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Recommended Citation

Colleen J. Doolin, *Determining the Taxable Status of Trusts That Run Businesses*, 70 Cornell L. Rev. 1143 (1985)
Available at: <http://scholarship.law.cornell.edu/clr/vol70/iss6/5>

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NOTES

DETERMINING THE TAXABLE STATUS OF TRUSTS THAT RUN BUSINESSES

Section 7701 of the Internal Revenue Code¹ draws the broad class of organizations called “associations”² within the ambit of the rules for taxing corporations. The Treasury regulations promulgated under section 7701³ and the cases interpreting that section⁴ set forth guidelines establishing when a trust⁵ may qualify as an “association.” Under the Treasury regulations the IRS will not subject a trust that resembles a corporation in form to double corporate taxation unless it meets a two-pronged, functional test.⁶

This Note addresses the policies underlying the taxation of trusts that resemble corporations.⁷ It isolates the grantor’s intent in forming the trust as the dispositive factor in determining whether the trust is taxed as a trust or as an association at corporate rates. It concludes that the regulations set forth sound guidelines for handling the classification question.

An understanding of why a trust can be similar in form to a corporation and still not be taxed as an association requires close

¹ I.R.C. § 7701(a)(3) (1982) states: “The term ‘corporation’ includes associations”

² Treas. Reg. § 301.7701-2 (1960). An “association” describes any “organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust.” See *infra* note 6.

³ Treas. Reg. § 301.7701-1 to -4 (1960).

⁴ See *infra* notes 32-71 and accompanying text.

⁵ In general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

Treas. Reg. § 301.7701-4(a) (1960).

⁶ I.R.C. § 11(a) (1982) imposes a tax on the taxable income of every corporation, and I.R.C. § 7701(a)(3) (1982) includes entities classified as “associations” in its definition of a corporation. Treas. Reg. § 301.7701-1(c) (1960) states: “The term ‘corporation’ is not limited to the artificial entity usually known as a corporation, but includes also . . . a trust classed as an association because of its nature or its activities” The Code treats this type of association, based on its tax status, as a corporation for all purposes. See J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 38A.01 (rev. ed. 1984); J. PESCHEL & E. SPURGEON, *FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES* ¶ 12.05[B] (1978 & Supp. 1983).

⁷ See *infra* notes 72-89 and accompanying text.

scrutiny of the policies underlying the taxation of ordinary trusts.⁸ Ordinary trusts escape the double taxation imposed on corporations⁹ because they represent a form of property distribution which society values and seeks to protect. Because society wants property owners to be able to protect and conserve property for the benefit of others,¹⁰ the rules governing taxation of trusts seek to give effect to the grantor's intent, even if the trust is identical in form to a

⁸ I.R.C. § 641(b) (1982). "The taxable income of [a] . . . trust shall be computed in the same manner as in the case of an individual The tax shall be computed on such taxable income and shall be paid by the fiduciary." I.R.C. subchapter J, subparts A-E, deal with the taxation of trusts.

Trust taxation operates on a "conduit" principle, with the trust, a separate taxable entity, reporting and computing its tax in a manner similar to that of an individual taxpayer. The trustee deducts the amount of income that he distributed to the beneficiary or was required to distribute to the beneficiary, resulting in one-time taxation. *Estate Planning After the Economic Recovery Tax Act of 1981*, TAX MGMT. (BNA) No. 11-9th, at A-21 to -22 (1982). For a detailed discussion of the rules governing taxation of trusts, see *Income Taxation of Trusts and Estates—General*, TAX MGMT. (BNA) No. 406 (Aug. 13, 1979 & Supp. May 14, 1984).

The main differences between the taxation of trusts and the taxation of individuals are (1) that the IRS allows a trust a deduction of either \$100 or \$300 per year in lieu of the personal exemption and dependency deductions allowed under I.R.C. § 642(b) (1982); (2) that instead of the zero bracket amount, trusts must use a separate rate schedule, I.R.C. § 1(e) (1981), under which the first dollar of taxable income is subject to tax; (3) that a trust's deduction for charitable contributions is not subject to the 20-30-50% limits of I.R.C. § 170 (1982), and in certain cases is not restricted to amounts actually paid during the taxable year, but instead is allowed for any amount of gross income which the trust provisions set aside for charitable purposes, I.R.C. § 642(c) (1982); (4) that the trust may deduct the amount of current income taxed to the beneficiaries, I.R.C. §§ 651(a), 661(a) (1982). See B. BITTKER & L. STONE, *FEDERAL INCOME TAXATION* 453 (5th ed. 1980); G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 261 (rev. 2d ed. 1977 & Supp. 1983).

⁹ The IRS taxes corporations on their income at the corporate level and taxes the corporations' shareholders on their dividends. The IRS uses the same tax scheme for trusts adjudged to be "associations" taxable as corporations. G. BOGERT, *supra* note 8, § 247.

¹⁰ Federal policies further this societal value in several ways. First, there are tax advantages in adopting a trust which merely "protect[s] and conserv[es]" property. Treas. Reg. § 301.7701-4(a) (1960). See *supra* note 8. Second, the government leaves the grantor free to structure his trust as he chooses, the trust being one of the most flexible devices in the legal system. One advantage of a trust is that it can "be employed for such purposes and subject to such provisions as the settlor may choose." 1 A. SCOTT, *THE LAW OF TRUSTS* § 59, at 563 (3d ed. 1967). This flexibility is of enormous advantage to a settlor creating a way to care for his family. In discussing the living trust, one commentator said: "The [grantor] may be interested in protecting his wife and children against their inexperience in business matters, or he may feel they are apt to make imprudent expenditures or gifts or may live beyond their means." G. BOGERT, *supra* note 8, § 231. This Note uses the terms "grantor" and "settlor" interchangeably. See BLACK'S LAW DICTIONARY 1231 (5th ed. 1979). The case law does distinguish a settlor as one who "furnishes the consideration for the creation of a trust . . . even though in form the trust is created by another." *Lehman v. Commissioner*, 109 F.2d 99, 100 (2d Cir. 1940) (quoting A. SCOTT, *THE LAW OF TRUSTS* § 156.3, at 785 (3d ed. 1967) (footnote omitted)).

corporation.¹¹

To give greater effect to a grantor's intent, the regulations¹² and the cases interpreting them¹³ have focused on two factors in determining the appropriate method of taxation for a trust that is similar in form to a corporation. First, the trust beneficiaries must be passive recipients of a grantor's good will rather than active participants indistinguishable from associates in a joint venture.¹⁴ Either the grantor or the beneficiaries themselves may establish the trust as long as it provides for the beneficiaries without needless activity on their parts.

Second, the trust must merely "protect and conserve" the trust corpus rather than operate as a profit-making business.¹⁵ The courts regard the literal language of the trust instrument as the primary evidence of a trust's purpose. Any trust that the IRS deems to be an association must have a "business purpose." These two characteristics—associates and business purpose—must be present before a trust will be taxed as an association.¹⁶ Such entities, consisting of people who voluntarily come together to run a business for profit, should be taxed as associations.¹⁷

Part I of this Note briefly discusses the policies underlying taxation of trusts and reviews *Morrissey v. Commissioner*,¹⁸ which first articulated the current tests for determining whether trusts should be taxed as associations. Part II examines in detail the application of the "associates" and "business purpose" tests developed by the courts since *Morrissey*. Part III describes the applicable regulations and demonstrates that although they do not explicitly define "associates" and "business purpose," the regulations imply that the two tests must be applied not independently, but conjunctively. This part then illustrates how improper results can be reached if the two tests are applied independently. Part IV examines the application of the "business purpose" test, and demonstrates that courts sometimes violate fundamental tax principles in finding a "business pur-

¹¹ "It is sometimes said . . . that the intention of the settlor is the law of the trust." I A. SCOTT, *THE LAW OF TRUSTS* § 59, at 563 (3d ed. 1967) (footnote omitted).

¹² Treas. Reg. § 301.7701-4 (1960). See *infra* notes 72-89.

¹³ See *infra* text accompanying notes 90-103.

¹⁴ See *infra* notes 34-47 and text accompanying note 81.

¹⁵ See *infra* notes 48-71 and text accompanying note 82.

¹⁶ "[T]he 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 business and divide the gains therefrom." Treas. Reg. § 301.7701-2(a)(2) (1960). Trusts generally have four additional characteristics common to both trusts and corporations. They are: "(iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests." *Id.* § 301.7701-2(a)(1).

¹⁷ Treas. Reg. § 301.7701-4(b) (1960).

¹⁸ 296 U.S. 344 (1935).

pose.” The Note concludes that the regulations correctly incorporate the two factors, “associates” and “business purpose,” in the test for determining how trusts should be taxed.

1

MORRISSEY AND THE REGULATIONS

The courts and the Commissioner currently use the six characteristics developed by the United States Supreme Court in *Morrissey v. Commissioner*¹⁹ to decide whether a business entity is a trust or an association.²⁰ The six characteristics common to all corporations are associates, business purpose, continuity of life, centralization of management, limited liability, and free transferability of interests. However, only the first two characteristics, associates and business purpose, are generally considered determinative of a trust's taxable status,²¹ as the last four characteristics are generally common to

¹⁹ *Id.* at 359-60.

²⁰ *Morrissey* and three companion cases decided the same day involved distinguishing trusts from associations. *Swanson v. Commissioner*, 296 U.S. 362 (1935); *Helvering v. Combs*, 296 U.S. 365 (1935); *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369 (1935). The Court had made various attempts during the 15 years before *Morrissey* to determine the taxable status of business-associated trusts. The first major case of this type was *Crocker v. Malley*, 249 U.S. 223 (1919). The *Crocker* Court formulated a two-part test for determining a trust's status. Only if the trustees actively managed the business rather than passively collected and distributed the income, and the beneficiaries exerted some control over the trustees, would the trust be taxed as a corporation. *Id.* at 232-33. See also Dean, *Federal Taxation of Trusts as Associations*, 14 TEMP. L.Q. 333, 335 (1940). The corporation in *Crocker* leased mill property and then transferred the leased property to trustees for its stockholders as beneficiaries. The trustees had extensive powers, such as an owner would, and remained free from the beneficiaries' control. The Court concluded that the arrangement was not taxable as an association because trustees normally collect rent, as they did in this case. The Court suggested that the beneficiaries' lack of control over the property precluded the possibility that an "association" existed. 249 U.S. at 233-34. The Commissioner and the courts interpreted this decision as requiring control by the beneficiaries in order to find an association. See Dean, *supra*, at 335-36; Spinney, *Multiple Settlor Trusts: Taxability as Association Re-Examined*, 89 Tr. & Est. 458, 459 (1950).

Five years later, in *Hecht v. Malley*, 265 U.S. 144 (1924), the Court revised the two-part test, replacing the beneficiary-control factor with a determination of whether trustees were acting as directors of a corporation and operating the trust in quasi-corporate form. *Id.* at 161. See Dean, *supra*, at 336. *Hecht* involved a family trust with property consisting of offices and businesses, which the trustees managed. The Court held the trust to be an association because the trustees were doing more than passively collecting and distributing income. They exercised general and exclusive powers of management and could fill vacancies among the trustees, elect other trustees, sell property, and amend the trust instrument. 265 U.S. at 161.

²¹ Recently courts have taken the approach of looking only to associates and business purpose to determine a trust's tax status, as in *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803 (1981); *Outlaw v. United States*, 494 F.2d 1376 (Ct. Cl. 1974); and *National Savings & Trust Co. v. United States*, 285 F. Supp. 325 (D.D.C. 1968). The *Elm Street* court stated: "Not only are [associates and business purpose] essential to any association classification, they are also usually the only ones that are relevant when it becomes necessary to distinguish between a trust and an association." 76 T.C. at 809. *But*

both trusts and corporations.²²

In considering this association-identity problem, the Court ignored mere cosmetic resemblance, such as the use of corporate structure or terminology or the presence or absence of formal "directors" or "officers."²³ If, however, "the 'trustees' . . . function 'in much the same manner as the directors in a corporation' for the purpose of carrying on the enterprise,"²⁴ the Court declared that it would treat the enterprise as a corporation for tax purposes.²⁵ *Morrissey* introduced the idea that even though a trust might appear identical to a corporation, its "nature and purpose" were the determining factors.²⁶ If the intent of the settlors was not to create an "organized community of effort"²⁷ to operate a business, but rather to hold property for the "benefit of named or described persons,"²⁸ the Court would consider the enterprise a trust. Trust owners do not ordinarily "plan a common effort or enter into a combination"²⁹

see Rev. Rul. 258, 1975-2 C.B. 503, 505 ("the determination of whether the [trust] is to be treated for tax purposes as an association depends upon whether it has a *preponderance* (more than two) of the following corporate characteristics: continuity of life, centralized management, free transferability of interests, and limited liability") (citation omitted) (emphasis added).

²² Treas. Reg. § 301.7701-2(a)(2) (1960).

²³ In gauging association status, structural similarity to corporations is a factor, but the *Morrissey* Court emphasized that "it is resemblance and not identity" which the Court considers. 296 U.S. at 357. Similar language is found in *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369, 373 (1935):

If such differences [of formal procedure] were to be made the test in determining whether or not an enterprise for the transaction of business constitutes an association, the subject would be enveloped in a cloud of uncertainty, and enterprises of the same essential character would be placed in different categories simply by reason of formal variations in mere procedural details.

²⁴ 296 U.S. at 358 (quoting *Hecht v. Malley*, 265 U.S. 144, 161 (1924)).

²⁵ The Internal Revenue Code does not define the term "corporation," leaving the task to the Commissioner, the courts, and the commentators. Two prominent scholars have formulated an analogy that should prove amusing as well as useful: "[A] corporation, like a lobster pot, is easy to enter, difficult to live in, and virtually impossible to get out of." B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 2.01, at 2-4 (4th ed. 1979). *See* J. PESCHEL & E. SPURGEON, *supra* note 6, at 12-20.

²⁶ 296 U.S. at 357. The *Morrissey* case involved a trust created to develop real estate and to build and operate a golf course and clubhouse. The trustees had broad powers to buy, sell, lease, and operate the land the trust owned. The trust instrument empowered them to collect income and make investments and loans. The trustees developed and sold some of the trust property, built the golf course, and later conveyed it to a corporation in exchange for stock. The trustees for a time continued to lease and operate the course, but eventually confined their activities to collecting income, selling land, and distributing the proceeds to the beneficiaries. The Court determined that such a venture was an association taxable as a corporation, finding associates and a business purpose.

²⁷ *Id.*

²⁸ *Id.* at 356-57.

²⁹ *Id.* at 357.

to conduct a business; therefore, most trusts will escape double corporate taxation.

In concentrating on the intent of those responsible for the trust rather than on the nature of the trust's business, the focus of judicial scrutiny reflects federal policy in this area. A trust may conduct business in a manner identical to that of a corporation, provided the intent of the trust creators is to care for others and not to create "a medium for the conduct of a business and sharing its gains."³⁰

To ensure the continuation of these policies, the *Morrissey* Court scrutinized the trust to see whether it had associates and a business purpose.³¹ Associates who voluntarily and actively manage their trust for the business purpose of pursuing profit are deemed by the IRS to have an association taxable at corporate rates rather than a trust taxable at trust rates. After *Morrissey*, the courts refined these characteristics on a case-by-case basis as litigants challenged different aspects of their definitions.

II

DEFINING ASSOCIATES AND BUSINESS PURPOSE

Of the six factors enumerated in *Morrissey*, the presence of two—associates and business purpose—are generally determinative of association status.³² This Note discusses only these two major characteristics, presuming the existence of all four of the minor characteristics: continuity of life, centralization of management, limited liability, and free transferability of interests.³³ This part sets forth the tests the courts have used to detect the presence of the two major factors.

³⁰ *Id.*

³¹ *Morrissey* advanced the approach that "trusts that . . . satisfy the primary conception of association and have the [other corporate] attributes [are] . . . sufficiently analogous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as that of corporations." *Id.* at 360. The criteria for determining whether trusts have "associates" or a "business purpose" are clearly stated:

"Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust—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. Such beneficiaries do not ordinarily, and as mere *cestuis que trust*, plan a common effort or enter into a combination for the conduct of a business enterprise.

Id. at 356-57.

³² See *supra* note 21 and accompanying text.

³³ See *supra* text accompanying note 22.

A. Cases Establishing the Definitional Framework

1. *Determining the Presence of Associates*

A court will not characterize an entity as an association absent associates. In deciding whether an entity has associates, a court reviews both the trust instrument and the actions of the beneficiaries or trustee-beneficiaries and determines (1) whether the beneficiaries have voluntarily associated themselves, and (2) whether they have participated actively in operating the trust.³⁴ The presence of either factor qualifies the participants as associates.

The first factor is dispositive because members who associate themselves voluntarily have exerted the concerted volitional activity characteristic of associates.³⁵ Thus, beneficiaries of testamentary trusts usually will not be deemed associates because their beneficiary status has been bestowed on them by another.³⁶

Where the beneficiaries have not voluntarily associated themselves, a court will still look at their degree of participation in the trust's management. Even if the beneficial interest in the trust is merely nominal, any participation beyond collecting the trust's profits will trigger associate status.³⁷ Thus beneficiaries who have no

³⁴ In determining the presence of associates, the tax court has emphasized the beneficiaries' role in creating the trust as well as the extent of their participation in the trust's business activities. *See, e.g., Elm St. Realty Trust v. Commissioner*, 76 T.C. 803, 815 (1981).

³⁵ The *Morrissey* Court concluded that beneficiaries must engage in some concerted volitional activity to be associates and stated that beneficiaries "do not ordinarily . . . plan a common effort or enter into a combination for the conduct of a business enterprise." 296 U.S. at 357.

³⁶ *E.g., United States v. Davidson*, 115 F.2d 799, 800-01 (6th Cir. 1940). *Davidson* involved a testamentary trust that directed the trustee to liquidate the trust and distribute it to the beneficiaries. The court found it significant that the beneficiaries did not voluntarily form or continue the trust. In addition, two of the four beneficiaries were unaware of the trust until more than six months after its creation, and the third beneficiary had consistently objected both to the creation of the trust and to its administration.

³⁷ Although one court considered an interest in the corpus, along with an interest in the profits, to be enough to tip the balance, other courts have not distinguished between these two ownership rights. In *Titus v. United States*, 150 F.2d 508, 511 (10th Cir. 1945), the owner of a corporation issued a tiny fraction of the outstanding shares to family members. He later formed a trust, of which he was sole trustee and manager, and transferred all the shares of the corporation, which later was dissolved, to the trust, keeping the same division of ownership. He tried to avoid taxation of the trust as an association by arguing that there were no associates. The court found associates even though the family members' involvement was limited to an interest in the corpus of the estate and its profits. By contrast, the court in *Commissioner v. Guitar Trust Estate*, 72 F.2d 544, 546-47 (5th Cir. 1934), found no associates in a similar situation. *See infra* note 38.

The *Titus* court probably was influenced by the taxpayer's use of a trust to conduct the same business as a corporation. The court said that "[i]f this arrangement was effective to create a corporation it is difficult to see why it would not constitute an association in the nature of a corporation, all other elements necessary to make such an association being present." 150 F.2d at 511. In its reasoning the court ignored the *Morrissey* direc-

input in controlling their trustee-managed business do not qualify as associates.³⁸ However, if they act in conjunction with the trustee to operate the business, they do qualify as associates.³⁹ Similarly, a business entity may have associates if the beneficiaries control the business through another person acting as a common agent or trustee-manager.⁴⁰ Finally, a sole beneficiary actively operating a trust and its business can be an associate, even though the word "associate" usually connotes one of at least two people.⁴¹

Some courts have imposed associate status on beneficiaries who were not active participants when the trust was established but later became active. For instance, if the beneficiaries did not create their trust, but later became involved in its activities by conducting and expanding a corporation placed in trust, they may be deemed associates.⁴² Accordingly, a Revenue Ruling⁴³ criticized the Tax Board for not designating beneficiaries as associates after the beneficiaries had made sizable contributions to the trust that they had neither

tive that formal resemblance to a corporation does not qualify an entity as an association and failed to analyze the transaction as a whole.

³⁸ In *Guitar Trust Estate*, 72 F.2d at 546, settlors of a trust property reserved to themselves a two-tenths interest in the million-dollar trust. The remaining eight-tenths went to their eight children. The beneficiaries could neither manage the business nor select trustees. The court found the trust's only resemblance to a corporation was its establishment to continue a going business and concluded that this was not unusual.

But see *Cooper v. Commissioner*, 262 F.2d 530, 535 (10th Cir. 1958) (family trust created with express purpose of operating trust properties and not liquidating them deemed an association).

³⁹ *E.g.*, *Berry Bros. Trust v. Commissioner*, 9 T.C. 71, 76 (1947) (where trust instrument gave trustees/beneficiaries authority to "own, control, operate, and manage" until all but one original trustee died, whereupon trust was to be liquidated, court rejected trustees' contentions that trust's "primary and sole purpose . . . [was] to liquidate the corpus at the proper time and to conserve it in the interim").

⁴⁰ *E.g.*, *Kilgallon v. Commissioner*, 96 F.2d 337, 337-38, 340 (7th Cir. 1938) (where landowners conveyed property to trustee-manager, vesting him with broad powers to hold, manage, improve, and dispose of land for benefit of owners and others who became beneficiaries, court described beneficiaries as "promoters of the business venture," and trustee-manager device did not save them from being associates).

⁴¹ The court in *Lombard Trustees, Ltd. v. Commissioner*, 136 F.2d 22, 23 (9th Cir. 1943), interpreting the word "beneficiaries" in the 1936 Treasury regulations as including the singular, ruled that a sole beneficiary served by the organized activities of the trustees was an associate.

⁴² In *Porter Property Trustees, Ltd. v. Commissioner*, 42 B.T.A. 681, 689-91 (1940), a family owning agricultural lands created a trust that took over the corporation which was operating the farm business and designated some of its members as trustees and others as beneficiaries. The court identified the key to characterizations of trusts formed for tax purposes when it noted that "[o]utside the statute's reach lie trusts created to safeguard and conserve the property of widows and infants . . ." *Id.* at 690. Concluding that this family contained no persons meeting that description, the court found that the "parents and children happily associated together . . . in carrying on their farming operations" and were associates. *Id.*

⁴³ Rev. Rul. 534, 1957-2 C.B. 924.

created nor contributed to originally.⁴⁴

The trust instrument cannot transform beneficiaries into associates if they are otherwise passive or prevent them from being associates if they are otherwise active.⁴⁵ The powers granted to the beneficiaries in the trust instrument may be significant, however, in showing intent to actively operate a business association.⁴⁶ Conversely, if beneficiaries unite to conduct business on the basis of implied powers, courts may find associates in the absence of a formal trust declaration.⁴⁷

2. *Determining Business Purpose*

The second major factor the courts consider in determining how a trust should be taxed is whether the trust has a business purpose. Although "every trust involves some business activity,"⁴⁸ a problem arises when the trust engages too extensively in business activity.⁴⁹ Courts examining a trust for the presence of a business purpose focus primarily on the language of the trust instrument and

⁴⁴ In *Living Funded Trust of Harry E. Lyman v. Commissioner*, 36 B.T.A. 161, 166 (1937), *nonacq.* 1957-2 C.B. 8, the grantor conveyed his business in trust to his family for their "maintenance, welfare, comfort and happiness." The court concluded that because the beneficiaries did not establish the trust and could not modify or terminate it, they could not be associates. *Id.* at 167-68. Although the IRS acquiesced to this decision in 1937-2 C.B. 17, it later withdrew its acceptance in 1957-2 C.B. 8, as explained by Rev. Rul. 534, 1957-2 C.B. 924. The later Revenue Ruling reached a point not addressed by the *Lyman* court when it noted that far from being passive, the beneficiaries on six different occasions contributed more than \$100,000 in property to the settlor's original \$65,985. 36 B.T.A. at 164. For a further discussion of the case, see *infra* note 72.

⁴⁵ *E.g.*, *Blum v. Commissioner*, 25 B.T.A. 119, 126 (1932) (trustees and beneficiaries with same interest in trust enterprise were not associates because trustee's duties were confined to collecting and disbursing rent from trust property); *accord* *Monrovia Oil Co. v. Commissioner*, 83 F.2d 417, 418, 420 (9th Cir. 1936) (beneficiaries deemed associates when they contributed assets to pursue business purpose, even though trust instrument specified that beneficiaries were not associates); *see also* *Helvering v. Combs*, 296 U.S. 365, 368 (1935) (Supreme Court imposed association status on oil trust noting that "the fact that the beneficiaries did not exercise control is not determinative").

⁴⁶ *E.g.*, *White v. Hornblower*, 27 F.2d 777, 778 (1st Cir. 1928) (where trustees had power to modify provisions of liquidating trust upon agreement by majority of certificate holders, court concluded that beneficiaries' control over the trust was not determining factor and allowed entity's status as liquidating trust).

⁴⁷ *E.g.*, *Thrash Lease Trust v. Commissioner*, 99 F.2d 925, 927-28 (5th Cir. 1938) (where oil lease assigned in trust but formal trust instrument never drawn up, percentage holders were associates united to carry on business). The court in *Thrash Lease* failed, however, to explain its characterization of the percentage holders as being "united" without a trust agreement, given that they had different degrees of interest in the lease.

⁴⁸ *Walker v. United States*, 194 F. Supp. 522, 527 (D. Mass. 1961) (trust whose primary purpose was orderly liquidation of trust estate not taxable as corporation).

⁴⁹ *Morrissey*, 296 U.S. at 356. "'Association' implies . . . entering into a joint enterprise . . . for the transaction of business." *Id.*

only rarely need to examine the trust's actual activities.⁵⁰ The Supreme Court established this approach in the 1935 case, *Helvering v. Coleman-Gilbert Associates*.⁵¹ The Court's rationale was that the level of activity authorized by the trust instrument retains its vitality no matter how long the powers lie dormant. For example, the trust instrument in *Morrissey* authorized the trustees to conduct business, and the Court found a business purpose even though the trustees had engaged in no business during the taxable year.⁵²

Courts accord great weight to the wording of the trust instrument and sometimes find a business purpose where its existence actually is quite tenuous. In one case,⁵³ a trust divested from its business operations by selling its real property, but retained the right to foreclose on and reacquire the property. After the transaction, the trustee failed to amend the trust instrument to reflect the reduction in his powers.⁵⁴ The court subsequently found a business purpose, reasoning that the trustee could regain control of the property and exercise the power authorized in the trust instrument to operate the trust as a business again.⁵⁵

The parties cannot deny the plain language of the trust instru-

⁵⁰ *Fletcher v. Clark*, 150 F.2d 239, 240-41 (10th Cir. 1945). The trustees in *Fletcher* had extensive powers to operate or develop six Wyoming mines owned by 18 beneficiaries. Although the trustees could execute deeds, leases, contracts, or other instruments at their discretion, the trust never owned mining equipment or operated a mine. The court cited *Morrissey* in rejecting the beneficiaries' contention that the test for business purpose is whether the enterprise actually operated, not the scope of authority permitted. The court concluded that the business purpose is found in the trust declaration, and it is irrelevant whether the trustees actually exercise the declared powers.

⁵¹ 296 U.S. 365, 369 (1935). The blueprint for this rule was set forth in *Coleman-Gilbert*:

We agree with the Circuit Court of Appeals 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. Not only were they actually engaged, as the Board of Tax Appeals determined, in carrying on an extensive business for profit, but the terms of the trust instrument authorized a wide range of activities in the purchase, improvement and sale of properties in the cities and towns of the state. The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted.

Id. at 373-74.

⁵² In *Morrissey*, 296 U.S. at 361, the Court found that although the business transactions in question had occurred prior to the years in question, the trust instrument still determined the entity's status. "[I]t was still an organization for profit, and the profits were still coming in." See also, e.g., *Reynolds v. Hill*, 184 F.2d 294, 296-97 (8th Cir. 1950) (trust liable for taxes because it was carrying on business even though it was more than 40 years after trust agreement).

⁵³ *Henry G. Mesier*, 15 T.C.M. (P-H) ¶ 46,099, at 46-303 (1946).

⁵⁴ *Id.* at 46-305.

⁵⁵ *Id.* See also *Sloan v. Commissioner*, 63 F.2d 666, 667-69 (9th Cir. 1933) (trust organized for subdividing property and collecting proceeds taxable as business even though all lots were sold and trust only collected installment payments).

ment. If the trust instrument expansively describes certain trustee powers, the parties cannot claim that their purpose was narrower than the boundaries of their permissible powers.⁵⁶ The courts also accept the plain language of the trust instrument, such as the stated intent to liquidate a business, as proof that a trust transacting business has no business purpose. In this type of situation, the courts may allow the trust to transact a substantial amount of business and even make a profit without concluding that the trust has a business purpose.⁵⁷

Courts examine the trust instrument closely to resolve ambiguity or lack of stated purpose. If the trust instrument has no express purpose, courts may infer the purpose from the nature of the trustees' powers. Trustees cannot avoid a court's finding of business purpose by claiming their trust has a liquidation purpose if such purpose is not stated in the instrument and the trustees have extensive powers to run a business.⁵⁸ Even though a trust's unstated purpose is consistent with mere preservation and conservation of property, powers broad enough to allow the trustees to engage in business may constitute a business purpose.⁵⁹

⁵⁶ See *Commissioner v. Security-First Nat'l Bank*, 148 F.2d 937, 938-39 (9th Cir. 1945) ("The character of the organization as to whether or not it is a 'business trust,' is determined by what the instruments creating the trust empowered the trustee to perform, and not by what powers the trustee actually exercised."); *Phillip Bordages Estate Trust v. Commissioner*, 159 F.2d 62, 62 (5th Cir. 1947) (family trust of real property and oil and mineral leases usually found to have business purpose when trustees empowered to conduct any business on behalf of the trust). But see *Commissioner v. Gibbs-Preyer Trusts*, 117 F.2d 619, 622-23 (6th Cir. 1941) ("The crucial test in determining whether a trust is an association, taxable as a corporation, must be found in what the trustees actually do and not in the existence of long unused powers. . . . [W]e must look to the actual activities of the entity rather than to its form or possible powers." (citations omitted)). See also *T. PESCHEL & E. SPURGEON*, *supra* note 6, at 12-22.

⁵⁷ See, e.g., *Trustees for the Creditors and Stockholders of Gonzolus Creek Oil Co. (Dissolved) v. Commissioner*, 12 B.T.A. 310, 318-21 (1928). This trust consisted of the assets of the dissolved Gonzolus Creek Oil Company which the trustees tried to sell. The Internal Revenue Bureau held that the dissolved company, whose activities apparently fell within applicable state law, had been a "bona fide trust" in 1923. *Id.* at 317. See also *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 44-46 (5th Cir. 1930). A widow organized a trust of her million-dollar Dallas property and ranchland for herself and her five daughters. She directed the trustees to sell the property and distribute the proceeds as quickly as possible, but empowered them to administer the property in the meantime. The trustees engaged in business operations for more than a decade. The *Blair* court characterized these activities as "slight business activities . . . conducted . . . in furtherance of the ultimate purpose of liquidation and distribution." *Id.* at 46. The court reasoned that the trust could not be considered to be doing business since ultimately it was to be liquidated. For a further discussion of the case, see *infra* note 72.

⁵⁸ E.g., *Williams Trust v. Commissioner*, 39 B.T.A. 612, 624-25 (1939) (where beneficiaries of real estate trust sought speedy liquidation of property but trust instrument did not specify purpose, court looked at trustees' extensive powers and found intent to engage in business activities for profit).

⁵⁹ E.g., *Estate of Cortlandt Parker*, 12 T.C.M. (P-H) ¶ 43,415 (1943) (where trust's purpose was to hold and conserve property and trustees' powers were not inconsistent

Courts also may disregard a stated purpose in the trust instrument if it seems inconsistent with the general tenor of the instrument. Favorable tax status will not follow from simply including a single sentence or phrase that rings contrary to a business purpose in the trust instrument. For example, where one clause in a trust instrument provides for liquidation, but the instrument gives the trustees extensive power to run a business, that one clause will not deter a court from finding a business purpose.⁶⁰ Further, if the powers of the trustees are so extensive that the trust obviously will operate with a business purpose, the courts will disregard even a stated liquidation purpose.⁶¹

Finally, a trust's function sometimes is obscured by a forest of technical arrangements in the instrument. In such cases, courts will look at the organizational structure, the activities conducted, and the organizers' purpose as stated in the trust instrument to determine business purpose. For example, trustees may try to prevent their trust from qualifying as an association by voluntarily relinquishing some of their powers of management and operation, but unless they amend the trust instrument to eliminate these powers, the trust will have a business purpose.⁶²

with holding property for this purpose, but were also broad enough to allow trustees to engage in a business, court held trust taxable as corporation).

⁶⁰ *E.g.*, Grange Trust, 14 T.C.M. (P-H) ¶ 45,136 (1945). The trustees had the power to sell property at their discretion, lease it, build on or develop it to produce more income, and buy and develop adjacent property. The trust was to be liquidated 21 years after "the death of the survivor of the presently existing issue of [one of the testators]." *Id.* at 45-455. The court said an uncertain future liquidation date did not change the present character of the organization, which was running a business for profit. *Id.* at 45-461. *But cf.* Blair v. Wilson Syndicate Trust, 39 F.2d 43 (5th Cir. 1930) (discussed *supra* note 57, *infra* note 72).

⁶¹ *E.g.*, United States v. Hill, 142 F.2d 622, 623 (10th Cir. 1944). Four individuals dissolved their partnership in a paper manufacturing company, then incorporated it. They transferred the operating assets to the corporation and the remaining assets, consisting of stocks and bonds, to the trust. The trust agreement stated the purpose of the trust as providing for the liquidation and ultimate distribution of assets not transferred to the corporation. However, the trustees bought and sold securities for profit, employed the services of investment experts, loaned money to the corporation, endorsed notes, and transferred trust assets to the corporation. The court was unimpressed by the purported distinction between the trust-run assets and those controlled by the corporation: "[A] careful analysis of the entire instrument establishes beyond a doubt that [liquidating and distributing assets] was not its real purpose. . . . [The purpose was] to hold and employ this property for the benefit of the corporation and during such period operate and manage it for profit and gain." *Id.*

⁶² *See, e.g.*, Fidelity-Bankers Trust Co. v. Helvering, 113 F.2d 14 (D.C. Cir. 1940). Although the court admitted the difficulty of unraveling some of the complex arrangements made by the trust, it found a business purpose with little trouble. The court said: "[W]hen men reach out for legal advantages by technical arrangements which confuse not only functions but forms, and are not consistent with their real objectives, or if so, those objectives are conflicting, only confusion can result for them and, unfortunately, too often for the law." *Id.* at 18. The court paid particular attention to the trust instru-

Although the courts focus primarily on the trust instrument to determine business purpose, the instrument alone is not always decisive. The trust's activities may reveal its purpose where the instrument is silent or where the purpose is "hidden."⁶³ Furthermore, courts may look to potential activities, as well as existing activities, to determine the purpose of a trust.⁶⁴

B. Cases Decided After Promulgation of the Regulations

The Internal Revenue Service adopted regulations⁶⁵ in 1960 that incorporated the *Morrissey* characteristics⁶⁶ and provided further explanation for classifying trusts as associations.⁶⁷ The few cases interpreting the regulations have adhered to well-established precedent in scrutinizing trusts for evidence of corporate characteristics. As in the pre-regulation cases, voluntary members of a trust⁶⁸

ment: "The modifying features [of the trust] cannot be given the effect of obliterating the fundamental structural organization and function without doing violence to the instrument of creation, expertly drawn and executed by men of great business experience and capacity, and to their expressed intentions carried out in their conduct." *Id.* at 22. See also *Commissioner v. Nebo Oil Co. Trust*, 126 F.2d 148 (10th Cir. 1942). After a period of actively running the trust, the trustee twice amended the trust instrument to limit his powers. The court held that even after the powers were limited, the trustee was not reduced to a mere "collection and disbursement agent," as he had retained essential powers of management to operate the leases. *Id.* at 150. But see *Michigan Ave. Syndicate*, 8 B.T.A.M. (P-H) ¶ 45,238 (1939). The trust in this case owned a piece of land in Chicago with an eight-story store and office building. The trustee had extensive management powers. The land, however, was leased for 99 years to Woolworth's, and after the company assumed its lease and took over the property in 1928, the trustees' powers dwindled. Ten years later, the trustees adopted a resolution striking out the old trust agreement and substituting more limited powers. The court said that if the features resembling a corporation were effectively removed from the instrument, no justification for taxing it as a corporation existed.

⁶³ See *supra* note 62. The *Fidelity-Bankers* court considered instances where the language in the instrument was not determinative of the trust's purpose, necessitating an examination of the participants' activities to discover the trust's purpose. 113 F.2d at 20-21. See also *Nee v. Main St. Bank*, 174 F.2d 425 (8th Cir. 1949). The *Nee* court stated that even when the trust instrument did not specify an enterprise purpose, the setting and circumstances surrounding its creation may indicate that its objective was to operate a business. Further, if the beneficiaries actually allow the trust to carry on an actual enterprise, business purpose should be found. *Id.* at 429.

⁶⁴ See *Nee*, 174 F.2d at 431. The court noted that although the trust language "hold, manage, lease and handle said property" had not per se transcended an ordinary trust, in "[t]hese circumstances and this setting" the land was potentially so promising for oil that the trust "rose to the height of providing an instrumentality to permit and facilitate exploitation of the property for profit." *Id.* The court concluded the trust doubtless was created to take advantage of this business property.

⁶⁵ Treas. Reg. § 301.7701-1 to -4 (1960).

⁶⁶ See *supra* text accompanying notes 19-20.

⁶⁷ See generally Treas. Reg. § 301.7701-1 to -4 (1960).

⁶⁸ See, e.g., *Outlaw v. United States*, 494 F.2d 1376, 1380 (Ct. Cl. 1974) (multiple beneficiaries who voluntarily join venture, such as by funding it, may be associates); *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803, 818 (1981) (holding that where beneficiaries neither participated in trust's creation nor affirmatively joined enterprise, some

and those who are actively involved in the trust's activities may be associates.⁶⁹ Courts will find a business purpose through the trustees' powers granted in the trust instrument⁷⁰ as well as the activities conducted by those with a beneficial interest in the trust.⁷¹

III

THE REGULATIONS

The regulations addressing classification of an organization for tax purposes stress the importance of the associates and business purpose tests in determining whether a trust will be taxed as a corporation.⁷² Of the six characteristics discussed in *Morrissey*, four

further voluntary activity by them would be necessary to satisfy associates requirement); Rev. Rul. 258, 1975-2 C.B. 503, 504 (persons who accept shares of beneficial interest in business enterprise may be associates).

⁶⁹ See, e.g., *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803, 818 (1981) (beneficiaries whose involvement in trust's activities was limited by conditions attached to exercise of their powers, such as concurrence by other beneficiaries or trustee, could not effect an "unfettered, significant influence" on trust and were not associates); *Hynes v. Commissioner*, 74 T.C. 1266, 1280 (1980) (sole owner of all beneficial interests in trust who actively controlled it and its profits as a trustee was an associate).

⁷⁰ The Sixth Circuit has adhered strictly to the regulations and the Internal Revenue Code mandate to examine the exact wording of the trust instrument in finding a business purpose:

While we recognize that in some sense this seems to elevate form over substance, the problems with any other interpretation of the revenue code and regulations are substantial ones The determination of what is or is not an "association" for purposes of section 7701 must be made in accordance with the declared intentions of the persons setting up the trust in the trust instrument

Abraham v. United States, 406 F.2d 1259, 1264 (6th Cir. 1969). See also, e.g., *Rohman v. United States*, 275 F.2d 120, 123-25 (9th Cir. 1960) (trust instrument "in its entirety" conclusive in establishing a business purpose for trust even though trust instrument limited trustee's powers and provided disbursement of proceeds of property sale, and even though the beneficiaries actively managed and leased property and negotiated sales, while holding property for 50 years); Rev. Rul. 258, 1975-2 C.B. 503, 504 ("Whether an organization has a business purpose is determined by the instrument creating it.").

⁷¹ See, e.g., *Outlaw v. United States*, 494 F.2d 1376, 1382 (Ct. Cl. 1974) (regardless of what powers are in trust instrument "it is proper to consider whether or not the venture actually engaged in business activities").

⁷² In the years before the Commissioner promulgated the regulations, courts had a tendency to apply the "associates" and "business purpose" tests loosely in order to give favorable treatment to trusts that had widows and infants as beneficiaries. In each of the cases discussed below, however, the beneficiaries were heavily involved in substantial profit-making activity. Since the promulgation of the regulations, however, no case has followed this approach, indicating that courts are no longer willing to side-step the associates and business purpose tests. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43 (5th Cir. 1930) (facts set forth *supra* note 57) was a case in which the trust deed authorized the beneficiaries to remove the trustees at will, with or without cause, and fill the vacancies. The beneficiaries also had the power to amend the trust deed and to terminate the trust at any time and receive their undivided interests in the trust property. The court did not find associates or a business purpose despite the trustees' extensive business activities and the beneficiaries' control over the trustees as well as their ability to control the trust.

Living Funded Trust of Harry E. Lyman v. Commissioner, 36 B.T.A. 161 (1937),

(continuity of life, centralization of management, free transferability of interests, and limited liability) are common to trusts and corporations and are not material in distinguishing between the two entities.⁷³ A trust will only be deemed an association if it has *both* associates and a business purpose.⁷⁴

Although the regulations explicitly define the four minor characteristics, they do not define the two major ones.⁷⁵ Instead of defining associates and business purpose, the regulations merely present illustrations of when a trust will be taxed as an association and when it will be taxed as a trust. These illustrations implicitly draw on the case law definitions of associates and business purpose.⁷⁶ A possible explanation for the different treatment is that the IRS hesitated to stifle the desires of property owners in selecting a method for disposing of their property. In an ordinary grantor trust, the property owner creates an arrangement to protect and

discussed *supra* note 44, involved a beneficiary group of children and grandchildren. In this case the grantor left to his children and grandchildren his rental real estate and other businesses for their "maintenance, welfare, comfort and happiness." *Id.* at 166. The trust instrument empowered the trustees to "operate any business or interest in business" with the full powers of an owner, and they exercised these powers. *Id.* at 162. Although the court recognized that the beneficiaries did not set up the trust, it ignored the fact that they subsequently operated it and contributed more than \$100,000 to it. The extensive powers granted the trustees to operate these going concerns and the subsequent active contributions by the beneficiaries should have caused the court to find both business purpose and associates, but the court denied association status, emphasizing that it was a family trust for the grantor's offspring.

Magoon Trust Estate, 11 B.T.A.M. (P-H) ¶ 42,406 (1942), involved a trust created by a widow for herself and her children. Where the trustee-beneficiaries extensively operated the trust businesses, with the beneficiaries transferring and conveying various properties to each other and to the trust, the court attempted to justify its failure to find associates and business purpose by saying that the trustee-beneficiaries' control and management of the properties was not "exclusive" in that they needed the consent of the widow-grantor in writing. *Id.* at 42-1012. The court simply ignored the trustees' extensive powers and control over the trust and the beneficiaries' subsequent activities with regard to the trust property. The court justified its failure to find these two characteristics at some length, saying the widow wanted to "secure intact to her children the principal of their father's estate." *Id.*

⁷³ "Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association [C]entralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations" Treas. Reg. § 301.7701-2(a)(2) (1960).

⁷⁴ The regulations discuss the necessity of having both associates and a business purpose in the context of co-owners developing their property for their separate benefit: "Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit . . . , the *absence of either of these essential characteristics* will cause [the co-owner's arrangement] not to be classified as an association." *Id.* (emphasis added).

⁷⁵ Continuity of life, centralization of management, limited liability, and free transferability of interests are defined, respectively, in Treas. Reg. § 301.7701-2(b) to (e) (1960).

⁷⁶ Treas. Reg. § 301.7701-2(a)(1) (1960); Treas. Reg. § 301.7701-4(a) & (b) (1960). See *supra* notes 32-71 and accompanying text.

conserve property for his own benefit or for the benefit of other persons.⁷⁷ The trust arrangement, a voluntary disposition of property, can assume a variety of forms, depending on the grantor's intent.

Partnerships, on the other hand, are expressly created to jointly carry on a financial venture,⁷⁸ a purpose analogous to that of a corporation. A partnership is a way for two or more people to combine their property or knowledge to "carry on a trade, business, financial operation, or venture and divide the profits thereof."⁷⁹ Possibly because of these differences, the IRS chose to leave the determinative factors for trusts to the discretion of the courts but retain strict definition of partnerships.

The regulations specifically defining whether an organization should be considered a trust distinguish between "ordinary" trusts and "business" trusts. The regulations require that only business trusts be taxed as associations.⁸⁰

An "ordinary" trust, according to the regulations, is an arrangement through which trustees protect and conserve property

⁷⁷ Treas. Reg. § 301.7701-4(a) (1960).

⁷⁸ "[T]he term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on . . ." Treas. Reg. § 301.7701-3(a) (1960).

⁷⁹ *Id.*

⁸⁰ A business entity which is established as a trust may possess characteristics that resemble a corporation in structure and function. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.03 (4th ed. 1979). Because certain attributes are common to trusts and corporations, it is necessary to search for criteria to distinguish an ordinary trust from one that resembles a corporation closely enough to be taxed as one. See *supra* note 23 and accompanying text.

As indicated in the Introduction, this Note deals only with the taxation of an ordinary trust which resembles a corporation. See *supra* text accompanying note 7. It does not address the taxation of the traditional "Massachusetts" or "business" trust. The business trust, which is taxed as an association, is defined in Treas. Reg. § 301.7701-4(b) (1960):

There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through a corporation. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if, applying the principles set forth in Sections 301.7701-2 and 301.7701-3, the organization more nearly resembles an association or a partnership than a trust.

Id. For an excellent discussion of the taxation problems attendant to business trusts, see G. BOGERT, *supra* note 6, § 247; Barrett & DeValpine, *Taxation of Business Trusts and Other Unincorporated Massachusetts Entities with Transferable Shares*, 40 B.U.L. REV. 329 (1960).

for the benefit of the trust's beneficiaries. The beneficiaries usually do not participate in planning or creating the trust instrument. This arrangement would not be taxed as an association; the trust has neither associates nor a business purpose.⁸¹ The trust has no associates because the beneficiaries are not involved in the trust management. Similarly, the trust has no business purpose because the trustees only protect and conserve property rather than use it to carry on a business.

The regulations also place a trust that has associates but no business purpose within the ambit of the "ordinary" trust classification. The regulations note that even if the beneficiaries are the creators of the trust, the trust will not be considered an association if the trustees only protect and conserve property. The beneficiaries generally are considered associates because of their active involvement in the trust's creation, but the absence of a business purpose saves the trust from association status.⁸²

The regulations contrast the ordinary trust with the business trust, which is "generally . . . created by the beneficiaries simply as a device to carry on a profit-making business."⁸³ This entity, which has associates because the beneficiaries created it, and a business purpose because of its profit-making orientation, will be taxed as a corporation.⁸⁴

Thus the regulations delineate three different situations: an entity with neither associates nor a business purpose, an entity with associates but without a business purpose, and an entity with associates and a business purpose. The first two will be taxed as trusts,⁸⁵ while the third will be taxed as an association.⁸⁶ Given this matrix of interaction between the associates and business purpose tests, the question arises as to how an entity without associates but with a business purpose would be taxed. Such an entity exists where the beneficiaries did not create the trust but the trustees were conducting a business. Although the regulations do not expressly describe such a situation, they clearly establish that the absence of either of the two major characteristics prevents association status. The entity, therefore, would be taxed as a trust.⁸⁷

The absence in the regulations of a specific definition of associates and business purpose is significant because it gives the courts

⁸¹ Treas. Reg. § 301.7701-4(a) (1960).

⁸² *Id.*

⁸³ *Id.* § 301.7701-4(b).

⁸⁴ *Id.* § 301.7701-4(a).

⁸⁵ *Id.* § 301.7701-2(a)(2).

⁸⁶ *Id.*

⁸⁷ The regulations cover this situation with the broad requirement that associations have both associates and a business purpose. *Id.*

greater discretion. The regulations simply describe how the two factors affect the entity's status. This approach highlights the relatedness of the two factors. It encourages courts to examine the trust as a whole rather than to apply the associates and business purpose tests separately without considering how the tests interrelate.⁸⁸

An example illustrates the danger of applying each test woodenly to determine whether the trust is an association. Suppose a woman creates a trust consisting of an entity which has a stated business purpose, a grocery store which she owns and has been managing. The sole beneficiaries are the woman's two children. A third-party trustee now manages the store. At the time the woman creates the trust, it would not be considered an association because the two children are not involved in the creation or management of the trust. Suppose that after a few years the two children become employees of the store, but their jobs consist of carrying out bags for customers. Should the trust now be considered an association? Wooden application of the association principles would say "yes" because the children are now associates, voluntarily and actively participating in the trust's activity. Looking at the trust as a whole, however, the trust should not be considered an association. Although the beneficiaries are active, their participation is unrelated to the trust's management. They are not involved in a profit-making business to the degree that a store manager or trustee is. Their activities as bag-carriers are actually unrelated to the business purpose of the trust. If the beneficiaries begin managing the store or expanding the business, however, they would be acting to further the trust's business purpose and only at this point should they be associates. A focus on how the beneficiaries' activities relate to the trust's business purpose will result in more accurate determinations of a trust's status and give greater effect to the grantor's intent.⁸⁹

⁸⁸ *Id.* § 301.7701-4(a). The regulations take a flexible but integrated approach in describing situations in which associates or business purpose are present, stressing the importance of the grantor's intent as expressed in the trust instrument, and determining whether the trust is an association.

⁸⁹ The recent tax court case of *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803 (1981), involved a trust owning a tract of rental property. The court correctly determined that the beneficiaries, who had no control over the trust, were not associates. Under this analysis, however, if they had performed any nominal activity connected with the property, such as maintenance work, they would have been considered associates. *Contra*, *Living Funded Trust of Harry E. Lyman v. Commissioner*, 36 B.T.A. 161 (1937), where the beneficiaries contributed extensive property to the trust, yet the court held that they were not associates. Because their activities were closely associated with the business purpose of the trust, however, the beneficiaries should have been associates. See *supra* notes 44, 72 for an extended discussion of the case.

IV THE TRUST INSTRUMENT

In evaluating whether a trust should be taxed as an association, courts should not only apply the associates and business purpose tests conjunctively. They should also avoid automatically relying on the language of the trust instrument in determining whether the trust has a business purpose. Certainly, deriving business purpose from the trust instrument furthers the policy of giving effect to the grantor's intent, which often is properly determinative of how the trust should be taxed. An unvarying adherence to this policy, however, will occasionally conflict with the fairness policy of the tax laws that similarly situated entities should be taxed similarly.⁹⁰

Rigid application of the business purpose test based on the grantor's stated intent in the trust instrument will work inequity in cases where a trust with a stated business purpose has in fact never run a business. If the courts focus mechanically on the trust instrument, two trusts that do not run businesses may be taxed differently, simply because of a difference in the wording of the trust instruments. In order to advance the sound policy that similar entities should be taxed similarly, the courts should evaluate trusts realistically to discern their status as taxable entities instead of relying strictly on the wording of the trust instruments.

The explanation in Part II of how courts derive business purpose provides the necessary background for an examination of the undue expansion of the business purpose test undertaken by the courts. The rule that courts must rely on the wording of the trust instrument was established in *Helvering v. Coleman-Gilbert Associates*.⁹¹ In *Coleman-Gilbert*, a trust was created to own and operate apartment houses valued at \$3 million and producing approximately \$420,000 in gross annual rental income. The Court found a business purpose

⁹⁰ Article I, § 8 of the United States Constitution provides for equal distribution of taxes, recognizing Congress's power to collect taxes and the uniformity of duties, imposts, and excises throughout the country. This uniformity is generally considered to be geographical uniformity.

The concept of fairness in taxing similarly situated entities similarly was expressed in the Supreme Court's opinion in *Head Money Cases*, 112 U.S. 580, 594 (1884): "[A] tax is uniform when it operates with the same force and effect in every place where the subject of it is found." Congress has the power to define the class of objects to be taxed, provided that the tax applies wherever the classification is found. *United States v. Ptasynski*, 462 U.S. 74, 82 (1983). One commentator has listed as a primary function of constructing, interpreting, and administering a tax law that "[f]air distribution of the burdens of government expenditures . . . must be the objective of any acceptable taxing system." He explained that "[f]air distribution of burdens is frequently called *tax equity*. *Horizontal equity* is imposing similar burdens on people in like circumstances . . ." W. ANDREWS, *BASIC FEDERAL INCOME TAXATION* 4 (2d ed. 1979) (emphasis in original).

⁹¹ 296 U.S. 369 (1935).

on these facts alone. The Court correctly rejected the lower court's finding that no business purpose existed because the trust did not use formal business procedures, such as having meetings of the beneficiaries, keeping records of the trust's activities, and using a majority vote to authorize action by the trustees. However, the Court went too far in its opinion and added unnecessary dicta to a clear holding. After deciding that "[n]ot only were [the trustees] actually . . . carrying on an extensive business for profit, but the terms of the trust instrument authorized a wide range of activities,"⁹² the Court added, "The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted."⁹³ Lower courts have adopted this dicta and used it as a license to ignore the trust's actual activities and to focus only on the language of the trust instrument.

Morrissey v. Commissioner,⁹⁴ decided the same day, involved a trust that had actively conducted a business but had exchanged its assets for stock of a corporation. It then leased back its former property and continued the business for a short time. The trustees' activities for the years in question consisted of collecting income and distributing the profits to the beneficiaries. The Court said the trust instrument determined the entity's character. "It was . . . still an organization for profit, and the profits were still coming in. The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized."⁹⁵

In cases such as *Coleman-Gilbert*, where the trust was operating an active business, and *Morrissey*, where the beneficiaries were collecting profits from the former business, the trust instrument's wording is a legitimate aid to deciding how to tax the entity. Nevertheless, this formalistic application of the trust instrument to a trust that has never conducted business does not further the policy that similar entities be taxed in a similar manner.

Later cases demonstrate the inequities that can result from this approach. In *Fletcher v. Clark*⁹⁶ a trust was established that gave the trustees full power to conduct a mining operation in Wyoming. The trustees never operated the mine, however, confining their activities to minor maintenance before selling the property. The court rejected the trustees' contentions that their actual activities should be considered instead of the scope of authority granted to them in the

⁹² *Id.* at 373-74.

⁹³ *Id.* at 374; see *supra* notes 50-57 and accompanying text.

⁹⁴ 296 U.S. 344 (1935).

⁹⁵ *Id.* at 361.

⁹⁶ 150 F.2d 239 (10th Cir.), *cert. denied*, 326 U.S. 763 (1945); see *supra* note 50.

instrument. The court did not analyze the circumstances of the trust. Instead it applied the wooden rule that "the character of an organization in respect to being formed for the promotion of business purposes must be determined by reference to the terms of the declaration of trust."⁹⁷ Although this trust had never conducted a business and could not be distinguished from a trust that was not authorized to operate a business, the court's approach resulted in taxing the two differently. To say that the trust instrument could have been amended does not redress the problem. If a trust does not carry on any business activities, to insist that the trust instrument conform to every new purpose elevates form over substance, the very danger warned against in *Coleman-Gilbert*.⁹⁸

A recent tax court case, *Elm Street Realty Trust v. Commissioner*,⁹⁹ addressed the same situation. The trust in *Elm Street* consisted of rental property conveyed to a trustee. The grantors of the trust divested themselves of any association with the trust, giving it to family members as beneficiaries. The trustee, who drafted the trust instrument, gave himself wide powers in order to deal with any unforeseen circumstances but did not grant himself the power to operate a business.¹⁰⁰ He was a professional trustee and served as trustee or co-trustee of approximately twenty other trusts in addition to the Elm Street trust. The tax court adhered to the rule that the trust instrument is determinative of the trust's status. The court admitted that "it seems reasonably clear that neither the original nor the subsequent beneficiaries ever intended that the trust would engage generally in the operation of a business. Nor can it be said that a business was ever actually conducted."¹⁰¹ The court then applied the rule that "the form of petitioner's governing instrument indicates that petitioner had the potential to operate a business. . . . The presence of such powers, regardless of their exercise, require [sic] a finding of a business objective."¹⁰² Thus, the court deliberately ignored the obvious lack of any business activity and concluded from the wording of the trust instrument that the trust had a business purpose.

The courts have decided that the trust instrument alone cannot

⁹⁷ *Id.* at 241.

⁹⁸ 296 U.S. at 373.

⁹⁹ 76 T.C. 803 (1981).

¹⁰⁰ *Id.* at 808, 810.

¹⁰¹ *Id.* at 810. The court went on, however, to determine that although the trust possessed a business purpose, the beneficiaries were not associates within the meaning of the regulations, and the trust, therefore, was not classified as an association. *Id.* at 818.

¹⁰² *Id.* at 810-11.

transform beneficiaries who are otherwise passive into associates.¹⁰³ It is inconsistent, therefore, to use the same trust instrument to transform a trust that is otherwise passive into an association with a business purpose.

CONCLUSION

The regulations correctly defer to the grantor's intent in specifying how trusts that resemble corporations should be classified and taxed. If the grantor intends to use the trust to protect and conserve property for designated beneficiaries, the courts generally will classify the entity as a trust, even though it is almost identical in form to a corporation. The regulations set forth the associates and business purpose tests to determine the status of the entities, implicitly incorporating well-settled case law to define each characteristic. In applying these tests, courts should carefully consider the circumstances of each case to prevent inequitable taxation. Formalistic application could cause a trust that has never run a business to be classified as an association and taxed as a corporation. In such cases, the specification of a business purpose in the trust instrument should be overridden by the settled tax policy of taxing similarly situated taxpayers similarly. Courts adopting such an approach will simultaneously advance the accepted social policy of giving effect to the grantor's intent and avoid inequitable application of the tax laws.

Colleen J. Doolin

¹⁰³ See *supra* notes 45-47 and accompanying text.