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NEWSLETTER



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EVENTS:

Presentations and Continuing Education:

Business Transition Planning Workshop. Wednesday, April 25, 2012, 8:00 a.m. Presented in part by Bradford N. Dewan. For more information call (619) 698-4330 or visit our website at www.mmpmh.com.

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BUSINESS TRUST: A GOOD OPTION WITH A SELF-DIRECTED IRA

Bradford N. Dewan

Self-directed IRAs provide the IRA owner with greater investment options than a standard IRA account. With a Self-Directed IRA the IRA owner initiates his or her own investigation and analysis of various investment opportunities, usually other than publicly traded stocks and mutual funds. Often 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 home or deeds of trust. Once a decision has been made to make an investment of the IRA funds in real estate, as an example, the next question is often whether to simply hold title to the real property in the IRA account or to create an entity into which the IRA funds will be invested. The entity will then make the investment with funds transferred into it from the IRA account and hold title to the real property investment until a decision is made to sell the real property and thereby realize the return on investment.

Business Trust. One example of such an entity is a "business trust." With a business trust the IRA account makes an investment in the business trust by acquiring the "beneficial interests" of the business trust. Often the IRA account will acquire 100% of the "beneficial interests" of the business trust. 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 is made in a business trust.¹

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).

Declaration of Trust. The initial step in forming and structuring a business trust is to prepare a "Declaration of Trust" (commonly referred to as the "trust agreement"). The Declaration of Trust sets forth the primary purposes and objectives of the business trust. The primary purpose of the business trust is, of

course, to make appropriate investments using the funds that were transferred to it from the IRA account. Consequently, all the activities and operations of the business trust 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. Typically the rights and powers of the beneficiary are very broad. For example, the beneficiary will have the right to make investment decisions and amendments to the Declaration of Trust. These broad powers are not exclusive; rather, the trustee is also given similar broad powers. Very importantly, the trustee is not 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. 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.

The owner of the IRA account will typically appoint himself or herself as the "trustee" of the business trust. Pursuant to the terms of the Declaration of Trust, the trustee 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.

Bank account. Once the Declaration of Trust has been finalized, the trustee will open a bank account in the name of the business trust. The trustee will typically be the "signator" on the

account. However, prior to contacting a bank regarding the account, the trustee will apply for an EIN or "tax identification number" from the IRS. This is generally a straight forward process that can be done on-line by filling out the Form SS-4. All banks require an EIN from entities opening accounts.³

One of the documents that the trustee 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 enforce, (iii) the IRA account is the "trustor" and "beneficiary" and is the party with the right to revoke or amend the Declaration of Trust, and (iv) that the trustee has the authority to open the bank account in the name of the trust.⁴ Importantly, the Certification of Trust is 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 was being opened or with the Articles of Organization if an account for a limited liability company was being opened. Thus the Certification of Trust provides the bank with the evidence and assurance that the entity, the business trust, does exist and the Trustee has the power and authority to open the bank account on behalf of the business trust.

The IRA owner, upon submitting his or her direction to the custodian to make the investment in the 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 business trust. Wiring the funds into the new bank account is the preferred method for transferring the funds.

Classification of Business Trust for Federal and State Income Tax Purposes. Since the business trust is an entity separate and apart from the IRA account (i.e. the IRA account is simply investing in, and holding, the "beneficial interests" of the business trust), the tax classification of the business trust becomes important to understand. 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 the "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."⁵ Since a "business trust" is not organized under such a state statute, then it will not be classified as a "corporation." With it not being 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.⁶ 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."⁷

It is probably worth briefly noting that a "business trust" is an "eligible entity"⁸ and thus has the ability to elect out of the default classification. The default classification is 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.⁹

If a business trust is classified as a "disregarded entity" because it has only one owner of the "beneficial interests," then the

business trust will not have to prepare and file either federal or state income tax returns.

No Minimum Franchise Tax. Every corporation doing business in California is subject to the minimum franchise tax of \$800.00 which is due annually.¹⁰ 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 \$800.00.¹¹

Other entities, such as partnerships and business trusts, are not required to pay a franchise tax. 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.¹²

No "Total Income" Fee. 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.¹³ But a business trust is not subject to the payment of this "fee." Thus another expense of operations is avoided.

No State Income Tax Return Filing if a Disregarded Entity. 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. However, this is not true at the state level. Despite being a "disregarded entity" for state income tax purposes, limited liability companies must still file returns.¹⁴

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 state income tax returns.

Summary. The above discussion provides a brief 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.

By choosing to use a business trust, instead of a limited liability company, certain costs and expenses can be avoided which results in increased income that will be allocated to the IRA account (which is not subject to tax). Avoidance of these expenses also increases the funds available for future investments by the business trust.

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

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."

³ Importantly, the IRA owner should not use his or her SSN in connection with the bank account. A separate EIN should always be obtained.

⁴ Essentially the CA Probate Code establishes the permitted terms of a Certification of Trust. CA Probate Code sec. 18100.5

⁵ Treas. Reg. sec. 301.7701-2(b)

⁶ Treas. Reg. sec. 301-7701-2(c)(1)

⁷ Treas. Reg. sec. 301-7701-2(c)(2)

⁸ An eligible entity is a business entity that is not classified as a corporation. Treas. Reg. 301.7701-3(a)

⁹ Treas. Reg. sec. 301.7701-3(b)

¹⁰ Rev & Tax Code sec.23153(a),(d)

¹¹ Rev & Tax Code sec. 17941

¹² See Rev & Tax Code sec. 23038; CA Administrative Code Title 18, sec. 23038(a), 23038(b)-1, 23038

¹³ See Rev & Tax Code sec. 17942(a), (b). 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.

¹⁴ See Rev & Tax Code sec. 18633.5; Cal Admin. Code, Title 18 sec.23038(b)-2(c)(2)

legislature has rejected over \$1.4 billion in spending cuts proposed by the Governor's office. Tax increases seem inevitable. Currently, three competing tax increase proposals are moving toward the November ballot; Governor Brown's proposal to increase the Sales Tax by 0.5% for four years and to increase income taxes by 2.0% for singles/couples earning more than \$250,000/500,000 for five years (expected to raise \$4.8-6.9 billion); a "Millionaires Tax" that would increase income taxes in two steps for those earning over \$1 Million (expected to raise \$4-9 billion), and the "Munger" proposal that would add 10 new income tax rates (expected to raise \$5-11 billion). Only the Governor's proposal requires the funds go to the General Fund (which can be used to pay existing commitments, including to schools). The other two proposals would constitute new spending and could not be used to cover the existing shortfall.

A new plan incorporating items from the Governor's plan and the Millionaires Tax was reached by compromise between the Governor and the California Federation of Teachers in mid-March. The plan calls for a smaller Sales Tax increase of 0.25% for four years, and higher income tax rates for those earning over \$250,000, ranging from 1-3%, with the highest tax rate of 12.3% for singles earning over \$500,000 for the next seven years. The modified proposal must still qualify for the ballot, so the Governor will continue to advance his existing plan as well.

If you would like to receive further information regarding the topics in this or past newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

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LEGISLATIVE UPDATE: California Tax Hike Proposals Move Forward

California's budget shortfall continues to dominate the news out of Sacramento. Revenues for February are expected to be 2.3% short of projections, threatening to increase the \$9.2 billion budget shortfall. This year, the

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