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Business Trust and Limited Liability Company: Good Options With a Self-Directed IRA

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Self-directed IRAs provide the IRA owner with greater investment options than a standard IRA account. Moreover, the IRA owner can have greater control over those investments if an entity is formed and capitalized by the IRA. The entity will then make the investments with the funds transferred into it from the IRA. The entity will own and take title to the assets until a decision is made to sell the assets and thereby realize a return on the investments. Importantly, most often it is the IRA owner that, because of his or her official role within the entity, makes the decisions regarding what investments to purchase with the funds in the entity and when to sell those investments.

Thus, one of the primary purposes for forming an entity that will be capitalized from the IRA funds is to simplify administration. Since the investment decisions will be made by those who are in control of the entity, there is no requirement to seek and obtain the approval of the IRA custodian of the documentation for each investment (or related expenditure or receipt). The individuals managing the entity will have opened a bank account in the name of the entity, and the funds for the investment will come from that bank account rather than funds held in the IRA.

Another primary reason for forming an entity is to facilitate the combining of investment funds from different investors. The IRA owner may know various unrelated individuals who want to join him or her in making the investments that he or she is proposing. Importantly, the documentation for the entity will set forth the legal relationships, duties, rights, and responsibilities of each of the investors. Moreover, the IRA owner may actually want to share the management and investment duties and responsibilities with one or more of the other investors. Thus, the organizational documents for the entity will describe how these duties and responsibilities will be shared between or among the persons empowered and authorized to make the management and investment decisions.

In certain situations, the IRA owner may decide to create two or more entities if several different assets will be acquired. The purpose of creating a separate entity for each asset is to insulate each asset from the inherent risks of each of the other assets.

Often, such an entity is formed and funded when the IRA owner has a strong

interest in acquiring for investment purposes various types of real estate, whether it be an apartment complex, commercial property, industrial property, single family rental homes, or deeds of trust.

Types of Entities Used: Limited Liability Company and Business Trust.

The two prime examples of such an entity are business trusts and limited liability companies. With a business trust, the IRA account makes an investment in the business trust by acquiring the beneficial interests of the business trust. With an LLC, the IRA account makes an investment in the LLC by acquiring the membership interests of the LLC. Often the IRA account will acquire 100% of the beneficial interests of the business trust or membership interests of the LLC. Acquiring the beneficial interests of the business trust is similar to an IRA account acquiring the membership interests of a limited liability company or shares of a corporation. Essentially, the term "beneficial interests" is the title for the equity interests in the business trust that are acquired when the investment by the IRA is made in a business trust[1] and "membership interests" is the title for the equity interests in the LLC that are acquired when the investment by the IRA is made in an LLC.

By acquiring 100% of the beneficial interests of the business trust, the IRA account has now become both (i) the trustor (or settlor) of the business trust (i.e. the party that has transferred assets into the business trust), and (ii) the beneficiary (i.e. the party that holds the beneficial interests of the business trust).

In comparison, by acquiring 100% of the membership interests of the LLC, the IRA becomes a "member" (and often the sole member) of the LLC.

Organizational Documents for Business Trust and LLC.

Public Filing Comparison. In order to form an LLC under state law, Articles of Organization (or Certificate of Organization, depending on the state) must be filed with that state's Secretary of State (or other designated state agency or department). The IRA owner may sign the Articles as Organizer and/or the IRA owner may be listed as the agent for service of process. Since the Articles become public once filed, the name of the IRA owner has now become public as well. In contrast, there is no public filing requirement when forming a business trust. While there are a number of states that have adopted statutes for business trusts, it is rare for an IRA owner to form a business trust under one of these statutes since these statutes do require the filing of a document with a state agency which then becomes public information. Thus, most IRA owners will not form a business trust under one of these state statutes for privacy reasons. Moreover, many IRA owners do not reside in a state that has adopted a statute for business trusts.

The primary organizational document for a business trust is a Declaration of Trust. This compares, pragmatically and legally, to an Operating Agreement for an LLC since it sets forth the rights, duties and responsibilities of the Trustee and Beneficiary (i.e. the holder of the "beneficial interests" which is the IRA). In comparison, an Operating Agreement specifies the rights, duties, and responsibilities of the Manager and the Member(s) (i.e. the holder of the "membership interests" which is the IRA).

Role of Declaration of Trust and Operating Agreement.

As noted above, the initial step in forming and structuring a business trust is to prepare a Declaration of Trust, which is often commonly referred to as the "trust agreement." In comparison, once the Articles of Organization for the LLC have been filed, then the Operating Agreement is drafted and agreed upon. The Declaration of Trust and the Operating Agreement typically set forth the primary purposes and objectives of the business trust and the LLC respectively. The primary purpose

1. See IRC sec. 4975(e)(2)(G); ERISA Regs. 2510.3-101(b)(1).

of the business trust and the LLC is, of course, to make appropriate investments using the funds that were transferred to it from the IRA. Consequently, all the activities and operations of the business trust or the LLC that are done in connection with the investments must be for the sole and exclusive benefit of the IRA account.[2]

The Declaration of Trust will set out the rights and duties of the beneficiary and the Trustee. Typically the rights and powers of the beneficiary are very broad. For example, the beneficiary will have the right to direct the Trustee to make specified investments and to make amendments to the Declaration of Trust. However, these broad powers will not be exclusive to the beneficiary. Rather, the Trustee will also be given similar broad powers, and, very importantly, the Trustee will not be required to obtain the consent and approval of the beneficiary for any investment or management decisions the trustee makes regarding the assets and investments owned by the business trust.

The rationale for this structure is straightforward. Since the beneficiary is the IRA account, then, if the trustee had no independent authority, all requests for approvals would have to go through the custodian of the IRA account. However, the business trust was created in order to minimize the number of decisions or transactions that would have to go through the custodian's review and administrative process.

Consequently, while it is advisable to reserve these broad powers with the beneficiary in the event a situation arises where obtaining the direction and approval of the beneficiary would be appropriate, granting the Trustee the power and authority to independently make investment and other asset management decisions achieves the "check book control" typically desired by the IRA owner.

In comparison, under the Operating Agreement for an LLC, the Manager is typically given very broad and often exclusive powers for making the investment decisions and overseeing the investments. The Member(s) of the LLC are typically not given any authority to direct the investment and management decisions and actions of the Manager. While the approval of Members may be required for various transactions, such as a sale of substantially all of the LLC assets, the dissolution and liquidation of the LLC or the admitting of a new Member, the role of Members is traditionally structured as "passive" and the Members do not expect to be involved in the investment decisions and the day-to-day oversight of the investments. That is all left to the Manager. As with the business trust, the objective is to minimize having to go through the custodian to get approval. Since any action taken by the IRA as the Member of the LLC would have to be reviewed and approved by the custodian, the goal is to minimize, if not eliminate, the need to submit any decisions or proposed transactions of the LLC to the custodian.

Trustee and Manager. The owner of the IRA account will typically appoint himself or herself as the Trustee of the business trust or the Manager of the LLC. Pursuant to the terms of the Declaration of Trust or Operating Agreement, the Trustee of a business trust or Manager of an LLC will have the authority to make all the decisions regarding (i) the purchase of investments, (ii) expenditures for the maintenance or upgrading of such investments, and ultimately (iii) the sale of each of the investments.

With the IRA owner serving as either the Manager of the LLC or the Trustee of the business trust, it is important for the IRA owner to understand two important rules that will be

2. When an IRA invests in an equity interest of an entity that is neither a publicly traded security nor a security registered under the Investment Company Act of 1940, then the assets of the IRA include both the equity interest and an undivided interest in each of the assets of the entity unless certain exceptions apply. See ERISA Regs. 2510.3-101(a)(2). This is often referred to as the "plan asset" rule.

As a result, any person who exercises discretionary authority over the management or disposition of the underlying assets, such as the trustee of the business trust, is a fiduciary of the IRA and must act solely in the best interests of the IRA. See IRC sec. 4975(e)(3) for the definition of a "fiduciary."

applicable. First, a Manager of an LLC is serving in a fiduciary capacity with respect to the Members of the LLC. Similarly, the Trustee of a business trust is serving in a fiduciary capacity with respect to the holders of the beneficial interests in the business trust. Thus, all actions (or no actions) and decisions by a Manager or Trustee must be solely for the benefit of the Members of the LLC or the beneficiaries of the business trust. Secondly, since the IRA owner is a fiduciary with the respect to the IRA and to the LLC or business trust into which the IRA invested, the IRA owner may not receive any compensation for the services rendered to the LLC or the business trust. Any compensation paid for such services would likely be viewed as a prohibited transaction since a fiduciary is a "disqualified person."[3]

Bank account. Once the organization of the LLC (filing of Articles of Organization, adoption of Operating Agreement) or business trust (adoption of Declaration of Trust) has been completed, the Manager of the LLC or Trustee of the business trust will then want to open a bank account in the name of the LLC or business trust. The Manager or Trustee will typically be the signer on the bank account. However, prior to contacting a bank regarding the account, the Manager or Trustee will apply for an EIN, or "tax identification number," from the IRS for the LLC or business trust. This is generally a straight forward process that can be done online by filling out the IRS Form SS-4. All banks require an EIN with respect to an entity opening an account.[4]

One of the documents that the Trustee of a business trust will be required to fill out in connection with opening the account is a "Certification of Trust." While each bank will have its own form for the Certification of Trust, the terms and information required are pretty standard. Essentially the Trustee will be certifying that (i) he or she is the Trustee, (ii) the Declaration of Trust is in force, (iii) the IRA account is the named trustor as well as the beneficiary and is the party with the right to revoke or amend the Declaration of Trust, and (iv) the Trustee has the authority to open the bank account in the name of the trust.[5] Importantly, the Certification of Trust is being provided to the bank in lieu of providing a full copy of the Declaration of Trust. Thus the privacy and confidentiality of the provisions of the Declaration of Trust are maintained.

Providing the Certification of Trust can be compared to providing the bank with a copy of the Articles of Incorporation if an account for a corporation is being opened or with the Articles of Organization if an account for a limited liability company is being opened. Thus, the Certification of Trust provides the bank with the evidence and assurance that the entity, i.e. the business trust, does exist and the Trustee has the power and authority to open the bank account on behalf of the business trust.

Regarding an LLC, a bank will typically require a copy of the filed Articles of Organization as well as the EIN for the LLC. Thus the documentation and process for opening an account for an LLC may be simpler than opening an account for a business trust.

The IRA owner, upon submitting his or her direction to the custodian to make the investment in the LLC or business trust, will provide the custodian with instructions and information necessary to have the funds in the IRA account wired directly into the bank account of the LLC or business trust. Wiring the funds into the new bank account is the preferred method for transferring the funds. This method provides better documentation to confirm that the transfer of funds from the IRA was made in conjunction with the IRA making an investment in the LLC or business trust and not a taxable distribution to the IRA owner.

Tax Classification of LLC and Business Trust. Both a business trust and an LLC will be classified for income tax purposes as a

3. IRC sec. 4975(e)(2)(A).

4. Importantly, the IRA owner should not use his or her SSN in connection with the bank account. A separate EIN should always be obtained.

5. In California, the Probate Code establishes the permitted terms of a Certification of Trust. See CA Probate Code sec. 18100.5

partnership under federal and state income tax regulations. If classified as a partnership, then the business trust and LLC must file income tax returns with the IRS and the respective state agency. However, an entity classified as a partnership that has only one owner will be "disregarded as an entity separate from its owner." Once classified as a "disregarded entity," that entity will not have to file federal income tax returns. A limited liability company with just one member will be classified for federal and state income tax purposes as a "disregarded entity." With this classification, the LLC will avoid having to prepare and file a federal income tax return.

However, this may not be true at the state level, at least not in California. Despite being a disregarded entity for California state income tax purposes, the LLC must still comply with California return filing requirements in order to pay California's minimum franchise tax of $800.00. In contrast, if a business trust has only a single holder of its beneficial interests, it will then be classified as a disregarded entity and, as a result, not have to file either a federal or state income tax return since California does not impose a franchise tax on business trusts. Thus the fees and costs of preparing a state income tax return, as well as a federal income tax return, are avoided.

Classification of Business Trust for Federal and State Income Tax Purposes.

Since the use of business trusts generally, and in conjunction with IRAs specifically, has not been very common or well known until relatively recently, the following provides a more in-depth discussion of how a business trust is classified for federal and state income tax purposes. By design and structure a business trust is quite distinct from and very unlike a trust that is used for gift and estate planning purposes.

A trust that is used in the gift and estate environment will be taxed under the provisions of Subchapter J of the Internal Revenue Code, starting with Section 641.

In contrast, the classification for tax purposes of a business trust is determined under "check-the-box" Treasury Regulations.

Under Treas. Reg. 301.7701-4(b), a "business trust" is treated as a "business entity" that will be classified for federal tax purposes under Treas. Reg. 301.7701-2. Under this regulation, a "business entity" with two or more members is classified for federal tax purposes as either a corporation or a partnership. A corporation is then defined to mean a business entity organized under a state statute which refers to the entity as incorporated or as a corporation.[6] Since a business trust is not organized under such a state statute, it will not be classified as a corporation. If not classified as a corporation, the business trust will likely then be classified as a partnership. The term "partnership" means a business entity that is not a corporation, as defined above, and has at least two members.[7] Thus, if the business trust has at least two beneficial owners, it will be taxed as a partnership.

Often the IRA account will own 100% of the beneficial interests of the business trust resulting in the business trust only having a single owner. When a business entity has a single owner, and is not a corporation, then it is "disregarded as an entity separate from its owner."[8]

It is worth briefly noting that a business trust is an "eligible entity"[9] and thus has the ability to elect out of the default classification, as noted above. An eligible entity will be classified as a partnership if it has two or more members; or it will be disregarded as an entity separate from its owner if it has a single owner.[10]

If a business trust is classified as a disregarded entity because it has only one owner of the beneficial interests, then the business trust, as noted above, will not have to

6. Treas. Reg. sec. 301.7701-2(b).
7. Treas. Reg. sec. 301-7701-2(c)(1).
8. Treas. Reg. sec. 301-7701-2(c)(2).
9. An eligible entity is a business entity that is not classified as a corporation. Treas. Reg. 301.7701-3(a).
10. Treas. Reg. sec. 301.7701-3(b).

prepare and file either federal or state income tax returns.

Franchise Tax For LLC. Every corporation doing business in California is subject to the minimum franchise tax of $800.00 which is due annually.[11] Similarly, a limited liability company doing business in California must pay annually for the privilege of doing business in this state the same minimum franchise tax of $800.00.[12]

But other entities, such as partnerships and business trusts, are not required to pay a franchise tax, i.e. a tax for the privilege for doing business in California. The non-applicability of the minimum franchise tax to a business trust is clear from the provisions of the California Revenue and Taxation Code and related regulations.[13]

"Total Income" Fee for LLC. In addition to the minimum franchise tax described above, every limited liability company doing business in California must also pay annually a graduated fee that is based on the "total income from all sources derived from" its activities in California. The term "total income from all sources" means gross income plus the cost of goods sold that are paid or incurred in connection with the trade or business of the limited liability company.[14] The fee ranges from $900, if the total income is between $250,000 and $499,999; $2,500, if the total income is between $500,000 and $999,999; $6,000, if the total income is between $1,000,000 and 4,999,999; and $11,000, if the total income is $5,000,000 or more.

On the other hand, a business trust is not subject to the payment of this fee.

If a Disregarded Entity, Then No State Income Tax Return Filing.

As noted above, a limited liability company with just one Member will be classified for federal and state income tax purposes as a disregarded entity. With this classification, the limited liability company will avoid having to prepare and file a federal income tax return. This is not so at the state level. Despite being a disregarded entity for state income tax purposes, the limited liability company must still comply with the return filing requirements for a limited liability company.[15]

In contrast, if a business trust has only a single holder of its beneficial interests, it will then be classified as a disregarded entity and, as a result, not have to file either federal or California income tax returns.

Subchapter C and Subchapter S Corporations. Corporations, in contrast to LLCs and business trusts, are rarely used by the IRA owner intending to obtain greater control over the investment decisions when using IRA funds. First, with respect to Subchapter S corporations, it is very clear that an IRA is not eligible or qualified to be a shareholder of an S corporation.[16] If an IRA were to acquire the shares of an S corporation, the S corporation would immediately lose its status as an S corporation.[17] Thus, while an S corporation is a "pass-through" entity (i.e. the income of the S corporation is taxed at the shareholder level and not at the corporate level) and a pass-through entity is the preferred type of entity for use by an IRA owner seeking greater control over the investments of the IRA, an S corporation is not an option available with an IRA. Subchapter C corporations are rarely used by the IRA owner since a C corporation is not a pass-through entity with respect to its realized income. Thus a tax is imposed on the realized income at the corporate level even though the IRA does not pay tax on its realized income. Moreover, while the IRA does not pay tax on any dividends received from the C corporation, the C corporation has already paid tax on its income before making the dividend distribution to the IRA.

11. Rev & Tax Code sec. 23153(a),(d).
12. Rev & Tax Code sec. 17941.
13. See Rev & Tax Code sec. 23038; CA Administrative Code Title 18, secs. 23038(a), 23038(b)-1, 23038(b)-2.
14. See Rev & Tax Code sec. 17942(a), (b).
15. See Rev & Tax Code sec. 18633.5; Cal Admin. Code, Title 18 sec.23038(b)-2(c)(2).
16. Rev. Rul. 92-73.
17. PLR 200434002.

Summary. The above discussion provides an overview of the factors to consider when selecting an entity that an IRA account will invest in with the goal of achieving "check book" control.

FEDERAL TAX NEWS

By DeEtte L. Loeffler, J.D., LL.M. Taxation

With one party now dominating both the House and the Senate, 2015 may finally be the year for tax reform. Maybe. Hot topics from prior years that we can expect to hear more about include tax inversions, corporate tax reform, Obamacare (and its related tax credits), increased federal gas taxes (to fund the failing Highway Trust Fund), more international FATCA agreements, enforcement against tax evaders, and federal law allowing states to tax internet sales to their residents. So far this year we have seen a bipartisan effort to increase the federal gas tax to save the Federal Highway Trust Fund. The bill, introduced in the Senate, would have increased the federal gas tax by 12¢ a gallon. The federal gas tax is currently 18.4¢ per gallon and 24.4¢ per gallon on diesel. This proposal received a vote of "no support" from House Speaker John Boehner, but anticipate further efforts to address this critical issue between now and May when the Fund is expected to run out of money. Another interesting proposal is the Marketplace Fairness Act, which would allow states to collect taxes on internet sales. This proposal may be added to the Permanent Internet Tax Freedom Act (introduced January 9th) which bill bans all but 7 states from taxing on access to internet broadband.

Are College Savings Plans At Risk?

President Obama proposed (but quickly withdrew) a plan to expand and make permanent the $2,500 American Opportunity Tax Credit (which phases out for families filing joint tax returns at $160,000 income). He abandoned the plan because of protests over the way he planned to pay for this cost. He proposed making all withdrawals from 529 college plans taxable, not just those for "disqualified" purposes. Under current law, withdrawals are not taxable if used for tuition, housing and related expenses. Other popular education related benefits he proposed eliminating were tax incentives for contributions to Coverdell accounts; the Lifetime Learning Credit, and deductions for tuition and fees. The changes were only to apply to future contributions to such plans.

Although this proposal was withdrawn for now, we can anticipate seeing other attacks on 529 Plans over the next few years. Such plans currently hold significant wealth and are seen by some as an excellent source of future government funding.

STATE TAX NEWS

By DeEtte L. Loeffler, J.D., LL.M. Taxation

This may also be the year for California tax reform. The new state controller general, Betty Yee, says the improved economy makes overhauling California's entire tax system this year more likely. A piecemeal approach may be more likely, though, as legislators continue to address individual issues such as spending for education. In addition, 2016 will likely see a marked increase in the number of Propositions, because the low voter turnout in 2014 will make it easier to qualify a proposal for the ballot.

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