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Financial
Tax Strategies

Integrating an LLC With a Beneficial Spendthrift Trust

Quite often, Real Estate Investors think that they are protecting their assets by setting up a Limited Liability Company (an LLC) for their business and purchasing properties 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 corporation.

However, with most small businesses, there really is no difference between the owner and the entity… The corporation 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 corporation 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 corporation 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 real estate investors, 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 corporation 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.

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 real estate investors unknowingly violate the test for "alter ego" and "piercing the corporate veil" that 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 a Real Estate Investor who became a client of the Trust

The Investor had setup an LLC that owned over 140 properties. Unfortunately, a tenant of one of those properties sued the LLC and alleged "alter ego". The court allowed the plaintiff's attorney to pierce the corporate veil and the Investor lost all of the priorities as well as his primary residence!

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

The answer is to utilize an LLC and a very specialized Trust at the same time.

The structure used to legally achieve this is an "Irrevocable, Discretionary, Complex, Non- Grantor, Spendthrift Trust Organization". 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 trust corpus may be used for the benefit of the beneficiaries.

Here is how you structure the use of an LLC and an Irrevocable, Discretionary, Complex, Non-Grantor, Spendthrift Trust that work together…

- First, setup the Non-Grantor Spendthrift Trust. The business owner is named as the Trustee or the Compliance Overseer or both.
- Next, setup the LLC naming the Trust as a 90% Limited Partner. Make the business owner a 10% General Partner.
- All real estate, as well as Intellectual Property (IP) (including the customer list, operations manual, etc.), should be sold by the LLC to the Trust. The LLC then leases the assets and IP from the Trust for approximately 70% of the monthly income of the LLC.

So, what impact does this have on protecting the assets as well as on mitigating the taxes? And why is this especially helpful for real estate investors?

With this specialized form of Trust, capital gains, as long as they are accumulated in the corpus of the Trust, are not considered taxable income to the Trust. *See Internal Revenue Code Section 643(a)(3).* Other items of gross income, designated as "Extraordinary Dividends" by the Trustee, through rules of the Internal Revenue Code, which are paid to the corpus of the Trust, by law, are not considered income to the Trust. *See 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 Trust. 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

The Trust that is utilized is a Non-Grantor, Irrevocable, **Discretionary**, Complex, Spendthrift Trust. In other words, the Trustee has the discretion to declare that gains (income) from the sale of real estate shall be allocated to the Corpus of the Trust. As such, the gains are considered an Extraordinary Dividend and therefore not treated as "income", based on Internal Revenue TITLE 26, Subtitle A, CHAPTER 1, Subchapter J, PART 1, Subpart A, Sec 643 (a)(4).

Here is an example of how the use of an LLC in conjunction with a Beneficial Trust would affect tax liability...

To make the math easy, let's say prior to establishing the Beneficial Trust, that the LLC earns $100,000 in income, in addition to $100,000 in profits earned from the sale of real estate. *What would the tax liability look like?*

Prior to investing in the Trust, the LLC owned the real estate and had the $200,000 in income ($100,000 from profits from the sale of real estate and $100,000 from other income sources than real estate). The LLC, would have been responsible for paying capital gains taxes of approximately $20,000 plus income taxes that would be approximately $70,000, for a total tax liability of $90,000!

Now, here's what happens when the Business Owner invests in setting up this specialized Beneficial Trust…

First, both the LLC and the Business Owner sell all of their assets to the Trust. The LLC then enters a Lease with the Trust for $70,000 per year, allowing the LLC to have access to those assets needed to operate the business (computers, IP, vehicle, etc.).

First, of the $100,000 earned by the LLC, $70,000 would be paid to the Beneficial Trust as a Lease Payment. This would reduce the net income to the LLC to just $30,000.

Since the Beneficial Trust is a 90% Limited Member of the LLC, 30% of the remaining $30,000 of net income, or a total of $27,000 of the net income, would be attributed to the Beneficial Trust which would add the income to the Corpus of the Trust and therefore declare the income to be an Extraordinary Dividend so that it could defer any taxes on the income in perpetuity.

The balance of the LLC's income would be $3,000 which would be attributed to the 10% General Member, the Business Owner. Since a single individual has a $12,000 tax exemption each year and a married couple has a $24,000 tax exemption each year, the Business Owner would not have to pay taxes on the $3,000.

The $100,000 earned in the Beneficial Trust from the sale of real estate held in the corpus of the Trust would have the capital gains taxes deferred in perpetuity. And, the income taxes due on the profits from the sale of real estate would also be deferred in perpetuity as well, making 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 practically $0 by combining the LLC and a Beneficial Trust!

NOTE: The Business Owner would need to have the Trust distribute enough for the Business Owner to pay for Food, Fun, and Fashion for himself and his family each month. This will create taxable income to the Business Owner, but again, if the amount is up to $24,000 per year or $2,000 per month for a married couple, or $12,000 per year or $1,000 per month for a single individual, it would be below the annual tax exemption and therefore, no taxes would be due.

As you can see, investing in a Non-Grantor, Irrevocable, Discretionary, Complex, Spendthrift, Beneficial Trust would save the Business Owner over $400,000 in taxes over a 5-year period.

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 creates a return on investment every year! But it's not the only reason the Business Owner should choose to combine an LLC and a Beneficial Trust...

Property held by a properly structured Trust of this type, is immune from tax liens, levies, seizures, lawsuits, divorce claims, and bankruptcy. In fact, since this type of Trust is not considered a "person", but rather a "contract", the Trust cannot be sued at all (other than for fraudulent conveyance which occurs of 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 Spendthrift Trust Organization as a business is that, because it is not a creature of the legislature, it is 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.

Considering all these facts, laws and regulations, the structure of the Trust operates well within the guidelines of the Internal Revenue Code and federal, state, and local laws. These regulations and laws are not subject to interpretation by individuals. Therefore, the Trust being used in conjunction with 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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