Internal Revenue Code and Legal Compliance for Non-Grantor, Irrevocable, Complex, Discretionary, Spendthrift Trust

Many questions and concerns have been communicated related to the tax laws, legal aspects and structures that legally lessen tax, defer tax, reduce tax, and, at the same time, limit or eliminate liability overall. This overview specifically addresses and answers these questions with legal cites, the Internal Revenue Code, the IRS Agent's Handbook, and IRS Private Letter Ruling # PLR-133314-14 released May 8, 2015.

Not everyone is familiar with the options available to individuals and businesses for legally accomplishing the lessening, deferment, and reduction of taxes. It requires a very special structure to be in legal compliance with the Internal Revenue Code and laws governing Trusts.

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 *Trust Primer* published in 2001, the Internal Revenue Service 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 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 a trust and appoints a person who owns 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 or some other third-party 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.

As these definitions suggest, this unique type of Trust is designed to protect assets and to defer, reduce, or lessen taxes. It also eliminates liability and provides for beneficiaries without legally affecting the corpus of the Trust. The corpus of a Spendthrift Trust is not subject to turn over orders by any court or Judge, whether federal, state or local.

Capital gains or gifts, as long as they are accumulated in the corpus of the Trust, are not considered taxable income to the Trust. 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 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.

The Trustees of the Trust are the sole and absolute managers of the Trust and determine distributions to Beneficiaries, the management of the assets, and liquidity of the Trust. This type of Trust specifies that the Trust is not required to distribute the corpus of the Trust, including all accumulations of income. The Trust complies with the law of perpetuity by ending 21 years after the death of the last remaining descendant of the youngest beneficiary living at the time the trust was formed. If not renewed before it ends, the trust corpus can then be distributed and taxes paid at that time. This can provide tax avoidance and deferral for a very long time.

These Trust provisions have been well established by the law and court cases. Also, please refer to the following definition of a Trust.

A "Trust" is defined by Black's Law Dictionary as "right of property, real or personal, held by one party for the benefit of another." The trustee(s) hold the legal and equitable title to the property for the benefit of the beneficiaries. Although the trustees hold the property title, they do not own the property. The trustees are designated the managers of the Spendthrift Trust Organization.

The beneficiaries also do not own the property, but they hold a beneficial interest in the trust assets subject to the Trustee's discretion. The "beneficial interest" is contractually non-assignable and, for that reason, a creditor may not legally attach it. The beneficiaries do not have any management or control of Trust assets. A Spendthrift Trust Organization is "created" and given life, through a "*Contract in the form of a manifestation of intention in the Terms and Conditions of the Trust of a Spendthrift Trust Organization*" which is often referred to as the "instrument".

A contract in the form of a Spendthrift Trust Organization, does not owe its existence to any act of the legislature. The authority for its creation is the common law right of the parties to enter into a contract. According to American law, the government cannot regulate or impose a tax upon a right. Our "right to contract" according to the Constitution of the United States, Article. §10 is *unimpariable*. That means that it is not within the power of the government or even a Judge to change one word of a Contract of Trust. Once property is transferred to a

Spendthrift Trust Organization, it is subject to its own indenture, which governs and protects the property held by it.

Also, assets conveyed to trusts are generally not gifts and may not be considered as such because there is no equitable title conveyed to any person or entity; all assets are held in the corpus of the trust for the benefit of the beneficiaries, who, even though they hold a beneficial interest, hold no title to said assets.

Property held by a properly structured contract in the form of a Spendthrift Trust Organization, is immune from tax liens, levies, seizures, lawsuits, divorce claims, and bankruptcy. The Spendthrift Trust Organization is not liable for the debts of the trustees or the beneficiaries and the assets held by the Trust cannot be seized to satisfy the debts of any of them. Further, the trustees and beneficiaries are not liable for the debts of the Trust Organization. *Hussey v. Arnold 182 U.S. 461, 21 S. Ct. 645*.

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***".

Pursuant to *Narragansett Mut. F. Ins. Co. v. Burnhanun 51 r1371, 154 a 909*, "*It is not an evasion of legal responsibility to take what advantage may accrue from the choice of any particular form of organization permitted by law."*
A Spendthrift Trust is not considered a taxable "Association" pursuant to tax law. Black's Law Dictionary defines Association as follows:

> "What is designated as a trust or partnership may be classified as an association [only] if it clearly possesses [all] corporate attributes. Corporate attributes include: (1) centralized management, (2) continuity of existence, (3) free transferability of interest, and (4) limited liability. "

A Spendthrift Trust Organization is not an "association" or an "unincorporated association" because it does not possess the same attributes of a corporation, such as continuity of existence and free transferability of [beneficial] interest. Further, unlike a corporation, a Spendthrift Trust Organization is not an "artificial entity" nor does it owe its existence to the charter power of the State.

A Spendthrift Trust Organization is also not an alter ego or a nominee for any trustee or beneficiary because no one individual holds both legal and equitable title and beneficial interest. Without equitable title and beneficial interest held by any one individual, there is no gift and therefore no gift tax consideration, to any asset conveyed to 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.

The fact that the trustees hold the property does not mean that the trustees own the property. Trust property cannot be held under an attachment nor sold upon the execution of trustee's personal debts. Trustees and beneficiaries cannot be held liable for debts incurred by the trust. If in fact, a trust has been created, the certificate holders are not liable on the obligation incurred by the trustees or managing agents appointed by the trustees. *Hussey V. Arnold 70 NE 87; Mayo V. Morin, 24 NE 1083*.

Pursuant to 695.30(a) of the CPC for the State of California and similar Civil Procedure Codes of other states: "Property of the judgment debtor that is not assignable or transferable is not subject to the enforcement of a money judgment".

This information on case law is irrefutable and not subject to debate.

As to the Internal Revenue Code, the Trusts were all written to be in full compliance with the Code and operate within the law and its guidelines. The rules and laws that govern the transactions of the Trust are contained in various sections of the Code but particularly in the following:

Internal Revenue TITLE 26, Subtitle A, CHAPTER 1, Subchapter J, PART 1, Subpart

A, Sec 643 (a)(3), (4), (7) and (b) 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, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

"(4) Extraordinary dividends and taxable stock dividends. For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock 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....

"(7) Abusive transactions. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations to prevent avoidance of such purposes. If the estate or trust Is allowed a deduction under section 642(c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which Is paid, permanently set aside, or to be used for the purposes specified in section 642(c) is deemed to consist of Items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing Instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

"(b) Income for purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. **Items of gross income constituting extraordinary dividends or taxable stock dividend which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income**."

The Internal Revenue Manual plainly states the rights afforded to individuals and businesses as to what means can be legally taken to accomplish the outlined actions the Trust undertakes. It states:

25.1.1.2.4
(01-23-2014)
Avoidance vs. Evasion

1. **Avoidance of tax is not a criminal offense. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent but shapes and preplans events to reduce or eliminate tax liability within the parameters of the law**.

2. Evasion involves some affirmative act to evade or defeat a tax, or payment of tax. Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are.

3. Common evasion schemes include:
• Intentional understatement or omission of income;
• Claiming fictitious or improper deductions;
• False allocation of income;
• Improper claims, credits, or exemptions; and/or
• Concealment of assets.

Also,9.1.3.3.2.1 (05-15-2008) 26 USC §7201 - Avoidance Distinguished from Evasion

1. Avoidance of taxes is not a criminal offense. Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible, the distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent. He/she shapes events to reduce or eliminate tax liability and upon the happening of the events makes a complete disclosure. Evasion, on the other hand, involves deceit, subterfuge, camouflage. concealment, some attempt to color or obscure events or to make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular investigation may show that an alleged partnership was not, in fact. established and that

one or more of the alleged partners secretly returned his/her share of the profits to the real owner of the business, who, in turn, did not report this income. This would be an instance of attempted evasion.

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, we find the Trust to be 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,

Matthew Jennings

(Signed Electronically)

Matthew Jennings, MBA, EA

Ginamarie Gaudio-Grace

(Signed Electronically)

Gina Gaudio-Grace, JD

- *Notre Dame Law School '91*
- *Notre Dame Law Review '89-'90*
- *Lead Note Editor, Notre Dame Law Review '90-'91*