Integrating a Business Trust with a Beneficial Spendthrift Trust

Quite often, entrepreneurs think that they are protecting their assets by setting up a Limited Liability Company (an LLC) for their business and conducting business in the name of the LLC, rather than in their personal name.

While it is true that legally, corporations (including LLC's, C Corps, and S Corps) are treated as being distinct from their owners. In other words, courts legally consider corporations to be the legal equivalent of a "person".

Because an entity is considered a person, corporations are able to enter into contracts, own assets, conduct business, sue and be sued, etc. In the event that the corporate entity is sued and a judgment is entered against it, the corporate veil *should* shield the owner of the company from personal liability,

This protection is known as "limited liability". It is what *should* prevent a business owner from losing their home or other personal assets in order to satisfy a lawsuit against the entity.

However, with most small businesses, there really is no difference between the owner and the entity… The entity is simply a fictitious extension of the owner, carrying out the wishes of the owner.

When a lawsuit occurs, courts will often acknowledge that there is no curtain between the owner and the entity. This opens the doors for the court to "pierce the corporate veil" and assign personal liability to the owner of the corporation.

In most cases, in order for a court to pierce the corporate veil, it must first find one of the following has occurred:

- Fraud
- Inadequate capitalization
- Intermingling of business and finances of the company and the owner
- Alter ego

For the court to find that the entity is merely the "alter ego" of the owner, any one of the following factors can be used:

- Gross under-capitalization
- Failure to observe corporate formalities
- Nonpayment of dividends
- Intermingling of personal and business funds
- Treatment by an individual of assets as if they were their own
- Siphoning of corporate funds by dominant corporation or shareholder
- Non-functioning officers and directors
- Absence of corporate records
- Corporation merely a facade for the dominate corporation or shareholder

The smaller the business, the easier it is to pierce the corporate veil. Piercing the corporate veil typically is most effective with smaller, privately held business entities (close corporations) in which the entity has a small number of owners. In larger corporations that have large numbers of shareholders, it is much less likely that a court will be able to pierce the corporate veil.

For most clients of ours, their entity is owned by one person or just a few people. Often, this is a husband and wife or one individual and a second partner. If the owners of the entity fail to hold annual meetings and prepare minutes of those annual meetings, it is readily considered as an "absence of corporate records", allowing a court to pierce the corporate veil and issue a judgment against the personally owned assets as am as the assets owned by the entity itself.

Likewise, if the business owner occasionally uses the business account to make a car payment, pay for a family meal, or in any other way, uses the business's funds to pay for personal items, this is considered "siphoning of the corporations funds" which could allow a court to pierce the corporate veil.

So many entrepreneurs unknowingly violate the test for "alter ego" and "piercing the corporate veil", making it is much easier for a court to pierce the corporate veil and not only attach assets owned by the entity, but also the personal assets of the business owner(s) as well!

In fact, this was the case with an entrepreneur who became a client of the Trust. The Investor had setup an LLC that offered restoration services following a flood, a fire, etc. Unfortunately, a client of that business sued the LLC for negligence that resulted in injury to one of the customer's employees. The customer's attorney alleged "alter ego". The court allowed the customer's attorney to pierce the corporate veil and the entrepreneur lost all of the equipment owned by the LLC as well as his primary residence!

So how can an entrepreneur obtain bulletproof Asset Protection if an entity isn't sufficient protection?

The answer is to utilize a Business Trust and a very specialized Trust called a Beneficial Spendthrift Trust, at the same time.

You'll want to understand the structure of the Beneficial Trust first because it's the vehicle that provides bulletproof Asset Protection. The structure used to legally achieve this is an "Irrevocable, Discretionary, Complex, Non- Grantor, Spendthrift Trust Organization", or Beneficial Trust for short. But what do all these terms mean?

In a variety of publications, including a *Trust Primer* published in 2001 by the Internal Revenue Service, the IRS defines each of these terms separately.

An **Irrevocable Trust** is one that by its terms, cannot be revoked. This is very different than a Revocable Trust which allows a grantor to revoke the Trust, at which time the assets revert to the grantor.

A **Discretionary Trust** is a trust that has been set up for the benefit of one or more beneficiaries. The trustee is given full discretion as to when to make distributions to the beneficiaries, what to distribute to the beneficiaries, and how to conduct the business of the Trust Organization.

To understand a **Complex Trust**, you must first understand a Simple Trust. A Simple Trust is one that may distribute all income earned by the assets held in the Trust in the current tax year. This creates a taxable event to the party or person receiving that income. A Complex Trust, on the other hand, can legally accumulate income derived from the assets of the Trust on an ongoing basis, adding the income to the Corpus of the Trust rather than distributing the income each year. When a Complex Trust accumulates income that adds to the Corpus of the Trust, no taxable event occurs. Rather, the Complex Trust is able to defer any taxes due on the income until such time as the Trust distributes from the Corpus of the Trust.

To understand what a Non-Grantor Trust is, you must first understand what a Grantor Trust is. Most Living Trusts (a type of Trust that is often used to avoid probate upon the death of an individual) are Grantor Trusts. This means that the individual who owns assets has a Trust document created and then transfers his or her assets into the Trust.

In the case of a **Non-Grantor Trust,** a third party called a Settlor establishes the trust and appoints a person who owns the assets as either the Trustee or the Compliance Overseer or both. The **Settlor** must be a neutral third party and cannot later play a role as either a Trustee or a Beneficiary. The Settlor files for an EIN number and the Settlor's role is complete. At this point, the Trustee has complete management and control of the Trust and begins the process of conveying assets to the Trust. The assets held in the Trust are called the **corpus of the Trust**.

Likewise, a **Spendthrift Trust** is a Trust that is created for the benefit of one or more persons (the beneficiaries). Provisions allow an independent trustee full authority to make decisions as to how the Beneficial Trust Corpus may be used for the benefit of the beneficiaries.

Together, these 5 prongs help to prevent the assets held within the Beneficial Trust from being touched through judgment, lien, levy, or even government seizure.

The Beneficial Trust can be used to generate income passively. This means fully can use it for any type of investing. But, if you have a business that produces revenue from non-passive activities, you'll need to combine the Beneficial Trust with a Business Trust as well.

Here is how you structure the use of a Business Trust and a Beneficial Trust that work together…

- First, setup the Business Trust. The Business Owner is named as both the Trustor and Trustee of the Business Trust. (The Trustor is the person responsible for setting up the Trust.) The Beneficial Trust is named as the ONLY Beneficiary of the Business Trust.
- Second, setup the Beneficial Trust. The Business Owner must be a Beneficiary of the Beneficial Trust. You'll also need to name a neutral third party as the Settlor of the Beneficial Trust. (The Settlor is the person setting up the Beneficial Trust. The Settlor cannot ever be a Trustee or a Beneficiary of the Beneficial Trust.) Either the Business Owner or Owner's spouse would also act as the Trustee and/or the Compliance Overseer of the Beneficial Trust. (Since the Business Owner is the Beneficiary, it is best if the Owner holds the role of Compliance Overseer and the Owner's Spouse holds the role of Trustee. If the Business Owner is single, then the Owner can either hold all the roles or the Owner can along someone else as the Trustee.)
- Next, the Owner would modify the LLC naming the Beneficial Trust as a Limited Member. The Business Owner would them become a minority General Member.
- All of the assets owned by the LLC, as well as all of the entity's Intellectual Property (IP) (including the customer list, operations manual, etc.), should be sold by the LLC to the Beneficial Trust. The Beneficial Trust would issue a Demand Note to the LLC for the value of the assets plus a small amount of interest. The Business Owner would also sell his or her personal assets to the Beneficial Trust. The Beneficial Trust would issue a

Demand Note to the Business Owner for the value of the assets plus a small amount of interest.

- The Business Trust would then enter into a lease with the Beneficial Trust. This allows the Business Trust to get access to the Business assets and IP from the Beneficial Trust so that the Business Trust can continue to operate the business.

So, what impact does this have on protecting the assets as well as on mitigating the taxes for both the entity and the Business Owner?

The Beneficial Trust can earn "passive income" and defer taxes on that income in perpetuity. This means that the Beneficial Trust can own stock investments, cryptocurrency investments, real estate investments, etc. And the income from these investments would be tax decreed on perpetuity.

As long as the passive income is accumulated in the Corpus of the Beneficial Trust, it is not considered "taxable income" to the Beneficial Trust. Rather, items of gross income that the Trustee designates as "Extraordinary Dividends" and that are paid to the Corpus of the Trust, through rules of the Internal Revenue Code, by law, are not considered income to the Beneficial Trust based on Internal Revenue TITLE 26, Subtitle A, CHAPTER 1, Subchapter J, PART 1, Subpart A, Sec 643 (a)(4). *See also Private Letter Ruling # PLR-133314-14 released May 8, 2015, Ruling 3* which states:

> "Section 643(a)(4) and the regulations thereunder exclude from the computation of distributable net income (with respect to trusts that qualify under subpart B) those items of gross income constituting extraordinary dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law."

Likewise, in *Ruling #4 of Private Letter Ruling # PLR-133314-14 released May 8, 2015,* the IRS held that when a Trustee acting in good faith, chooses to declare income of the Trust as an Extraordinary Dividend that is allocated to the Corpus, it is not considered taxable income to any beneficiary either.

Furthermore, if you look at the text of Internal Revenue TITLE 26, Subtitle A, CHAPTER 1, Subchapter J, PART 1, Subpart A, Sec 643 (a)(3), (you'll find the complete text of section 643 at https://tinyurl.com/y3qg226h, it states:

> "(3) **Capital gains and losses**. Gains from the sale or exchange of capital assets shall

be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year."

Since the profits from the sale of real estate are not considered "capital gains" under this section, no capital gains taxes would need to be paid at all by the Beneficial Trust if it had any profits from the sale of real estate. And, since there would be no capital gains, no 1031 exchange would be necessary to defer the capital gains taxes on the profits from such a sale.

(This is also discussed on page 5 of the article Internal Revenue Code and Legal Compliance for Non-Grantor, Irrevocable, Complex, Discretionary, Spendthrift Trust)

This is perfectly legal! In *Weeks v. Sibley DC 269£, 155, Edwards V. Commissioner. 41512£! 532 10th Cir. (1969)* and *Philips v. Blanchard 37 Mass 510*, the courts ruled that a Spendthrift Trust Organization is not illegal even if formed for the express purpose of reducing or deferring taxes. *Edison California Stores, Inc. v Mccolgan. 30 Cal 26472.183 P2d 16*, ruled that persons may adopt any lawful means for the lessening of the burden of income taxes. The *Department of the Treasury, IRS Handbook for Special Agents § 412, Tax Avoidance Distinguished from Evasion* states: "***Avoidance of Taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible***".

This is a huge benefit to the Business Owner and usually creates a return on investment every year! But it's not the only reason the Business Owner should choose to combine a Business Trust and a Beneficial Trust...

Property held by a properly structured Beneficial Trust of this type, is immune from tax liens, levies, seizures, lawsuits, divorce claims, and bankruptcy. In fact, since this type of Beneficial Trust is not considered a "person", but rather a "contract", the Trust cannot be sued at all (other than for fraudulent conveyance which occurs if a person creates a Trust to protect assets from a cause of action that already occurred prior to the creation of the Trust).

Another major advantage to operating a Beneficial Trust combined with a Business Trust to run a business instead of using an LLC is that, because Trusts are not creatures of the legislature, they are not subject to the myriad of strangling legislative controls, rules, and regulations that are applicable to corporations and other legislative entities. The Supreme Court Case *Elliot v. Freeman 220 US 178* ruled that a Spendthrift Trust Organization is not subject to legislative control. The Supreme Court holds that the trust relationship comes under the realm of equity based on common law and is not subject to legislative restrictions, as are corporations and other organizations created by legislative authority.

Here is an example of how the use of a Business Trust in conjunction with a Beneficial

Trust would affect tax liability...

To make the math easy, let's say prior to establishing the Business and Beneficial Trusts that the entity earns $100,000 in income from its primary business activities, in addition to $100,000 in profits earned from the sale of real estate it owns. *What would the tax liability look like?*

Prior to investing in the Business and Beneficial Trusts, the LLC owned the real estate and had $200,000 in income ($100,000 from profits from the sale of real estate and $100,000 from income sources other than real estate). The owners of the LLC would have been responsible for paying capital gains taxes plus income taxes that would have been an approximate total tax liability of $90,000.

Now, here's what happens after the Business Owner sets up these specialized Business and Beneficial Trusts…

First, both the LLC and the Business Owner sell all of their assets to the Beneficial Trust. Each receives a Demand Note from the Beneficial Trust that is equal to the total cost basis of the assets sold to the Beneficial Trust.

The Business Trust then enters a Lease with the Beneficial Trust, allowing the Business Trust to have access to those assets needed to operate the business (computers, IP, vehicle, etc.). The amount should be a percentage of the total income of the LLC.

Here's the outcome from a tax standpoint...

First, the $100,000 gross revenue earned by the Business Trust could be reduced to $30,000 after the lease payment is made to the Beneficial Trust by the Business Trust and payment of any salaries to employees (but NOT to the business owner).

The $30,000 remaining would be paid to the Beneficial Trust by the Business Trust as a pass through. This would be reported on a form K-1 issued by the Business Trust to the Beneficial Trust. This effectively puts essentially all of the business's income into the Beneficial Trust. *So, what are the tax consequences to the Beneficial Trust?*

The Beneficial Trust would have $100,000 in Trust Income (a portion from the lease payment plus a portion from the pass through). Let's assume that the Beneficial Trust also had $13,300 in Trust Expenses, incurred by providing for the well-being of the Trustee and Beneficiaries. This would reduce the Beneficial Trust's Net Income to $86,700.

The Trustee would declare an Extraordinary Dividend of $60,690 and this amount would be added to the Beneficial Trust Corpus. Taxes on this portion of income would be deferred in perpetuity under Internal Revenue Code Section 643.

The remaining Net Income would be reported on a K-1 to the Business Owner, amounting to $26,010 in Net Income to the Business Owner.

If the Business Owner is married, the first $24,400 in income would be tax exempt. This would leave $2,010 in taxable income at a tax rate of 10%. So, the Business Owner's entire tax liability would be $201. If the Business Owner is single, the first $11,200 in income would be tax exempt. This would leave $13,200 in taxable income at a tax rate of 10%. So, the Business Owner's entire tax liability would be $1,320.

The $100,000 earned in the Beneficial Trust from the sale of real estate held in the Corpus of the Beneficial Trust would have no capital gains taxes due as long as the profit was added to the Corpus of the Beneficial Trust after being declared by the Trustee to be an Extraordinary Dividend.

The income taxes due on the profits from the sale of real estate would be deferred in perpetuity, so long as that income was added to the Corpus of the Beneficial Trust and the Trustee declared it to be an Extraordinary Dividend. This would make the total tax liability of the Beneficial Trust $0 for the real estate income.

So, this means that ***the original tax liability of $90,000 per year that the LLC would have been responsible for is reduced to just $201 to $1,320 (depending upon whether the Business Owner is married or single) by utilizing the Business Trust and a Beneficial Trust together!***

If the Business Owner wants to further reduce expenses, the LLC can even be permanently shut down with the state, so no annual fees would be required to maintain the entity.

The only time that the entity must be maintained once the Business and Beneficial Trust are in place is when the business is operated through an S Corporation because the nature of the business does not allow it to be operated as a Trust. (This is the case with law practices, accounting practices, dental practices, physicians, and other licensed professional businesses.)

NOTE: The Business Owner would need to have the Trust distribute enough money for the

Business Owner to pay for Food, Fun, and Fashion for himself and his family each month. If the $26,010 isn't enough for the Business Owner, he can take additional sums out of the Beneficial Trust by drawing against the Demand Note that he received when he sold his personal assets to the Beneficial Trust. Those dollars drawn out against the Demand Note are not considered taxable income to the Business Owner as they are treated as repayment of a loan. The Beneficial Trust would be responsible for paying a small amount of interest on the withdrawal and the amount paid for the interest would be taxable to the Business Owner.

As you can see, investing in a Business Trust and Beneficial Trust package would save the Business Owner over $400,000 in taxes over a 5-year period.

Therefore, the Business Trust being used in conjunction with a Beneficial Trust, instead of operating a business as an LLC, is one of the very few structures for individuals and businesses that fulfill completely the needs of these entities with regard to minimizing current tax liability and reducing risk by protection of assets.

Sincerely:

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