HOW TO CHOOSE THE RIGHT BUSINESS ENTITY

&

TRUST OWNERSHIP STRUCTURE

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COURSE SUMMARY

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This course will cover the various types of business entities available to conduct business and analyze for the participants the *pros* and *cons* of each: Sole Proprietorship; "C" Corporation; "S" Corporation; Limited Liability Company ("LLC"); General Partnerships; Limited Partnerships and Limited Liability Partnerships ("LLP"). In addition, there will be a detailed discussion on the benefits of holding the family business in a Trust.

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Mr. Mur is a Patron of the Arts; Member of the Board of Directors of Art Synergy, Inc.; Co-Author of *Now Your Cooking with Latin Flavors*; was the recipient of the American Juris Prudence Award on International Tax and the recipient of the MDC Outstanding Alumni Award. Mr. Mur graduated from Florida International University in 1981, and received his J.D. in 1985 and LL.M. in Taxation in 1987 from the University of Miami. Mr. Mur was admitted to the Florida Bar in 1985. In addition to being a well-recognized published Author who has frequently lectured at National and International Conferences on Global Asset Protection Strategies and International Tax Planning, Mr. Mur is Special Counsel to foreign law firms and accounting firms on sophisticated International Tax Planning matters and consults for numerous foreign governmental trade agencies on International Trade issues.

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INTRODUCTION - How to Choose the Right Business Entity

With Corporate Income Tax Rates at 21% after Trump's Tax Cuts, why isn't everyone doing business as a "C" Corp.?

Choosing the right business entity allows an entrepreneur to reduce liability exposure, minimize taxes, and ensure that the business can be financed and run efficiently. It also provides business owners with a mechanism for ensuring that the business operations will continue, rather than being automatically terminated, upon the death of an owner. Formalizing the business also clarifies the ownership of all participants in the venture.

When choosing a business entity, you should consider:

(1) the degree to which your personal assets are at risk from liabilities arising from your business;

(2) how to best pursue tax advantages and avoid multiple layers of taxation;

(3) the ability to attract potential investors;

(4) the ability to offer ownership interests to key employees; and

(5) the costs of operating and maintaining the business entity.

You should not approach this subject with the idea that there is only one entity type that's right for your business. The choice you make will inevitably involve weighing the advantages and the disadvantages of several factors that apply to your particular business. You should also keep in mind that there will inevitably be various changes in the nature of your business over time, and these changes may make it more advantageous either to change your entity type or its tax classification. With that in mind, let's take a look at the main entity types that are available.

The availability of a particular entity type initially depends on the number of owners. A single owner may operate as a sole proprietor, a corporation, or a limited liability company. If there are two or more owners of the business, by definition it cannot be a sole proprietorship, but it can be a corporation, limited liability company, general partnership, limited partnership, or, in certain situations, a limited liability partnership.

We'll first review the entity choices available for a single business owner.

I. What is a Sole Proprietorship?

A sole proprietorship is a business owned by one person. It has no legal distinction from the owner, and usually requires no governmental filing other than a fictitious business name statement ("DBA") if the owner is doing business in any name other than a personal name. A sole proprietorship is probably the most common form of business because it is simple to start and avoids the operating expenses required for other legal entities such as corporations and limited liability companies.

No Personal Liability Protection

Because there is no legal distinction between the owner and the business, a sole proprietor is personally liable for all the debts and obligations of the business. It also means that on the death of the owner, the business enterprise terminates, leaving only the assets of the business such as equipment, accounts receivable, and real property. Because the assets used in the business are not separated from the other assets of the business owner, it may be difficult to sell the business as a whole after the death of the sole proprietor.

No Double Taxation Concern

For tax purposes, there is no distinction between the sole proprietor and the business. All income and expenses of the business are reported on the sole proprietor's personal tax return. This means that the net income from the business is taxed only once.

II. Corporation Types: C Corporation, S Corporation, Nonprofit and More

A corporation is a separate entity from its owners for both legal and tax purposes. Corporations are formed by filing Articles of Incorporation with the Secretary of State. A corporation is comprised of three groups of people: shareholders, directors, and officers. The shareholders elect the board of directors who are responsible for setting major goals of the corporation and making major decisions. The board of directors appoints the officers, who run the business on a day-to-day basis.

Separate Entity Means Personal Liability Protection

Since a corporation is a separate legal entity, the corporation generally is responsible for the debts and obligations of the business. In most cases, shareholders are insulated from claims against the corporation.

Advantages of a Corporation

In addition to the limited liability protection enjoyed by shareholders, a corporation offers many other advantages over other types of entities:

Ownership interests in the business are freely transferable: the ready transferability of shares in the corporation facilitates estate planning;

Shares of the company may be sold to investors in order to raise capital; (Private Placements are regulated by the Securities and Exchange Commission ("S.E.C") and require a Private Placement Memorandum).

Corporations, to a much greater extent than sole proprietorships and partnerships, may take advantage of pension plans, medical payment plans, group life and accident plans, and other fringe benefits available under the Internal Revenue Code.

A corporation exists forever, so long as corporate regulations are met. There is no need to cease operations if a shareholder, director, or officer dies.

How a Corporation is Taxed: C and S Corporations

A "for-profit" corporation may be taxed in one of two ways: under Subchapter C of the Internal Revenue Code (a "C" Corporation) or under Subchapter S of the Internal Revenue Code (an "S" Corporation). A corporation taxed at the entity level is known as a C corporation. Income that has been taxed at the entity level will again be taxed if, and when, is distributed as dividends to shareholders. This double taxation is, perhaps, the single greatest disadvantage to operating a business as a corporation. However, S Corporations may avoid much of this double taxation. (Under the newly enacted Tax Cuts and Jobs Creation Act, corporations are taxed at a 21% rate; however, a C corporation may continue to expose the shareholders to double taxation once dividend are paid out; or Personal Holding Company Tax if excess earnings are accumulated.)

Requirements for S Corporation Election

To elect to be treated as an S Corporation, certain requirements must be met and an election form must be filed with the IRS. The main requirements are:

- There may be no more than 100 shareholders;
- Only one class of stock is permitted;
- Shareholders must be individuals, estates, or certain types of trusts, and <u>must not be nonresident aliens</u>.

If a corporation elects to be taxed as an S Corporation and meets the requirements, it will be taxed at the federal level very similarly to partnerships and limited liability companies. That is, the income, losses, and gains will be passed through directly to the shareholders and there will be no tax "at the entity level." And in some cases, may be eligible for the new 20% business deductions under the new Act. This requires consulting with your Certified Public Accountant.

III. What is an LLC or Limited Liability Company?

A limited liability company, or LLC, may be formed by one or more owners, called members. It provides members with limited liability protection for their personal assets in most cases, just as a corporation does for its shareholders. It also offers the members with "pass-through" taxation like a sole proprietorship or partnership, avoiding the potential of double taxation in a C Corporation.

How to Form an LLC

Like a corporation, an LLC is formed at the state level by filing Articles of Organization with the Secretary of State. For a single member LLC, this is essentially all that is required to begin operating a business as an LLC. If the LLC has two or more members, they will need to enter into an operating agreement, similar to a partnership agreement, which should be in writing. This often requires the expertise of an attorney to be properly prepared, and adds to the cost of forming an LLC. Also, beware that a single member LLC may be pierced and that may be a problem if you are seeking to limit liability.

Owners and Management in an LLC

An LLC may have an unlimited number of owners and there are no restrictions on the type of persons who may be owners. One of the main advantages of an LLC over a corporation is the greater flexibility in the management of the business. An LLC may be managed in the following ways:

- solely by its members;
- by one or more managers;
- by its members and officers.

Though an LLC and an S Corporation are both "pass-through" tax entities, an LLC is not subject to the requirements that must be met in order to be an S corporation. There are no restrictions on the type of persons who may be members in an LLC. The LLC may have an unlimited number of members, and the LLC may have more than one class of equity interest. Further, an LLC, unlike an S Corporation, may provide for allocations of profits, losses, and distributions disproportionate to the percentage of equity interest held in the LLC.

Disadvantages of an LLC

Compared to a corporation, an LLC is a less favorable entity choice as far as raising capital from outside investors or offering ownership interests to employees. The corporation structure has been in existence far longer than the LLC and is better understood with respect to its structure and how ownership interests are represented in stock certificates. These characteristics have less certainty and may be more difficult to comprehend in an LLC because of the potential complexity of an LLC operating agreement.

IV. What Are the Types of Partnerships?

When your business has two or more owners, in addition to an LLC, there are two types of partnership entities available: a general partnership or a limited partnership. (A limited liability partnership may also be available, but is generally restricted to certain types of professions or occupations and not a general purpose business.)

A. What is a General Partnership?

A partnership is an association of two or more persons carrying on a business venture as co-owners for profit. Next to a sole proprietorship, a general partnership is the easiest entity to form under most state laws. Although a formal written partnership agreement is not required to form a general partnership, the partners should ordinarily set forth the rights and duties in a written document. In the absence of a written agreement, however, when two or more people who engage in a business together and do not specifically choose any other entity type, they will be treated as a general partnership if there is an understanding between them that they will share in profits and losses of the business.

No Personal Liability Protection

Each partner in a partnership has personal liability for the obligations of the partnership. General partnerships are limited in their ability to raise capital from outside investors because of the prospect of potential personal liability and the usually limited market for resale of a general partnership interest.

General Partnerships Enjoy Pass-Through Taxation

One of the advantages of a general partnership is that, like a sole proprietorship, the business is not taxed. Rather, income, losses, and gains are passed through to the general partners in accordance with the allocations provided in the partnership agreement. A particular advantage to this form of business is that the partners can agree among themselves as to how income, losses, and gains are divided among the partners.

B. What is a Limited Partnership?

A limited partnership is a partnership in which the duties and obligations of the partners are divided between one or more "general partners," and one or more "limited partners." The formation and operation of limited partnerships are generally regulated under state statutes defining the obligations and duties of partners and imposing other obligations.

Limited Partners Have the Advantage of Limited Liability

A general partner is responsible for managing the partnership and its operations. Like the partners in a general partnership, general partners in a limited partnership are personally liable for all of the partnership's debts and obligations. A limited partner is usually not personally liable for the partnership's debts and obligations, but is prohibited from taking part in the partnership's management and day to day operations. The risk of a limited partner is usually limited to the money or other assets invested in the partnership. As a result, it is far easier to market limited liability partnership interests as an investment, particularly with respect to projects such as a real estate development.

In contrast to a general partnership, a limited partnership requires a written partnership agreement. In addition, a certificate of limited partnership must be filed in the state in which the partnership is formed. Thus, a limited partnership is normally more expensive to form a general partnership.

Partners of a limited partnership are generally taxed in the same way as partners of a general partnership. They are also given the same flexibility to allocate profits, losses, and gains regardless of the percentage of equity interest in the partnership.

C. What is a Limited Liability Partnership?

A limited liability partnership is an entity that is usually reserved for certain licensed professionals. Each state determines which professionals may form a limited liability partnership, but they typically include attorneys, accountants, architects, and certain medical professionals.

Licensed Professionals Have Some Limited Liability Protection

Limited liability partnerships are partnerships in which the liability of all the partners is limited. Generally, the partners in limited liability partnerships are not responsible for the debts, obligations, or liabilities of the partnership resulting from negligence, malpractice or wrongful acts, or misconduct by another partner, employee, or agent of the partnership. However, a partner of a limited liability partnership is liable for other partnership debts and obligations as well as for his or her own negligence, malpractice or wrongful acts, or misconduct, and that of any person under their direct supervision and control.

How a LLP is Formed?

Limited liability partnerships are formed by either filing a registration certificate with the Secretary of State, or filing a certificate to convert an existing general partnership to a limited liability partnership. Limited liability partnerships are governed like general partnerships and have a similar degree of management flexibility.

CONCLUSION: Final Thoughts on Choosing the Proper Business Type

The initial choice of an entity will usually come down to answering three basic questions:

1. Who will be the business owners?

2. How does the business expect to distribute profits to its owners?

3. Is the business expected to generate profit or losses in the early stages?

Ownership of the Business

If the business is owned by one individual who does not expect to add ownership interests, then the management structure and flexibility is not of particular concern and any of the above business entities other than partnerships may be appropriate. The owner's decision will depend more on tax considerations and personal liability protection.

Distribution of Profits or Keeping Cash in the Business

If the objective of the owners is to distribute the profits of the business each year, they will want an entity type that allows for "pass-through" taxation. On the other hand, if the owners intend to expand the business, use profits to purchase equipment, additional raw materials, or accumulate cash for future business purposes, a C Corporation may be the best choice. Specially, now that C corporations are taxed at a 21% rate.

If it's anticipated that the business will have operating losses in its first year or two, the owners may prefer an entity that allows "pass-through" taxation so that losses may be used to offset income from other sources.

V. The Section 678 Trust and the Family Business

Typically, when a client is considering options to help protect assets from the reach of creditors and reduce future potential estate taxes, the client must consider techniques that require the client to part with at least a portion of the assets he or she has accumulated over the years, as well as part with future appreciation. For example, many estate planning techniques involve gifting and/or selling the client's assets to trusts that benefit the client's children or family members. As a result, the client permanently parts with all of the future appreciation, as well as the income stream from the assets.

In these situations, it can be difficult to balance the client's desire to protect assets from the reach of creditors and reduce estate taxes with the client's need to retain sufficient assets to maintain his standard of living.

One vehicle that allows the client to combine asset protection, estate tax savings, and the continued ability to benefit from assets he or she has accumulated over the years is the "Section 678 Trust."

THE SECTION 678 TRUST

The Section 678 Trust is named after the Internal Revenue Code Section upon which it is based, which states that a beneficiary who has a withdrawal right under a Crummey Power will be treated as the owner, for income tax purposes, of the portion of the trust over which the withdrawal power lapsed.

The Section 678 Trust can be structured and customized to fit many different situations. For example, a 678 Trust can be a useful tool under two particular fact patterns:

1. The first is when the client is contemplating purchasing an asset, starting a new business venture, or revitalizing and expanding an existing business that has high appreciation or income-generating potential.

2. The second is when the client has significant assets that are already material in value, which the client wants to transfer to the Section 678 Trust.

Structuring the transfer of the assets to the Section 678 Trust in both fact patterns are discussed in more detail below.

A. STRUCTURE OF A 678 TRUST

The Section 678 Trust is established by the client's parents, sibling, or close friend with a gift of $5,000.

This is the only gift that should ever be made to the Trust. It is important that the $5,000 contribution to the Trust be a true gift and that the creator of the Trust receive no quid pro quo payments or benefits as a result of making the gift.

The Trust is structured as a "Crummey" Trust, so the beneficiary has a period of time to withdraw the $5,000 gift. If the beneficiary does not demand the gift, his withdrawal right lapses after a certain period of time (*e.g.*, thirty days).

In order for the Section 678 Trust technique to work as intended, it is crucial that the beneficiary not be given a withdrawal right exercisable with regard to any other trust at any earlier point in the year of the gift. *NOTE: This may require careful review in the event the client's parents or relatives are also establishing a Section 678 Trust and/or may have an existing Irrevocable Life Insurance Trust which have such standard withdrawal rights. See footnote 1 below on "Crummey" Powers and footnote 2 for Sample Notice of Right of Withdrawal.*

The client is the primary beneficiary of the Section 678 Trust and can receive distributions for health, education, maintenance, and support purposes. The client can also be named as the trustee, and is in fact named as Trustee of the Section 678 Trust. The Grantor of said Trust, if yet to be determined, but could very well be relatives or some other person.

The Trust is structured initially as a "non-grantor" or "complex" trust for income tax purposes. Therefore, at inception, the Section 678 Trust is a separate taxpayer for income tax purposes. However, said Trust also includes a "Crummey" withdrawal right for the client.

When the client allows the withdrawal right over the initial $5,000 contribution to lapse, the Section 678 Trust becomes a grantor trust as to the client (under the authority of Section 678 of the Code). Thus, all income tax effects of the Section 678 Trust from that point forward should become the responsibility of the client.

While the client is treated as the owner of the Trust for income tax purposes, the client will be responsible for paying the income tax on the income generated by the Trust's assets. Assets outside of the Trust can be used to pay the income taxes, allowing the Trust assets to grow without being depleted by income taxes. This also allows the client to "spend down" assets that would otherwise be includable in his estate and subject to estate taxes at death or perhaps be subject to the reach of creditors during his lifetime.

If the time came that the client were unable to pay the income taxes out of his own assets, the Section 678 Trust could make a distribution to the client in the amount of the income taxes under the health, education, maintenance, and support standard.

B. BENEFITS OF THE SECTION 678 TRUST

As discussed above, the assets owned by The Section 678 Trust will not be subject to estate taxes at the client's death.

While the client is living, he will continue to have access to the funds for health, education, maintenance, and support purposes and can serve as trustee of the Section 678 Trust.

In addition, the assets owned by the Section 678 Trust will not be subject to the claims of the client's creditors.

NOTE: Specifically, Florida Statute Section 736.0504, states that a beneficiary's creditors cannot compel a trustee to make a discretionary distribution of income or principal to a trust beneficiary, even if the trustee is also the beneficiary, when the distribution would become vulnerable to the claims of the beneficiary's creditors.

Thus, the client's creditors will not be able to reach the Trust's assets if he or she is also named as the trustee, so long as the trustee-beneficiary's distribution standard is limited to health, education, maintenance, and support.

As noted above, the Section 678 Trust technique helps reduce estate taxes, provides creditor protection, and gives the client the ability to continue to benefit from the assets during his or her life. When compared to other estate planning techniques, such as GRATs, the Section 678 Trust is superior because, among other things:

(i) the client does not have to survive the transaction with the Section 678 Trust by any period of time in order for the assets to be outside of the client's estate; and

(ii) the estate tax inclusion period rules do not apply, so that GST exemption can be allocated to the Trust on its creation.

C. BUILDING VALUE IN THE SECTION 678 TRUST

The Section 678 Trust can be utilized by almost any type of client. The most obvious use of a Section 678 Trust is for clients who are expecting to purchase an asset that has high appreciation potential, are starting a business, or are expanding an existing business (but as discussed below, it can also be used for existing assets with appreciation potential or that may be subject to valuation discounts). Some examples include buying a new business opportunity, or investing in the stock market, etc.

In those cases, the client can make a loan to the Section 678 Trust to enable it to buy the asset, start the new business, or expand the existing business. In order for the loan to be respected by the IRS, it must carry an interest rate equal to, at a minimum, the applicable federal rate for the type and length of the loan.

As the asset or business grows in value, the loan can be repaid. The asset will continue to be owned by the Section 678 Trust, where it will not be subject to estate tax at the client's death and will continue to be beyond the reach of creditors. Once the Section 678 Trust has built up significant assets, it can simply purchase new assets using its own credit.

NOTE: A closely-held business owner who might be presented with an opportunity to sell the business at some point in the future would be an ideal candidate to sell his or her ownership interest to the Section 678 Trust prior to such a liquidity event (the earlier, the better). In these cases, it would be desirable for the client to sell the asset to the Section 678 Trust in exchange for a promissory note and/or Private Annuity.

For the reasons discussed below, it is important that the sale be structured so that it will be respected by the IRS as a bona fide sale under Section 2036 of the Code. The Section 678 Trust needs to have sufficient substance to support the sale, which can be problematic if the Trust is new and has not yet built up significant value. To remedy this situation, the Section 678 Trust can have other trusts or individuals (other than the client) guarantee the note owing to the client. The assets pledged should equal at least 10% to 20% of the size of the note (the higher, the better).

NOTE: If no other trusts or individuals are available to guarantee the note, the client can create a separate trust for his or her children and make a gift to it. With a $11 million (plus) lifetime exemption, the client can make a gift of up to $11 million (or $22 million if the client is married) and pay no gift tax. The new trust can then provide a guarantee to the Section 678 Trust in exchange for a guarantee fee. To supercharge the new trust, it can be structured as a grantor trust with respect to the client for income tax purposes and as a GST exempt dynasty trust.

It is important when the client transacts with the Section 678 Trust that the transaction be structured at fair market value, and that no gifts be made to the Section 678 Trust beyond the initial $5,000 gift contributed by a third party Grantor, as noted above.

Any additional gifts could alter the income tax and estate tax characteristics of the Section 678 Trust. Furthermore, if the client is treated as having made a gift to the Section 678 Trust, then the Trust's assets will be subject to estate taxes when the client dies. In order to guard against the client being treated as having made a gift to the Section 678 Trust when he loans money to the Trust, the interest rate on the loan should be at least equal to the applicable federal rate in effect at the time the loan is made.

When assets are sold to the Trust, the sales price must be equal to the fair market value of the asset.

NOTE: Sale documents can also include adjustment clauses, where the Section 678 Trust and the client agree that, if the fair market value of the asset sold to the Trust is ever determined to be different than that agreed upon by the Trust and the client, the sales price will be adjusted to reflect the differently determined fair market value. This adjustment clause could help avoid the argument that the client made a gift to the Section 678 Trust if the sales price were determined to be lower than the asset's fair market value.

In addition, it is advisable to have the asset sold to the Section 678 Trust professionally appraised (*i.e.*, a certificate of valuation from the client's CPA). The appraiser should be advised that the value sought should be on the mid-range of the scale of reasonableness. If the appraisal is too aggressive, and results in a value lower than that reasonably determined by the IRS, it is possible that the client will be treated as having made a gift to the Trust equal to the difference between the appraised value and the IRS-determined value. As a result, the appraisal should not be overly aggressive.

NOTE: The Section 678 Trust can also allow the client to exercise a special power of appointment ("SPOA") over the Trust assets. By possessing an SPOA with respect to the Trust assets, any inadvertent gift that the client may have made to the Trust will be treated as an incomplete gift. Treasury Regulation § 25.2511-2(b) provides that, if a donor transfers property (to a trust or otherwise) but retains the power to control how the property will be disposed of, then the gift by the donor will be incomplete. The SPOA gives the client-beneficiary the power to control how the property will be disposed of at his or her death. As a result, if the client is treated as having made a gift to the Section 678 Trust, the gift will be incomplete from a gift tax perspective and no gift tax will be due at that time. Although the gift will be incomplete for gift tax purposes, the gift will still cause all of the Trust assets to be included in the client's estate at death because the client will have made a gift to a trust of which he or she is a beneficiary. As a result, the tax will not be avoided by virtue of the gift being treated as incomplete; it will merely be postponed until the client's death. The SPOA also gives the client the flexibility to modify the terms of the Trust on his or her death to account for changed circumstances. The SPOA can be so broad as to allow the client to exercise it in favor of anyone (including other individuals, trusts, and charitable organizations) other than the client, the client's estate, the client's creditors, or the creditors of the client's estate.

D. RESULTS OF 678 TRUST PLANNING

The Section 678 Trust should be structured as a GST exempt dynasty trust. When the initial gift is made to the Section 678 Trust, the client's parents (or other third party who makes the gift) should allocate GST exemption to the Trust, which will allow it to pass to future generations free of transfer taxes. As a result, the assets owned by the Trust should not be subject to estate tax at the death of the client or the client's children.

In addition, the Section 678 Trust should contain a spendthrift provision, in which case the Trust assets should be protected from the client's creditors.

Furthermore, assets in the Section 678 Trust do not constitute marital property, protecting the assets if a beneficiary of the Trust gets a divorce.

With regard to assets sold to the Section 678 Trust, the value of the assets owned by the client is frozen at the value of the note the client received in the sale and if the sale was in exchange for a Private Annuity, then unlike a promissory note, the Private Annuity would automatically terminate at the time of death resulting in nothing being included in the client's estate.

The client can spend down the other assets by paying the income tax liability generated by the Trust's assets and allow the assets owned by the Section 678 Trust to grow without being depleted by income taxes, as noted above.

The Trustee of the Section 678 Trust has the ability to distribute Trust assets to the client and his issue for health, education, maintenance, and support needs, and the client may be given a limited inter vivos or testamentary power of appointment over the assets of the Section 678 Trust to account for changes in family circumstances or the law.

Upon the client's death, the Section 678 Trust can be drafted to divide into separate trusts for his or her children, and those trusts will be considered "complex" trusts (rather than "grantor" trusts) for income tax purposes.

E. REPORTING REQUIREMENTS

The creator of the Section 678 Trust should file a gift tax return reporting the $5,000 gift to the Trust and allocating GST exemption to the gift. The gift tax return will be due on April 15 of the year following the year in which the $5,000 gift is made. When the client transacts with the Section 678 Trust, he or she should file a gift tax return disclosing the sale or loan in order to start the running of the 3-year statute of limitations. Assuming that the disclosure is adequate, if the IRS does not audit the gift tax return within the 3-year period, it will be prohibited from challenging the transaction later. The gift tax return will be due on April 15 of the year following the year in which the transaction takes place.

F. DISCUSSION OF STATUTORY AUTHORITY

NOTE: THE FOLLOWING IS INTENDED FOR INFORMATIONAL PURPOSES ONLY, SUBJECT TO FURTHER REVIEW AND DISCUSSION WITH THE CLIENT'S CERTIFIED PUBLIC ACCOUNTANT, AND DOES NOT CONSTITUTE A LEGAL OPINION WITH RESPECT THERETO.

Although the beneficiary may be deemed to be the grantor of the trust for income tax purposes, he or she is not considered the grantor for estate and gift tax purposes. Under Section 2041 and Section 2514 of the Code, a lapse of a withdrawal right is not deemed to be a gift to the Trust from the beneficiary so long as the lapse does not exceed the greater of $5,000 or 5% of the Trust assets (the “5 and 5 power”). As a result, allowing the withdrawal right to lapse will not cause the assets of the Section 678 Trust to be subject to estate taxes at the client’s death. (Note that an affirmative release of a withdrawal right may have the opposite effect. If a holder of a withdrawal right releases the right, he or she could be treated as having made a gift to the Trust, causing the Trust assets to be subject to estate taxes at the holder’s death. Therefore, in order to clearly qualify for the statutory “5 and 5” exception, the plan is for the beneficiary to allow the withdrawal right to lapse, rather than release it.)

Under Section 678(a)(1), a person who “has a power exercisable solely by himself to vest the corpus or the income” of the Trust in himself will be treated as the owner of the portion of the Trust over which the power is held. A withdrawal right gives the beneficiary the right to vest the corpus or the income of the Trust in himself and, as a result, is a power that will cause the Trust to be owned by the beneficiary for income tax purposes under Section 678(a)(1) so long as the power remains outstanding. If the withdrawal right applies to all of the assets owned by the Section 678 Trust (as in the case of the initial $5,000 gift), then the entire Trust will be treated as owned by the beneficiary for income tax purposes. Once the withdrawal right lapses, however, the income tax treatment of the Trust is not as clear.

Under Section 678(a)(2), a person who “has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof” will be treated as the owner of the portion of the Trust over which the power was partially released or modified. The question, therefore, is whether the client would be treated as the owner of the Trust under Sections 671 to 677 of the Code if he or she had been the initial grantor of the Trust.

Under Section 677, the grantor of a trust will be treated as the owner of the trust for income tax purposes if the income of the trust may be distributed to the grantor or held and accumulated for future distribution to the grantor. the client is the beneficiary of the Section 678 Trust, and as such, income and principal may be distributed to him. Accordingly, if the client releases or otherwise modifies his withdrawal right, then he will be treated as the owner of the Trust for income tax purposes. Based on the plain language of the statute, it appears that this would apply to the entire Trust (both the income and the principal) since the withdrawal right exists over the $5,000 gift, which would comprise the entire Trust at the time the right was granted.

Note that Section 678(a)(2) refers to a “partial release” (as opposed to a “lapse”) of a withdrawal right as the triggering event. Although this terminology does not mirror that contained in Sections 2041 and 2514, the IRS has issued a recent private letter ruling interpreting a lapse under Sections 2041 and 2514 to be a partial release under Section 678. PLR 200949012. In addition, the IRS has implied in prior private letter rulings that a lapse under Sections 2041 and 2514 would have the same effect of a partial release under Section 678. See, e.g., PLRs 200747002, 200104005, 200147044, 200022035, 9809005, 8342088.

If the IRS changes its policy expressed in the private letter rulings and argues that a lapse is not treated as a release under Section 678, it is possible that the client will not be treated as the owner of the Trust for income tax purposes after the withdrawal right lapses. To help mitigate that result, we propose including additional provisions in the Section 678 Trust.

First, the withdrawal right granted over the initial $5,000 gift to the Trust could extend until at least December 31 of the year in which the gift is made (i.e., the withdrawal right does not lapse until after December 31). Any sales to the Section 678 Trust should occur before the withdrawal right lapses. During the time that the withdrawal right remains outstanding, the client should clearly be treated as the owner of the Trust for income tax purposes and should be able to transact tax-free with the Trust.

Second, in December of each year, the client could be given a withdrawal right over all of the Trust income earned during that year, to the extent that the income does not exceed the greater of $5,000 or 5% of the Trust assets. (Note that, if the client dies while the withdrawal right is outstanding, the amount of assets over which the withdrawal right exists will be included in the client's taxable estate.) To the extent that the income is less than or equal to this amount, the client should be treated as the owner of the Trust income for income tax purposes. It is not clear whether this withdrawal right would cause the client to be treated as the owner of the Trust's principal for income tax purposes.

If the client is not treated as the owner of the Trust's principal, then the Trust may be required to pay any capital gains taxes out of its own assets. As a result, the tax amount would deplete the assets that will be protected from estate taxes, as opposed to the client's assets, which will be subject to estate taxes. In addition, if the client is not treated as the owner of the Trust's principal, capital gains taxes could be triggered when the Trust makes principal payments on the note owing to the client.

The client and the Trust should also consider entering into an agreement that, if the client pays income taxes and it is later determined that the taxes should have been paid by the Trust, the client will be treated as having loaned the amount paid to the Trust with interest at the applicable federal rate. This should help prevent the client being treated as having made a gift to the Trust by virtue of paying income taxes on the Trust's behalf.

Nevertheless, the client should, at a minimum, be able to sell assets to the Section 678 Trust while the withdrawal right is outstanding without being required to recognize gain on the sale.

In addition, if the client sells assets to the Section 678 Trust in exchange for a promissory note or loans money to the Section 678 Trust, the client should not be required to recognize the interest payments as income. This characteristic may also cause the Section 678 Trust to be a permissible owner of S corporation stock, without requiring the Trust to elect to become a qualified subchapter S trust ("QSST") or an electing small business trust ("ESBT"). The IRS has issued a recent private letter ruling stating that a 678 Trust is a permitted S corporation shareholder under Code Section 1361(c)(2)(A)(i). PLR 201739010. However, it may be advisable to make a protective QSST or ESBT election in the event that the IRS argues that 678(a)(2) does not apply to the Trust assets.

So as you can see, a Section 678 Trust is an excellent tool for holding ownership of the family business.

Sources: CCH, Business Entity Library, et. al.: Forbes, LLCs, S Corps., and PCs: Choosing A Business Entity, August 19, 2015.