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TAXATION - INCOME TAX - A FIXED INVESTMENT TRUST AS A TAXABLE ASSOCIATION

Harry M. Nayer
University of Michigan Law School

TAXATION — INCOME TAX — A FIXED INVESTMENT TRUST AS A TAXABLE ASSOCIATION—Bonds of a prescribed kind were deposited in an investment trust with defendant, who issued certificates representing equal undivided interests in the trust corpus. Additional interests were created by the deposit of eligible bonds and sufficient cash to make up the current value of an interest, and all such bonds and cash were commingled. The depositor was not confined in making up the new units to the same kinds of bonds that were used in the original units, but could vary them in his discretion. The depositor could order the elimination of unsound bonds by sale, and the proceeds of such a sale together with interest and the proceeds from called or matured bonds were to become currently distributable funds and could not be reinvested. The commissioner assessed an income tax deficiency against defendant on the ground that it was taxable as an association. *Held*, the power in the depositor to vary the character of the investment by exercising his discretion in the selection of bonds for additional units constituted business activity and made the trust taxable as an associa-

tion under the Revenue Act of 1934, § 801(a) (2).[1] *Commissioner of Internal Revenue v. North American Bond Trust*, (C. C. A. 2d, 1941) 122 F. (2d) 545 (Chase, J., dissenting).

The Bureau of Internal Revenue has long been concerned with combatting the use of the trust device to escape the more onerous burdens of corporate income taxation. However, the sole provision in the revenue statutes on this subject is the rather laconic statement that "The term 'corporation' includes associations. . . ." [2] Thus the growth of the law in this field has been singularly a product of judicial decision.[3] At present the Supreme Court is committed to the view that the presence of corporate attributes in a trust, i.e., centralized control, continuity of management, limited liability, and the association of persons for the purpose of doing business, constitute it an association. A traditional trust is distinguished from this on the ground that its sole function is to hold and conserve property.[4] While this standard appears to be simple enough, because of the seemingly endless varieties of organizations possible in the trust form and the elusive character of the concept of "doing business," [5] courts have experienced great difficulty in its application.[6] The Treasury Regulations have included investment trusts as associations, whether of the fixed or management type.[7] It is clear that in the management trust, where the trustee plays an active part in buying and selling securities and reinvesting the proceeds and where he has unlimited power to change the character of the investment, there is business activity.[8] The real difficulty arises in the case of the so-called fixed trust, where

[1] 48 Stat. L. 771, § 801(a) (2) (1934), 26 U. S. C. (1934), § 1696, Internal Revenue Code (1939), § 3797.

[2] Id.

[3] At first the Supreme Court indicated that the test for an association was the amount of control the beneficiaries exercised over the trustees. Crocker v. Malley, 249 U. S. 223, 39 S. Ct. 270 (1919).

[4] Hecht v. Malley, 265 U. S. 144, 44 S. Ct. 462 (1923). This view reached its fullest development in Morrissey v. Commissioner of Internal Revenue, 296 U. S. 344, 56 S. Ct. 289 (1935). See also Helvering v. Coleman-Gilbert Associates, 296 U. S. 369, 56 S. Ct. 285 (1935); Swanson v. Commissioner of Internal Revenue, 296 U. S. 362, 56 S. Ct. 283 (1935), decided on the same day as the Morrissey case.

[5] See Ittleson v. Anderson, (C. C. A. 2d, 1933) 67 F. (2d) 323, where the court said that the difference between an investment trust and doing business is one of degree.

[6] See Davidson v. United States, (D. C. Mich. 1938), 4 C. C. H., FEDERAL TAX SERVICE, ¶ 9260 (1939) (not officially reported), for a full statement of the difficulties encountered.

[7] Treas. Reg. 86, art. 801-2 (1935), continued over to the present in Treas. Reg. 103, § 19.3797-2 (1940).

[8] In the following cases trusts of this character were held taxable associations: Hamilton Depositors Corp. v. Nicholas, (C. C. A. 10th, 1940) 111 F. (2d) 385; Investment Trust of Mutual Investment Co., 27 B. T. A. 1322 (1933); Brooklyn Trust Co. v. Commissioner of Internal Revnue, (C. C. A. 2d, 1936) 80 F. (2d) 865; Ittleson v. Anderson, (C. C. A. 2d, 1933) 67 F. (2d) 323. An interesting feature of this case was the fact that the trust was created by the grantor with himself as the sole beneficiary. Despite this, the trust was held taxable as an association. Continental Bank & Trust Co. of New York v. United States, (D. C. N. Y. 1937) 19 F. Supp. 15. See G. C. M. 1881, 7 INT. REV. BULL. 42 (1928).

the activities of the trustee are narrowly limited. The court which decided the instant case, in a decision handed down the same day, refused to tax such a fixed trust, disregarding the administrative interpretation of the statute in the regulations, and distinguishing it from the instant case on the ground that the trustee had no such discretion in the composition of additional units, since he was confined to the same kind of stock as was used in the original units. The trustee's power to eliminate unsound stocks, in itself, was held insufficient to constitute business activity.[9] The result reached in the principal case may be justified if we accept the apparently sound premise that a stream of new investors will continue to afford the trustee ample opportunity to take advantage of the market and change the investment accordingly.[10] Nevertheless, in comparing the instant decision with the *Chase* case, it is felt that income tax liability should not be determined by standards so subjective as to be unsatisfactory in their application.[11]

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[9] Commissioner of Internal Revenue v. Chase Nat. Bank of New York, (C. C. A. 2d, 1941) 122 F. (2d) 540. Judge August Hand vigorously dissented and said that under the Morrisey case as well as under the regulations, an association might include a fixed investment trust even if the trustee did no more than collect and distribute the income. He pointed out that large profits had been realized from the sale of stock of rights and stock dividends, which sales were within the trustee's discretion, and that it was easy for the thousands of certificate holders to sell out their interests and realize these gains.

In New York, the taxation of fixed investment trusts under the corporate franchise tax law, 59 N. Y. Consol. Laws (McKinney, Supp. 1941), art. 9-A, §§ 208(4), 214-b, which is measured by net income and applies broadly to associations and businesses conducted by trustees, will probably give rise to the same difficulties as exist under the federal law. See 1 C. C. H., NEW YORK STATE TAX SERVICE, ¶ 10.109.11 (1940), where the commentator in absence of any decisions says that the taxability of fixed trusts within this language depends upon the presence of power in the trustee to reinvest proceeds coming into his hands from the operation of the trust, or the power to change the character of the investment.

[10] This result would not occur if the trust were of the fixed unit type, where the stocks and bonds are not commingled but each unit is kept separate and intact. In such a case, the change in composition of the new units would have no effect on the older units.

[11] It is ironical that although the court held this trust taxable as an association because of the discretionary powers reposed in the trustee, a recent survey of investment trusts has indicated that this very trust was not a good investment for the average investor, because it was of the fixed type and the supervisory powers of the trustee were too narrowly circumscribed. HARWOOD, INVESTMENT TRUSTS AND FUNDS FROM THE INVESTOR'S POINT OF VIEW 34, 56, 68 (1940).