

BUSINESS PROTECTION TRUSTS

Introduction

We find that many of our estate planning clients also have business planning needs. Among the issues to consider when incorporating business planning into your overall plan are:

- Protection from creditors;
- Saving estate taxes; and
- Planning for control over the business when clients retire.

Although operating your business within the framework of a corporation or a limited liability company does offer certain protections from creditors, it does not necessarily help reduce estate taxes or set in place a particular plan of succession of control.

Implementing a Business Protection Trust can help you accomplish these goals.

Example

Jane Client and her husband, John, have decided to start a software development business and intend to run the business as a limited liability company.

1. The personal assets of the owners (“members”) of a limited liability company are usually protected from the liabilities of the company.
2. When a husband and wife form a limited liability company in California, however, they may not be able to protect the company’s assets from their personal liabilities.
3. Their member interests in the new company will be subject to estate taxes.
4. Whoever inherits or otherwise receives their member interests in the new company will be able to control the company.

The Clients’ Goals

Jane and John want to avoid having the business assets subject to their personal liabilities and vice versa. They also want to be able to dictate who will control the company after they retire. Additionally, they expect the company to appreciate in value over the

years, and, if possible, they would like to avoid having this appreciation in value included in their estates, for estate tax purposes.

What Can Jane and John Do?

Jane and John might be able to accomplish their goals by having a Business Protection Trust form the company.

A Business Protection Trust (“BPT”) is similar to a Generation Skipping Trust often used in estate planning, but is designed for business owners (e.g., entrepreneurs, developers, etc.) in order to protect new (and established) businesses from creditors and estate taxes for multiple generations.

Steps to setting up the BPT:

1. Persuade Jane’s (or John’s) parents to fund a BPT with \$10,000, for the benefit of both Jane and John and their family, which gift will use up some of Jane’s (or John’s) parents’ lifetime exemptions from gift, estate and generation skipping tax.
2. Have Jane and John appointed as co-trustees of the BPT.
3. Arrange for the trust terms to include the following:
 - a. That the co-trustees have the discretion to accumulate or pay out the income earned by the BPT’s assets to Jane and John and/or their family members (this will allow the BPT to use income for repayment of loans, additional contributions of capital to the company, etc.);
 - b. Give the co-trustees the power to borrow on behalf of the BPT as well as all other possible fiduciary uses of the assets (this will allow the BPT to borrow money for further investment in the company);
 - c. Give Jane and John the power to name successor trustees (this will allow them to decide who will control the company, no matter who inherits the beneficial interest in the company);

For example, assume Jane and John have two children, Sam and Susie. Jane and John want both children to equally benefit from any profits earned by the company, but, because of the children’s circumstances, Jane and John believe Sam would be in a better position to make decisions regarding running the business. Thus, they could appoint Sam to succeed them as trustee of the BPT. In

contrast, if Sam and Susie received their member interests outright, Susie would have as much right to control the business as Sam.

- d. Give Jane and John each a power to determine future beneficiaries of one-half of the BPT assets (“Power of Appointment”) (in case Jane and John divorce, this will give them each, basically, control over one-half of the assets in the BPT); and
 - e. Make the Powers of Appointment limited, meaning they cannot appoint the assets outright to themselves or their creditors:
 - (1) This provides an added creditor protection feature.
 - (2) It will also protect the assets from estate taxes at their deaths (and at the deaths of future generations if the trusts for the children and other issue have similar terms).
 - f. Make the Power of Appointment exercisable during their lifetimes (if they exercise their powers during their lifetimes, they should not have to report the existence of the BPT on their estate tax returns).
- 4. As co-trustees of the BPT, the John and Jane will use the \$10,000 original gift to capitalize the company, which company will be fully owned by the BPT.
 - 5. Jane and John could then personally lend the BPT any additional funds required for the operation of the business or required to prevent the company from being undercapitalized (an alter-ego, creditor protection issue).
 - a. The loan should be carefully documented and honored so that it is clear that Jane and John have not personally contributed assets to the BPT.
 - b. As an alternative to Jane and John making a personal loan to the BPT, the BPT could borrow from a third party. If required, Jane and John could personally guarantee the third-party loan, but should arrange for the BPT to pay them an appropriate guaranty fee.
 - 6. When the company earns profits, such profits can be distributed to the BPT (as the owner), and the BPT can use these distributions to pay taxes, make payments on outstanding loans, and/or make distributions to the various beneficiaries (Jane and John and/or their family members).

Results

1. The company and its profits will not be included in Jane and John's estates (or their children's or possibly even grandchildren's estates) for estate tax purposes.

Jane and John have no powers or rights which make any of the BPT's assets includible in their estates.

2. Jane and John, as Primary Beneficiaries, can have all benefits from the BPT.

No one else has any current rights in the trust.

3. Jane and John can determine what happens to the BPT's assets, including making transfers of income or principal to whomever they like with no negative gift or estate tax consequences.

- a. Income can be shifted by Jane and John, as co-trustees of the BPT, to any of their family members.

For instance, the BPT's higher income tax rates can be avoided if the family members are in a lower tax bracket.

- b. The income received by Jane and John's family members will be their separate property and generally not subject to any of Jane and John's creditors.

- c. Since Jane and John have no "right" to the income, they are not making gifts when distributions of income from the BPT are made to their family members.

They must, however, appoint an independent trustee to make distributions of income to themselves (as such distributions are discretionary); this is not usually a significant problem.

- d. Also, because Jane and John will each likely be employees of the company (a different "hat" than their positions as "co-trustees" and "trust beneficiaries"), if they need it, they can also receive income in the form of salary directly from the company.

If income is not needed, however, Jane and John could forego any salary and use up their non-trust assets for living expenses, thereby further reducing their estates and their assets that would otherwise be

subject to their personal creditors. As yet, the IRS would not consider such a forbearance of salary as a gift to the company.

- e. Jane and John will also each have a Power of Appointment over one-half of the assets in the BPT during their lifetimes. Thus, if they desire their children to have ownership in the company prior to their deaths, they could exercise such powers in favor of their children without any negative gift or estate tax consequences.
4. Jane and John's creditors should not be able to attach any assets in the BPT.
- a. Jane and John do not have any "rights" as beneficiaries under the BPT and did not "contribute" any of their assets.

It is important, however, that Jane and John deal with the BPT at arm's length, (e.g., properly documenting any loans and being appropriately compensated for any guarantees, etc.).

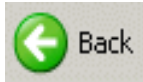
- b. If the BPT provided for mandatory income distributions (rather than discretionary distributions) to Jane and John, then their creditors could attach that income stream, and any shift in the income or principal of the BPT to other family members would be a taxable gift by John and Jane.
5. It is important to have Jane's (or John's) parents use up their lifetime exemptions from gift, estate and generation skipping tax to initially fund the trust with the \$10,000.
- a. This is somewhat different from what is usually recommended with respect to Generation Skipping Trusts. In the latter context, it is sometimes prudent to give the beneficiaries the power to withdraw the gift (a "Crummey" power to withdraw) in order for the gift to qualify for the annual exclusion from gift tax (thereby not using up any of the lifetime exemptions).
 - b. In the context of a BPT, however, if Jane and John were given a Crummey power to withdraw the gift, Jane and John's creditors may be able to take the position that the BPT is a "grantor" trust to them for civil law purposes, which means such creditors might have the ability to attach the BPT's assets.

What If Jane and John Already Have an Existing Company?

If Jane and John already had an established business, it may be possible for them to “sell” the existing business to a BPT and experience the same benefits described above. The overall purchase price can be reduced by transferring smaller, minority interests over the course of several years. Of course, a competent appraiser should be used to verify the value of the minority interests sold to the BPT, so as to avoid Jane and John’s having made a gift to the BPT, which could be fatal to the plan.

Conclusion

As is demonstrated above, implementing a Business Protection Trust into your overall estate and business plan can provide protection from creditors and estate taxes and can help business owners properly plan for who will control the business after they retire.



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