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# TAX CLASSIFICATION OF TRUSTS: THE HOWARD CASE AND OTHER CURRENT DEVELOPMENTS

*Joseph V. Sliskovich\* and Stewart S. Karlinsky\*\**

## I. INTRODUCTION

The distinction for tax purposes between a partnership and a corporation has been the subject of numerous court cases, Treasury regulations, rulings and procedures.<sup>1</sup> In the 1950's and 1960's, a major classification issue arose involving the tax status of professional corporations.<sup>2</sup> During that time, the determination of the appropriate tax status of the entity in question was especially important because of the limited pension and fringe benefits available to partnerships. In the 1970's and 1980's, the focus shifted to the proper classification of limited partnerships.<sup>3</sup> If the partnership was determined to be an association, taxable as a corporation, then none of the losses, credits and special allocations would pass through to the investors. The corporation versus partnership classification issue remains vitally important.<sup>4</sup>

The distinction between a trust and a corporation has received much

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1. For an overview of the definitional questions raised in the corporate versus partnership classification issue, see generally, B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 2.01-2.06 (4th ed. 1979 & Supp. 1985); W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* Ch. 3 (1977).

2. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); *Forman v. United States*, 232 F. Supp. 134 (S.D. Fla. 1964).

3. For example, see *Larson v. Commissioner*, 66 T.C. 159 (1976); *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); Sperling & Lokken, *The Limited Partnership Tax Shelter: An Investment Vehicle Under Attack*, 29 U. FLA. L. REV. 1 (1976).

4. See Nelson, *The Tax Classification of Partnerships: Distinguishing from Arm's-Length Economic Arrangements*, 40 N.Y.U. TAX INST. 15-1 (1982).

less attention but is, nevertheless, more important than ever. If a trust is determined to be taxable as a corporation, then the income of the entity would be subject to double taxation and lose other pass-through characteristics. Several recent developments, including the United States Claims Court decision in *Howard v. United States*,<sup>5</sup> have heightened the importance of ascertaining the trust's correct tax status. The increased use of royalty, liquidating and family trusts, as well as the advent of flexible investment unit trusts,<sup>6</sup> require that the trust instrument be carefully drawn to avoid the trust being classified as an association, taxable as a corporation. In making this determination, the two crucial attributes are the presence of business purpose and associates. The term "associates" denotes some voluntary aggregation of participants in a venture. "Business purpose" is present if the trust document permits the conduct of business activities as opposed to the mere preservation of corpus. This is true even if the trust does not in fact conduct business activity.

Only if *both* of these characteristics are present will the entity be treated as a corporation. The court in *Howard* specifically addressed these issues, and in so doing reaffirmed the importance of the trust instrument in determining whether a business purpose is present, while strongly suggesting that the associates attribute is directly linked to the level of transferability.<sup>7</sup>

This Article will first present an historical perspective on the trust classification issue—the so-called business versus ordinary trust distinction—by examining judicial and administrative rules. A discussion of *Howard* and other current developments in the trust area will follow. These current developments will then be analyzed in the context of commonly used trust techniques, as well as some innovative investment instruments.

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5. 5 Cl. Ct. 334 (1984).

6. Historically, the Treasury Department has ruled that a "fixed investment trust" is taxable as an ordinary trust because the business objective criteria was lacking. Typically, this type of trust has one class of ownership and allows the investor to acquire undivided beneficial ownership in a diversified investment portfolio. More recently, investment bankers have developed variations on the fixed investment trust theme by splitting the portfolio into a current income interest and a future appreciation interest. This has been done with stocks, securities and mortgage instruments. This allows one group of investors to protect themselves against a premature call option possibility or to receive capital gain income rather than ordinary income. The Treasury has proposed that these arrangements are associations taxable as corporations or partnerships because they allow the investor to fulfill a specific profit-making objective. Prop. Treas. Reg. § 301.7701-4(c), 49 Fed. Reg. 18,743 (1984).

7. See *infra* notes 64-120 and accompanying text.

II. HISTORICAL PERSPECTIVE: *MORRISSEY* AND ITS PROGENY

In the 1930's, the United States Supreme Court rendered several important decisions which established the factors which determine whether a trust or other organization is an association, taxable as a corporation: *Morrissey v. Commissioner*,<sup>8</sup> *Swanson v. Commissioner*,<sup>9</sup> *Helvering v. Coleman-Gilbert Associates*,<sup>10</sup> *Helvering v. Combs*,<sup>11</sup> and *A.A. Lewis & Co. v. Commissioner*.<sup>12</sup>

Since 1935, the crucial determinants of an entity's tax status involve the following six fundamental elements of a corporation: associates, profit motive, centralized management, limited liability, continuity of life and free transferability of interest.<sup>13</sup> For a trust to be taxed as a corporation both the associates and profit motive attributes must be present.<sup>14</sup>

In *Morrissey*, the Supreme Court's leading decision in this area, a trust was created to develop land by constructing and operating a golf course and clubhouse, with broad powers to purchase, operate and sell the property. Shares of beneficial interests with prescribed rights were issued. The beneficiaries and all persons dealing with the trustees could only look for payment or indemnity from the trust property. Shareholders' meetings were held, but votes were only advisory. The death of a trustee or a beneficiary did not end the trust, which was to continue for twenty-five years unless terminated by the trustees. A major portion of the trust's property was subdivided into lots which were sold; the golf course was constructed and conveyed to a corporation; and the trustees operated the golf course under a lease from the corporation. After the trust had been in operation for some time, the trustees' activities were confined to the receipt of principal and interest on installment notes, interest on bank balances, and certain fees. The trustees also received dividends from the incorporated club, and distributed money to the beneficiaries.<sup>15</sup>

The Supreme Court held that the *Morrissey* trust was taxable as a corporation, since it met the Court's requirements for taxability as an association, namely:

(1) " 'Association' implies associates."<sup>16</sup> It implies the entering into

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8. 296 U.S. 344 (1935).

9. 296 U.S. 362 (1935).

10. 296 U.S. 369 (1935).

11. 296 U.S. 365 (1935).

12. 301 U.S. 385 (1937).

13. Treas. Reg. § 301.7701-2(a)(1).

14. See *infra* notes 35-63 and accompanying text.

15. 295 U.S. at 347-48.

16. *Id.* at 356.

a joint enterprise for the transaction of business and is distinguished, therefore, from the ordinary trusts,

whether created by will, deed, or declaration—by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. . . . In what are called “business trusts” the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains.<sup>17</sup>

(2) “The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity.”<sup>18</sup>

(a) It is not required that the association be organized under the statute or with statutory privileges, nor is the association limited to joint stock companies.<sup>19</sup>

(b) More formal procedures are not a controlling test. A trust may constitute an association even though the beneficiaries do not hold meetings, or elect their representatives, or exercise control over the trustees, or have “directors” or “officers”; nor will the particular method of transferring beneficial interests determine the issue.<sup>20</sup>

(3) The salient features of a trust, when created and maintained to carry on a business enterprise and share its gains, which may be regarded as making such a trust analogous to a corporate organization, are: (a) a continuing entity throughout the trust period; (b) centralized management; (c) continuity of the trust uninterrupted by death among the beneficial owners; (d) means for transfer of beneficial interests; and (e) limitation of personal liability of participants to the property embarked in the undertaking.<sup>21</sup>

(4) The character of the organization is determined by the terms of

17. *Id.* at 356-57.

18. *Id.* at 357.

19. *Id.*

20. *Id.* at 357-58. The Court stated:

Thus an association may not have “directors” or “officers,” but the “trustees” may function “in much the same manner as the directors in a corporation” for the purpose of carrying on the enterprise. The regulatory provisions of the trust instrument may take the place of “by-laws.” . . . Again, while the faculty of transferring the interests of members without affecting the continuity of the enterprise may be deemed to be characteristic, the test of an association is not to be found in the mere formal evidence of interests or in a particular method of transfer.

*Id.* at 358.

21. *Id.* at 359. These factors have been incorporated into Treas. Reg. § 301.7701-2(a)(1) (1960).

the trust instrument rather than the activities actually carried on in the taxable year.<sup>22</sup>

Thus, *Morrissey* established several important principles that are echoed in other Supreme Court and lower court cases. The associates and profit motive attributes must both be present, and the trust document, rather than the activity of the trust, is controlling. For example, in several of the trust's tax years, the actual activity of the trust was clearly fiduciary in nature. Nevertheless, the Court ruled that the trust instrument, in allowing business activity, was sufficient to justify finding the profit motive attribute present.<sup>23</sup>

*Swanson v. Commissioner*<sup>24</sup> involved a real estate trust created for the purpose of acquiring land and erecting and operating an apartment house. Under the terms of the trust, the trustees were given management and control of the property. They could exchange, sell, improve, remodel, reconstruct or encumber the property. The beneficiaries received "transferable receipts" representing their interest in the trust. The Court, applying the resemblance test of *Morrissey*, held that the trust was taxable as a corporation.<sup>25</sup> To some, this finding was surprising since there were a limited number of beneficiaries and the trust held only one piece of real estate. The Court found, however, that because the trust instrument allowed business activity and permitted transferability of interest, the entity was a business trust.<sup>26</sup>

In *Helvering v. Coleman-Gilbert Associates*,<sup>27</sup> a trust was created for the purpose of owning and operating twenty apartment houses. The Supreme Court held that the trust was an association taxable as a corporation under *Morrissey*. The Court stated that the trust's purpose is determined by reference to the terms of the trust instrument and not what the parties claimed the purpose to be.<sup>28</sup> Here again, the fact that the

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22. *Morrissey*, 296 U.S. at 364-65.

The fact that these sales were made before the beginning of the tax years here in question, and that the remaining property was conveyed to a corporation in exchange for its stock, did not alter the character of the organization. Its character was determined by the terms of the trust instrument.

*Id.*

23. *Id.* at 360-61.

24. 296 U.S. 362 (1935).

25. *Id.*

26. *Id.*

27. 296 U.S. 369 (1935).

28. *Id.* at 373-74. The *Coleman-Gilbert* Court held: "We agree . . . that weight should be given to the purpose for which the trust was organized, but that purpose is found in the agreement of the parties." *Id.* at 373.

trust authorized business activity and allowed transferability of interests caused the trust to be classified as a business trust.

*Helvering v. Combs*<sup>29</sup> involved a trust created to finance and drill one oil well. The Court held that the trust was taxable as an association because the following factors were evident: the parties associated into a common enterprise for the transaction of business and there was centralized management, continuity of business interest and transferability of beneficial interests (represented by certificates). Once again, the Court's decision was not affected by the fact that the parties confined their activities to a single investment.<sup>30</sup>

In 1937, the Supreme Court was once again faced with a case involving the appropriate classification of a trust. In *A. A. Lewis & Co. v. Commissioner*,<sup>31</sup> realty was conveyed to a trustee to hold for the benefit of the settlor and another person who was the exclusive sales agent and manager of the property. The trust was formed to facilitate the subdivision and sale of the realty.<sup>32</sup> The Court held that this trust answered the description of an ordinary trust in that by its terms, "a designated piece of real property was conveyed to the trustee on specified trusts, for the benefit of definitely named persons . . ."<sup>33</sup> The duties of the trustee were found to be purely ministerial and, therefore, the Court held that the trust was not analogous to a corporate organization.

Thus, the Court's rulings expressly applying the holding of *Morrissey* outline several important factors. First, *both* associates and business activity must be present before a trust is classified as an association. For example, as in *A. A. Lewis*, the subdivision of land might be construed as business activity, but because the beneficiaries were specifically designated (not transferable), the Court allowed the trust to preserve its ordinary trust status. Second, the trust instrument and not the actual activity is determinative. For example, in *Morrissey*, the later shift to passive investment activity was not controlling.

Although the Supreme Court has established the principles governing the taxability of trusts, partnerships and other organizations as associations, these rules have often been difficult to apply in practice.<sup>34</sup>

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29. 296 U.S. 365 (1935).

30. *Id.* at 368.

31. 301 U.S. 385 (1937).

32. *Id.* at 386-87.

33. *Id.* at 388.

34. See Fisher, *Classification Under Section 7701—The Past, Present, and Prospects for the Future*, 30 TAX LAW 627 (1977); Taft, *The Family Trust*, 174 N.Y.L.J. 1 (1975).

## III. TREASURY INTERPRETATIONS

The Treasury Department looks at two primary factors to determine the appropriate classification of trusts. The determination of whether a trust is to be treated as an ordinary trust or as an association taxable as a corporation depends on whether there are: (1) associates, and (2) an objective to carry on business and divide the gains.<sup>35</sup> The Treasury has stated in its regulations that because the attributes of centralized management, continuity of life, free transferability of interests, and limited liability are generally common to both trusts and corporations, such attributes are "not material" in distinguishing between trusts and corporations.<sup>36</sup>

The regulations further provide that the term "trust" as used in the Internal Revenue Code refers to an "ordinary trust."<sup>37</sup> The regulations define an ordinary trust as a trust created by will or by inter vivos declaration of the grantor, where the trustees take title to the property for the purpose of protecting or conserving it as customarily required in chancery and probate courts.<sup>38</sup> The beneficiaries of an ordinary trust generally do no more than accept the benefits of the trust and are usually not the voluntary planners or creators of the trust. If the beneficiaries do create the trust, they do so only to conserve the trust property.<sup>39</sup>

In contrast to arrangements that protect or conserve property for the beneficiaries, business trusts are created to carry on a profit-making business and are classified as corporations or partnerships under the Treasury Regulations.<sup>40</sup> Business trust status may be found even though the beneficiaries did not supply the corpus of the trust.<sup>41</sup>

While the primary focus of this Article is on the trust versus corporation tax classification, the reader should not overlook the possibility of a trust versus partnership classification.<sup>42</sup> Thus, if a trust is classified as a business trust, an examination of the attributes outlined in *Morrissey v. Commissioner*<sup>43</sup> would be advisable to determine if the entity was taxable

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35. Treas. Reg. § 301.7701-2(a)(2) (1960).

36. *Id.*

37. *Id.* § 301.7701-4(a).

38. *Id.*

39. *Id.*

40. *Id.* § 301.7701-4(b).

41. *Id.* The Regulation makes this clear, stating: "[T]he fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership." *Id.*

42. While the tax consequences of partnership classification would not generally be as severe as corporate reclassification due to the retention of pass-through treatment, the nature of that treatment may nevertheless vary and should therefore be considered. See generally, W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 1.

43. 296 U.S. 344 (1935); see *supra* notes 14-23 and accompanying text.



as a partnership or a corporation. Such an analysis was the subject of a recent tax advisory memorandum in which the Internal Revenue Service National Office determined that a trust was to be treated as a partnership, rather than a corporation.<sup>44</sup> In the memorandum, the trust in question was determined to have both the associates and business purpose attributes. The Internal Revenue Service (IRS) then examined the trust agreement and found that it did not have more corporate than noncorporate characteristics, because although it had continuity of life and a modified form of free transferability, there was a lack of centralized management and limited liability. Thus, the trust was classified as a partnership rather than a corporation.<sup>45</sup>

A similar analysis was performed in *Olmsted Hotel v. Commissioner*<sup>46</sup> in which, once again, a trust was held to be a business trust since it had both the business purpose and associates attributes. The court held that the entity was taxable as a partnership since limited liability and centralized management were lacking.<sup>47</sup>

#### IV. CURRENT DEVELOPMENTS

Several recent revenue rulings and court cases specifically address the trust versus corporation classification issue and will have a significant impact on tax planning involving trusts.

##### A. Revenue Rulings

In Revenue Ruling 78-371,<sup>48</sup> a trust was established by the heirs of contiguous parcels of real estate with the following trustees' duties and powers:

- (1) To collect the income, pay all expenses of the property, manage, maintain and repair the property under the terms of the trust and distribute the net income to the beneficiaries.
- (2) To accept from any source and retain real estate contiguous or adjacent to the trust's real estate.
- (3) To sell any real estate of the trust, and purchase any real estate adjacent to the trust's real estate.
- (4) To borrow money, mortgage and lease property, raze or erect any building and make any improvements they deem

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44. Ltr. Rul. 8510001, 1985 PRIVATE LETTER RULINGS (PH) ¶ 1027.

45. *Id.*

46. 11 T.C.M. (CCH) 694 (1952).

47. *Id.* at 697.

48. 1978-2 C.B. 344.

proper.<sup>49</sup>

The ruling discussed regulation sections 301.7701-4(b) and 301.7701-2(a)(2), as well as two cases, *Wyman Building Trust v. Commissioner*,<sup>50</sup> and *Sears v. Hassett*.<sup>51</sup> The ruling held that the foregoing powers "taken together indicate that the trustees . . . are empowered to do more than merely protect and conserve the trust's property."<sup>52</sup> Thus, the arrangement had the characteristic of a joint enterprise for the conduct of a business for profit. The associates attribute was also present since the heirs' volitional act created the trust and other relatives could join the enterprise by contributing contiguous real property. Therefore, the ruling held that the entity was a business trust, taxable as a corporation.<sup>53</sup>

In Revenue Ruling 79-77,<sup>54</sup> the trust agreement empowered the trustee "to act on behalf of the beneficiaries as signatory of leasing arrangements and management agreements, to hold title to the land and building and to the proceeds and income of the property, to distribute all trust income and to protect and conserve the property."<sup>55</sup>

The Treasury distinguished this ruling from Revenue Ruling 78-371 by stating that "the trustee [in the instant case] is restricted to dealing with a single piece of property subject to a net lease. Further, the trustee has none of the powers described in Rev. Rul. 78-371."<sup>56</sup> The arrangement was held to be an ordinary trust. The lack of business purpose was sufficient to prevent classification as an association, even though the grantor, as a beneficiary, may have been sufficient to cause a finding of the associates attribute.<sup>57</sup>

### B. Judicial Interpretation

In *Elm Street Realty Trust v. Commissioner*,<sup>58</sup> the issue before the Tax Court was once again whether the entity was an ordinary trust or a corporation. The court found the trust was not an association taxable as a corporation as defined by Internal Revenue Code section 7701(a)(3).<sup>59</sup> The court found that the trustee's powers were not merely limited to the

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49. *Id.* at 344.

50. 45 B.T.A. 155 (1941), *acq.* 1941-2 C.B. 14.

51. 111 F.2d 961 (1st Cir. 1940).

52. Rev. Rul. 78-371, 1978-2 C.B. at 345.

53. *Id.*

54. 1979-1 C.B. 448.

55. *Id.* at 449.

56. *Id.* at 449-50.

57. *Id.* at 450.

58. 76 T.C. 803 (1981).

59. *Id.* at 818.

conservation and protection of Elm Street property for the trust's beneficiaries. Rather, the trust was found to have a business objective, because the trust agreement gave the trust the power to carry on a business, even though it was clear that no business was actually conducted, nor was there ever any intention to carry on a business.<sup>60</sup> Thus, the ability to conduct business and not the actual conduct of a business was the crucial element.

However, the court found that the trust lacked associates within the meaning of section 7701(a)(3).<sup>61</sup> The court focused on three factors: (1) the absence of free transferability of trust interests; (2) the fact that the beneficiaries received their interests gratuitously; and (3) the fact that the beneficiaries did not play a role in the creation of the trust itself. The beneficiaries' influence over and ability to participate in trust activities were limited in scope by virtue of the trust indenture.<sup>62</sup> Thus the court concluded that although the Elm Street Trust had a business purpose, it did not possess the associates attribute and was, therefore, not an association taxable as a corporation under section 7701(a)(3).<sup>63</sup>

## V. THE HOWARD CASE

In light of the increasing popularity of liquidating, unit investment trusts, royalty trusts and similar readily traded investment vehicles, a recent Claims Court case, *Howard v. United States*,<sup>64</sup> may have important repercussions in the ordinary versus business trust determination. The following is an analysis of this case and its implications.

### A. Background

*Late 1880's*: James J. Hill and several other individuals acquired stock in ten corporations. Nine of the ten corporations owned mineral property in Minnesota and negotiated leases with mining companies for the extracting of ore from these properties on a royalty basis.<sup>65</sup>

*1899*: James Hill arranged the transfer of stock in the ten corporations to the Lake Superior partnership "for the benefit of stockholders of the Great Northern Railway Co. ('the Railway')."<sup>66</sup> The Lake Superior partnership was thereafter used as a holding company.

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60. *Id.* at 812-13.

61. *Id.* at 818.

62. *Id.* at 816-17.

63. *Id.* at 818.

64. 5 Cl. Ct. 334 (1984).

65. *Id.* at 336.

66. *Id.* at 337.

1906: The Railway directed Lake Superior to transfer the shares in all ten corporations to the four trustees of the Great Northern Iron Ore Products ("GNIOP") trust.<sup>67</sup> This was done to avoid violating the recently passed Hepburn Act.<sup>68</sup> The trust agreement contained eighteen paragraphs setting forth its provisions, of which five were of primary importance to the court: Paragraph 1 mandated that the trustees shall "exercise their power . . . to preserve the existence and the organization of such corporation, and to secure at all times proper management of the property and business and affairs of such corporation."<sup>69</sup> Paragraphs 9, 10, 13 and 14 complemented the managerial powers conferred by Paragraph 1 by permitting the trustees to dispose of trust property and reinvest or hold the proceeds with the same powers and duties, hire employees, and make rules to govern the operation of the trust.<sup>70</sup> The corporations apparently did not have a group of officers, as Paragraph 13 authorized "the trustees to choose one among them as president, who shall be the 'active manager and executive officer in carrying on the business devolving on the trustees.'"<sup>71</sup>

1917-1919: GNIOP paid income taxes as an association taxable as a corporation which were later refunded when the trust received a favorable ruling from the IRS that it was taxable as an ordinary trust.<sup>72</sup>

1942: In light of the 1935 Supreme Court decisions discussed above,<sup>73</sup> the IRS reversed its earlier ruling and held that GNIOP was taxable as a corporation.<sup>74</sup>

1948: The taxpayer challenged the IRS reversal in the District Court of Minnesota in *Hill v. Reynolds*,<sup>75</sup> but was unsuccessful. The Eighth Circuit Court of Appeals affirmed the district court's decision, noting that a number of paragraphs in the trust agreement, especially Paragraph 1, indicated that GNIOP contained a preponderance of corporate characteristics.<sup>76</sup>

1906-1956: The trustees retained the stock of the corporations and continued to exercise an active part in the affairs of the corporations'

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67. *Id.*

68. Ch. 104, 24 Stat. 379 (1887) (codified as amended at 49 U.S.C. §§ 10701-10786 (1982)). Specifically, the Railway wished to avoid violating 49 U.S.C. § 10746 which prohibits a railroad company from transporting commodities owned by it. *Howard*, 5 Cl. Ct. at 337.

69. 5 Cl. Ct. at 337.

70. *Id.* at 338.

71. *Id.* (quoting the GNIOP trust agreement) (emphasis provided by the *Howard* court).

72. *Id.* at 338-39.

73. See *supra* notes 68-72.

74. 5 Cl. Ct. at 339.

75. 75 F. Supp. 408 (D. Minn. 1948).

76. *Reynolds v. Hill*, 184 F.2d 294, 297 (8th Cir. 1950).

business of leasing mineral lands to lessees and providing directional and policy-making services.<sup>77</sup>

1956: The trustees decided to liquidate the corporations. The liquidation did not cause any changes in property interests, management of the properties or in the equity value represented by the Certificates of Beneficial Interest.<sup>78</sup>

1956-1979: The corpus of the trust, the mineral properties, remained intact. The trustees made no purchase or sale of mineral lands.<sup>79</sup>

1984: The taxpayers, who purchased their trust certificates through the New York Stock Exchange, brought suit for refund of taxes paid with respect to the income they received from GNIOP which they had reported as dividends. They contended that the royalties received by the trust should have been taxed to the beneficiaries of the trust as a pass-through.<sup>80</sup>

### B. *Opinion of the Claims Court*

The Claims Court began its analysis with a review of Internal Revenue Code section 7701(a)(3) and the regulations thereunder, which define the term "corporation" to include associations.<sup>81</sup> The definition of "association" is found in regulation section 301.7701-2(a).<sup>82</sup> Of relevance here is regulation section 301.7701-2(a)(2) which provides, in pertinent part:

Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on busi-

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77. *Howard*, 5 Cl. Ct. at 339.

78. *Id.* at 339-40.

79. *Id.* at 340.

80. *Id.* at 335-36.

81. *Id.* at 341.

82. *Id.*

ness and divide the gains therefrom.<sup>83</sup>

Consistent with this regulation, the parties agreed that the four common characteristics listed in regulation section 301.7701-2(a)(1) were present in GNIOP. Thus, the question of GNIOP's tax status in 1979 turned exclusively on whether it had (1) associates *and* (2) an objective to carry on business and divide the gains therefrom. The court focused its analysis on these two characteristics.

### 1. Associates

The Claims Court noted that *Morrissey v. Commissioner*<sup>84</sup> requires "some concerted volitional activity on the part of those beneficially interested"<sup>85</sup> before the associates criterion will be present. This includes not only participation in the creation of the trust but also subsequent affirmative action through the purchase of beneficial interests.<sup>86</sup>

The court found sufficient evidence to support the finding that both the initial beneficiaries and the subsequent purchasers of beneficial interests were "associates."<sup>87</sup> First, the initial beneficiaries (the shareholders of the Railway) had control over the disposition of their stock that ultimately became the trust corpus.<sup>88</sup> Second, as the Supreme Court stated in *Morrissey*, "the terms of an association may make the *taking or acquiring* of shares or interests sufficient to constitute participation, and may leave the management or even control of the enterprise to designated persons."<sup>89</sup> The court relied upon this language in finding that the subsequent purchasers of the beneficial interests (many through the New York Stock Exchange) were also "associates."<sup>90</sup> Further, the officers/trustees who themselves owned beneficial interests were also "associates" of GNIOP.<sup>91</sup> Thus, the courts and the regulations,<sup>92</sup> though minimizing the significance of the four characteristics common to both trusts and corporations, nevertheless seem to link the associates and transferability attributes.

The taxpayers contended that because the income beneficiaries of

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83. Treas. Reg. § 301.7701-2(a)(2) (1960).

84. 296 U.S. 344 (1935).

85. *Howard*, 5 Cl. Ct. at 342 (quoting *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803, 813 (1981)).

86. *Howard*, 5 Cl. Ct. at 342; *Morrissey*, 296 U.S. at 357; *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803, 814 (1981).

87. *Howard*, 5 Cl. Ct. at 342.

88. *Id.*

89. *Id.* (quoting *Morrissey*, 296 U.S. at 357) (emphasis provided by the *Howard* court).

90. *Howard*, 5 Cl. Ct. at 342-43.

91. *Id.* at 343.

92. Treas. Reg. § 301.7701-2(e) (1960).

GNIOP had no reversionary interest in the trust corpus, the association was hostile and unfriendly.<sup>93</sup> The court rejected this contention by pointing out that the law only requires that the association be voluntary.<sup>94</sup> Thus, the court held that GNIOP had the associates characteristic.

## 2. Business objective

The Claims Court then turned to the question of whether the trust was an organization devised to carry on a business and divide the gains.

The taxpayers contended that the activities of GNIOP were similar to those of an ordinary family trust—leasing mineral lands, and collecting and distributing income to the beneficiaries. These activities, the taxpayers argued, constituted conserving the corpus.<sup>95</sup> In response, the court pointed out that even if the activities of GNIOP in 1979 were merely to conserve and protect the corpus, the relevant factor is what activities are allowed by the trust instrument.<sup>96</sup> The court then turned to a discussion of case law in support of its position.

The importance of the trust instrument's terms, rather than actual activity conducted, was discussed in *Fidelity-Bankers Trust v. Helvering*,<sup>97</sup> where the court stated that "recent Supreme Court decisions have shifted emphasis to simulation of corporate attributes and the purpose for which the trust is organized as expressed in the creative instruments."<sup>98</sup> The court in *Fidelity-Bankers*, citing the *Morrissey* line of cases, made it clear that the purpose for which the trust was organized has often been the most important single factor in determining whether the entity was taxable as an association, and that the purpose of the trust was to be primarily determined with reference to the trust instrument.

In *Helvering v. Coleman-Gilbert Associates*,<sup>99</sup> the taxpayer was not allowed to claim that the purpose of the trust was narrower than that which was set forth in the trust instrument.<sup>100</sup> In *Title Insurance & Trust v. Commissioner*,<sup>101</sup> the fact that the trustee did little more than

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93. *Howard*, 5 Cl. Ct. at 343.

94. *Id.* at 343. See *Walker v. United States*, 194 F. Supp. 522, 526 (D. Mass. 1961).

95. *Howard*, 5 Cl. Ct. at 343.

96. *Id.* "The persuasive force of plaintiff's . . . contention . . . is overcome by the long-settled rule that the primary source for determining the business objective of a trust is the trust instrument." *Id.*

97. 113 F.2d 14 (D.C. Cir.), cert. denied, 310 U.S. 649 (1940).

98. *Id.* at 18 (footnotes omitted).

99. 296 U.S. 365 (1935).

100. *Id.* at 374. See *supra* notes 27-28 and accompanying text.

101. 100 F.2d 482 (9th Cir. 1938).

collect the rent and distribute the profits was not decisive, where the powers conferred upon it in the trust instrument were much broader.<sup>102</sup> Finally, the *Howard* court quoted *Elm Street Realty Trust v. Commissioner*,<sup>103</sup> for the proposition that “[t]he presence of [business] powers, regardless of their exercise, require a finding of a business objective for purposes of Section 7701(a)(3) and the regulations thereunder.”<sup>104</sup>

Next, the *Howard* court discussed the distinction between “ordinary trusts” and “business trusts” as found in the regulations,<sup>105</sup> summarizing the regulations as follows: “[O]rdinary trusts’ [are] entities designed simply and exclusively to protect or conserve property for the beneficiaries, while ‘business trusts’ are entities technically cast in the trust form but with the paramount purpose of conducting a business for profit.”<sup>106</sup> The court recognized that since almost every trust involves the doing of some business, “[t]he dispositive question, therefore, becomes whether the carrying on of business by a trust in the commercial sense is incidental to the paramount purpose of conserving or protecting the property.”<sup>107</sup>

Thus, the difficulty arises in attempting to determine whether the paramount purpose of a given entity is conserving and protecting property, or conducting a business for profit. The dividing line has not always been clear since implicit in a fiduciary’s responsibility is the duty to conserve and protect property, and put that property to its best and most productive use, which may incidentally involve the making of a profit.<sup>108</sup>

In addressing this question, the Claims Court turned its discussion to an examination of GNIOP’s trust instrument and the facts underlying the creating of the trust. The court found that “there can be no question that the ‘principal objective’ in the creation of GNIOP was the exploitation of minerals for profit on lands owned by the trust, with a substantial managerial role to be played by the trustees.”<sup>109</sup>

The court found that Paragraph 1 of the trust instrument gave the trustees “wide latitude to manage all business operations involving the trust corpus.”<sup>110</sup> The fact that this power had been exercised by leasing

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102. *Id.* at 485.

103. 76 T.C. 803 (1981).

104. *Howard*, 5 Cl. Ct. at 342 (quoting *Elm Street Realty Trust*, 76 T.C. at 811).

105. Treas. Reg. § 301.7701-4(a)-(b) (1960).

106. *Howard*, 5 Cl. Ct. at 344.

107. *Id.*

108. See generally G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES §§ 571, 574, 611, 612 (2d ed. 1977).

109. *Howard*, 5 Cl. Ct. at 344.

110. *Id.*



the trust property to third-party mining concerns was immaterial.<sup>111</sup> Thus, the controlling factor was the *power* to conduct business, even though no business was actually conducted.

As an example, the *Howard* court cited *Reynolds v. Hill*,<sup>112</sup> where the Eighth Circuit Court of Appeals found that the activities of the trustees from 1938 to 1944 clearly warranted a finding that GNIOP was created for business purposes.<sup>113</sup> Subsequently, the GNIOP trustees liquidated the corporations and the business purpose for which the trust was created no longer existed.<sup>114</sup> The *Howard* court concluded that a change in trust activities is not sufficient to remove the taint of business purpose, since it does not change the purpose for which the trust was created "unless the powers set out in the Trust Agreement have likewise changed."<sup>115</sup>

The Claims Court examined the circumstances surrounding the creation of GNIOP and stated that the land constituting the corpus was purchased with the objective of developing it, through mining operations, for the financial benefit of the shareholders of the Railway.<sup>116</sup> The court concluded that "it appears clear from GNIOP's Trust Agreement and the circumstances of the trust's creation that GNIOP was created for business purposes, as defined by case law and applicable regulations."<sup>117</sup> Therefore, the court held that the GNIOP entity was a business trust taxable as a corporation because it had both the associates and business profit characteristics.<sup>118</sup>

### C. Analysis

The link between the associates attribute and the transferability of interest now seems clear. The notion of volitional conduct discussed in *Howard v. United States* has at its heart those elements of voluntary transfer found in the regulations discussing transferability. Those participants who are unable to alter their relationships voluntarily are not associates within the scope of *Morrissey v. Commissioner*.<sup>119</sup> Members who can readily enter or leave the relationship will be considered associates.

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111. *Id.*

112. 184 F.2d 294 (8th Cir. 1950).

113. *Id.* at 298-99.

114. *Howard*, 5 Cl. Ct. at 339.

115. *Id.* at 346.

116. *Id.* at 345.

117. *Id.*

118. *Id.* at 349.

119. 296 U.S. 344 (1935); see *supra* notes 15-23 and accompanying text.

Consistent with the reasoning that the stated purpose of the trust rather than the actual activities are to be viewed as controlling, courts have held that a change or reduction in the activities of the business trust will not be sufficient to reclassify the entity as an ordinary trust.<sup>120</sup> Where, however, the trust instrument is formally amended to restrict the powers of the trustees so that they can no longer carry on a business, or so that the beneficiaries will no longer be considered associated, the trust, after amendment, may be held not taxable as an association.<sup>121</sup>

## VI. CURRENT TRUST UTILIZATION

Most traditional trusts have some activity that might be construed as profit motivated, but fail the associates test since the beneficial interests are not traded or subject to volitional conduct. Recently, trusts have been used in a variety of less traditional ways which require more careful planning in drafting the instrument in order to ensure the desired tax status is achieved. It has become increasingly common for trust units to be traded on various stock exchanges. This feature is similar to the "transferable receipts" in the *Morrissey* line of cases, which the Supreme Court found to be indicative of the associates attribute. Thus, in the case of these tradable trust units, the associates characteristic is present and particular care as to the business attribute is imperative. For example, the royalty trust is often used, as in *Howard*, to avoid corporate double taxation and, therefore, to tax overriding royalty income only once.<sup>122</sup> The vitality of this technique has been severely limited by recent tax legislation.<sup>123</sup> Because such trust units are listed and traded, the associates

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120. See, e.g., *Morrissey*, 296 U.S. 344; *Commissioner v. Vandegrift Realty & Inv. Co.*, 82 F.2d 387 (9th Cir. 1936); *Howard v. United States*, 5 Cl. Ct. 334 (1984).

121. See *Commissioner v. Nebo Oil Co., Trust*, 126 F.2d 148 (10th Cir. 1942), in which the court looked at the amended trust indenture terms in determining the appropriate entity status. In that case, the amendments were found to be insufficient to avoid either the associates or business purpose attributes. *Id.* at 150-51. See *supra* text accompanying note 115.

122. *Houston Oil and Minerals Corporation, and Sabine Corporation*, among others, have used this technique successfully. HOUSTON OIL AND MINERALS CORP., PROXY STATEMENT FOR THE APRIL 24, 1981 ANNUAL MEETING OF SHAREHOLDERS at TR1-TR5 (Mar. 27, 1981); SABINE CORP., PROXY STATEMENT FOR THE NOVEMBER 12, 1982 SPECIAL MEETING OF SHAREHOLDERS at 24-27 (Oct. 4, 1982).

123. Tax Reform Act of 1984, Pub. L. No. 98-369, § 54(a), 98 Stat. 494, 568-69 (1984) (codified at I.R.C. § 311(d) (1982 & Supp. 1984)); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 223(a)(1), (3)(A)-(B), 96 Stat. 324, 483-84 (1982) (codified as amended at I.R.C. § 311(d) (1982 & Supp. 1984)). Prior to the Tax Equity and Fiscal Responsibility Act of 1982, I.R.C. § 311 generally provided for the nonrecognition of gain at the corporate level with respect to the distribution of appreciated property. See generally *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). The revised statute provides that a corporation which distributes appreciated property to its shareholders in any ordinary, non-liquidating distribution must recognize gain as if the property had been sold for its fair market

characteristic is clearly present. To preclude the trust from being characterized as a corporation, the trust instrument should expressly prohibit business activity.<sup>124</sup> Thus, sophisticated companies, recognizing that the associates attribute is present, have apparently avoided business trust status by prohibiting business activities.<sup>125</sup>

Liquidating trusts are often used to facilitate corporate liquidations under IRC sections 331, 333 and 337.<sup>126</sup> Generally these trusts are used on a short term basis to facilitate the orderly and timely liquidation of a corporation. Care must be taken to assure that the trust agreement specifically forbids business activity. This is crucial since the associates attribute may already be present due to a pre-existing volitional status between shareholders. This assertion is supported by regulation section 301.7701-4(d).<sup>127</sup> In specifically discussing the business attribute, section 301.7701-4(d) implies that the associates attribute is already present. The regulation goes on to state that if the trust's life is unreasonably prolonged or the trust's purpose is obscured by its business activities, the trust will be recharacterized as a corporation or a partnership.

*J. B. Wenger v. Commissioner*<sup>128</sup> further supports the need for caution in the liquidating trust area. This case involved grantor/beneficiaries who purchased a liquor sales company and liquidated the inventory over several years.<sup>129</sup> The court held that the trust was an association taxable as a corporation because business purpose was present, associates seemed to be present and the association more closely resembled a corporation than a partnership.<sup>130</sup>

Family tax planning often includes use of a trust to facilitate a sale-leaseback or gift-leaseback of property. The trust may be construed as conducting a business activity, but generally the absence of associates will prevent the trust from being classified as a business trust. Of course,

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value at the time of the distribution. I.R.C. § 311(d) (1982 & Supp. 1984). However, this technique is still viable for a company with net operating loss carryovers or a company distributing recently acquired property or property with an adjusted basis greater than its fair market value.

124. It is interesting to note that in several recently filed proxy statements, the trust agreements forbid the trustees from engaging in any business, commercial or management activity, and even limit investment activity to ensure that the trusts are not construed as engaging in business activity. Indentures even forbid the amendment of the agreement to permit the trustees to engage in business or investment activities. HOUSTON OIL PROXY STATEMENT, *supra* note 122, at TR1-TR5; SABINE CORP. PROXY STATEMENT, *supra* note 122, at 24-27.

125. *See supra* notes 122 & 124.

126. I.R.C. §§ 331, 333, 337 (1982).

127. Treas. Reg. § 301.7701-4(d) (1960).

128. 13 T.C.M. (CCH) 24 (1954).

129. *Id.* at 24-28.

130. *Id.* at 28-29.

this assumes that the beneficiaries' interests are non-transferable and do not otherwise involve the associates attribute. It is important to note that even if the trust's activities are on a net lease basis, the terms of the trust agreement will determine the presence or absence of the business attribute.

Wall Street continues to be creative in developing investment vehicles that meet the needs of investors. A relatively new instrument is the flexible investment arrangement in which a pool of mortgages (or other assets) are placed in a trust with multiple classes of beneficial interests. The Treasury has proposed to classify these arrangements as corporations or partnerships, rather than as ordinary trusts.<sup>131</sup> The associates attribute is clearly present because the interests are fully transferable. Therefore, the crucial determination that the Proposed Regulation addresses is whether the business attribute is present. The Proposed Regulation maintains that if multiple classes of ownership are present then investors are able to "fulfill varying profit-making objectives through the division of rights, and the sharing of risks."<sup>132</sup>

## VII. CONCLUSION

Even after numerous Supreme Court cases on point, the trust classification area still has several ambiguities and unresolved questions. The effect of a trust being classified as a corporation can be catastrophic to the tax planner and the beneficiaries. Therefore, it is imperative that the form as well as the substance of the trust and its activities be carefully considered. For business trust status to be found, *both* the associates and business attributes must be present. Thus, if the associates attribute is present, the trust indenture should clearly forbid the trustee from entering into any profit-making or business transaction. Alternatively, if business activity is contemplated, the trust should restrict the transferability of beneficial interests and any other volitional beneficiary activity.

Moreover, although *Morrissey v. Commissioner*<sup>133</sup> and its progeny<sup>134</sup> enumerate six distinguishing characteristics in the association classification area, it appears that the attributes of transferability and associates are very closely linked. In effect, therefore, when analyzing the tax status of a trust, a finding of transferability may automatically trigger the associates characteristic. Even if transferability is not present, the associates attribute may result from prior volitional acts of the beneficial owners.

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131. Prop. Treas. Reg. § 301.7701-4(c), 49 Fed. Reg. 18, 743 (1984); *see supra* note 6.

132. *Id.*

133. 296 U.S. 344 (1935).

134. *See supra* notes 9-12 and accompanying text.

Finally, it seems clear that even if the trust's activities do not include the business purpose or associates attributes, the fact that the indenture permits the tainted activity may be sufficient to cause the attribute to be present. Alternatively, a subsequent amendment of the trust instrument may succeed in prospectively cleansing the trust of the business or associates attributes.