respected.

1. The loan should be for a stated term.

2. There should be an expectation that the loan will be repaid.

3. To the extent that the loan is to be secured by a mortgage against the property, real estate counsel should be engaged to draft loan and mortgage instruments as the same is typical in the jurisdiction where the property is located. Mortgages should be duly recorded among the land records in order to secure the debt.

Other considerations might include:

1. Timing should consider the time the beneficiary's bank may wish to hold funds before wiring them to the real estate attorney's trust account (or however the real estate attorney advises).

2. A direction letter should direct the fiduciary to accept the loan documents prepared by real estate counsel. There should be coordination among professionals to ensure that all of the documents that are drafted to give effect to the loan match each other.

3. Consideration should be given to rounding the loan amount higher so that there will be no shortfall of funds. The beneficiary can always pay any excess back to the trust when the transactions conclude.

4. The fiduciary should disburse the funds to the beneficiary's personal bank account directly, not to the title company or attorney.

5. Once the beneficiary receives the loan funds to her personal account, the beneficiary should arrange to transfer funds as instructed by her real estate attorney handling the closing.

A mortgage owed by the beneficiary child and the child's spouse might also give the trust opportunities to create additional protections for trust assets, mitigate state income taxes, and equalize among other beneficiaries of the trust.

## I. Having a trust Guarantee a Beneficiary's Borrowing to Buy the House.

Another option for a trust to assist a beneficiary acquire a home may be for the trust to guarantee the beneficiaries borrowing. So, for example, the child may seek a mortgage from an independent bank or other lender. The trust might provide a guarantee for that mortgage to help the child secure the loan, or to secure a loan at a lower rate. As a beneficiary there may be no requirement to pay a fee to the trust for such a guarantee. Income tax implications. Depending upon the structure of the loan, there could be different income tax implications that need to be considered and communicated to the client, the trustee and the beneficiary.

A below-market loan to a beneficiary of a non-grantor trust would cause imputed interest income to the trust under IRC Sec. 7872. It would then appear the same would be true for a grantor trust for a loan to a beneficiary who is not the grantor or grantor-spouse where the grantor would then recognize the imputed interest income.

## Conclusion

Many of our clients will want to help their children purchase homes and start their lives. It is important for advisors guiding these clients to remind clients about asset protection and wealth preservation goals that the clients have for themselves and their families.