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## Forgotten Trust: A Check-the-Box Achilles' Heel

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*The classification question “is a practical one, dependent upon experience. The demand for symmetry ignores the specific difference that experience is supposed to have shown to mark the class. It is not enough to invalidate the law that others may do the same thing and go unpunished, if, as a matter of fact, it is found that the danger is characteristic of the class named.”<sup>1</sup>*

### I. INTRODUCTION

The 1997 “check-the-box” Regulations<sup>2</sup> replaced the 1960 *Kintner*<sup>3</sup> corporate resemblance tests,<sup>4</sup> substituting simplicity and certainty for complexity and uncertainty regarding the federal tax classification of unincorporated business entities.<sup>5</sup> The check-the-box Regulations have

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1. Justice Oliver Wendell Holmes, *Pastone v. Pennsylvania*, 232 U.S. 138, 144 (1914).

2. Treas. Reg. § 301.7701-2 (as amended by 8697, 1997-1 C.B. 215); Treas. Reg. § 301.7701-3 (as amended by T.D. 8697, 1997-2 I.R.B. 11). The entity literally selects its tax classification by checking a box on the two-page Form 8832, Entity Classification Election.

3. Treas. Reg. § 301.7701-1(b) (1960).

4. Treas. Reg. § 301.7701-2(a)(3) (1960).

5. See generally Carter G. Bishop, *Reverse Piercing: A Single Member LLC Paradox* 54 S.D.L. REV. 199 (2009); Carter G. Bishop, *Through the Looking Glass: Status Liability and the Single Member and Series*

attracted some criticism. One broad modern critique argues that the regulations fail in several important respects to reach their full promise.<sup>6</sup> While this Article is also critical of the check-the-box Regulations, the approach is different and indeed is based on an issue barely mentioned in the broader modern critique: “it does seem appropriate not to subject the latter type of entity [ordinary trust] to a regime designed to tax businesses.”<sup>7</sup> Because of this conclusion, the issue was not further explored and the critics failed to seriously consider the reasonable alternatives and consequences of other approaches. While the broad modern critique is well reasoned in other aspects, this Article directly investigates whether an Achilles’ heel of check-the-box Regulations was its failure to address the ancient but vitally important distinction between business trusts and ordinary trusts.<sup>8</sup>

Extensive early litigation focused on the federal tax classification of common-law trusts, such as the Massachusetts business trust,<sup>9</sup> as ordinary or business trusts.<sup>10</sup> The ordinary trust was taxed under Subchapter J whereas a business trust was classified and taxed as a corporation under Subchapter C. As business entity forms shifted from trusts to partnerships, and particularly limited partnerships, extensive litigation once again used early developed case law standards to differentiate partnerships taxed under Subchapter K and those more properly taxed as corporations. As an ultimate factor, a partnership was taxed under Section 7704 as a corporation when the partnership interests were publicly traded.<sup>11</sup> Over time, as business forms further shifted to limited liability companies, the *Kintner* Regulations became burdensome to apply and the check-the-box Regulations were released and became final in 1997. While the original case law tax classification efforts were directed at trust classification problems, the *Kintner* Regulations and Section 7704 were

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*LLC Perspective*, 42 SUFFOLK U. L. REV. 459 (2009).

6. See generally Heather M. Field, *Checking in on “Check-The-Box”*, 42 LOY. L.A. L. REV. 451 (2009).

7. *Id.* at 502.

8. While the term “business trust” is also used in many other contexts, like the Bankruptcy Code, it is not defined in that context. See 11 U.S.C. § 101(9)(a)(v) (2006); Takemi Ueno, Comment, *Defining A ‘Business Trust’: Proposed Amendment of Section 101(9) of the Bankruptcy Code*, 30 HARV. J. ON LEGIS. 499, 499-501 (1993) (describing “business trusts”).

9. See Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 423-24 (1988).

Unlike a corporation, which is a creature of state statute, a business trust is created by agreement. Filing a declaration of trust with the Commonwealth of Massachusetts is not a condition precedent to the existence of the trust. Indeed, if no filing of any kind is made, the trust entity will still exist, even though its trustees are in violation of Massachusetts law. In contrast, a corporation will not exist unless the requisite documents are executed and filed with the appropriate state authority because normally a corporation can be created only through statutory compliance.

*Id.*

10. See *infra* Part III (discussing the *Kintner* Regulations).

11. I.R.C. § 7704 (1988).

primarily used to distinguish first limited partnerships and later limited liability companies from corporations. The check-the-box Regulations were designed to solve the limited partnership and limited liability company classification problem, not the trust classification issue. Thus, trusts were the forgotten element. For all the good done by the check-the-box Regulations in classifying unincorporated business entities, the regulations failed miserably to clarify distinctions between ordinary trusts and business trusts.

That exclusion is becoming more problematic as business forms continue to evolve. The statutory trust is now being used to conduct businesses previously conducted in partnership or limited liability company forms.<sup>12</sup> Many states<sup>13</sup> have now adopted a statutory business trust form and, indeed, the National Conference of Commissioners on Uniform State Laws (NCCUSL) has promulgated a Uniform Statutory Trust Entity Act (USTEA).<sup>14</sup> A USTEA statutory trust may be formed for any lawful purpose<sup>15</sup> but may not be used for a predominately donative (ordinary trust) purpose.<sup>16</sup>

There is no specific answer available as to why the check-the-box Regulations fail to provide any guidelines for distinguishing business trusts,<sup>17</sup> subject to the regulations,<sup>18</sup> and ordinary trusts,<sup>19</sup> subject only to Subchapter J restrictions.<sup>20</sup> The effect is to dodge the question and its importance entirely and subject the trustees for business trusts to an uncertain tax classification status determined by reference to the most ancient litigated cases distinguishing ordinary and business trusts.

Like other business entities under the check-the-box Regulations,<sup>21</sup> unless a business trust elects to be taxed as a corporation,<sup>22</sup> it is taxed as a disregarded entity, if it has only one beneficiary,<sup>23</sup> or a partnership under Subchapter K, if it has more than one beneficiary.<sup>24</sup> Due to the fact that an ordinary trust is not a business entity, because it exists merely to conserve and protect property, it was

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12. A statutory business trust may have any lawful purpose except that it may not have a predominantly donative purpose. UNIF. STAT. TRUST ENTITY ACT § 303.

13. See, e.g., DEL. CODE ANN. tit. 12, §§ 3801-3824 (2009); MASS. GEN. LAWS ch. 182 §§ 1-14 (West 1996); MD. CODE ANN., [CORPS. & ASS'NS] §§ 12-101 to 12-810 (West 2009); see also Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31, 36 n.22 (setting forth states that have adopted business trust laws). See generally Tamar Frankel, *The Delaware Business Trust Act Failure As The New Corporate Law*, 23 CARDOZO L. REV. 325 (2001)

14. UNIF. STAT. TRUST ENTITY ACT (Proposed Official Draft 2009), [http://www.law.upenn.edu/bll/archives/ulc/ubta/2009am\\_approved.pdf](http://www.law.upenn.edu/bll/archives/ulc/ubta/2009am_approved.pdf).

15. *Id.* § 303(a).

16. *Id.* § 303(b).

17. Treas. Reg. § 301.7701-4(b) (as amended by T.D. 8697, 1997-1 C.B. 215).

18. Treas. Reg. § 301.7701-2(a) (as amended by T.D. 8697, 1997-1 C.B. 215).

19. Treas. Reg. § 301.7701-4(a) (as amended by T.D. 8697, 1997-1 C.B. 215).

20. I.R.C. §§ 641-692 (2006); Treas. Reg. § 301.7701-2(a) (as amended by T.D. 8697, 1997-1 C.B. 215).

21. Treas. Reg. § 301.7701-2(a) (as amended by T.D. 8697, 1997-1 C.B. 215).

22. Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-1 C.B. 215).

23. Treas. Reg. § 301.7701-3(b)(1)(ii) (as amended by T.D. 8697, 1997-1 C.B. 215).

24. Treas. Reg. § 301.7701-3(b)(1)(i) (as amended by T.D. 8697, 1997-1 C.B. 215).

excluded from the check-the-box regime.<sup>25</sup> An ordinary trust is taxed under Subchapter J either as a grantor trust, with all income taxed to the grantor, or as a simple or complex trust, with income taxed to the beneficiaries or the trust. The unfortunate check-the-box inclusion of business trusts and exclusion of ordinary trusts reinforces and ignores the uncertain difference between the two trusts with very little tax revenue or policy at stake. The exclusion perpetuates the uncertain classification of common-law trusts as an ordinary or business trust in the first instance. Rather, the ordinary-business trust distinction continues to rely on uncertain rules gleaned mostly from case law parameters developed since the early twentieth century. In order to eliminate this lingering uncertainty that plagues lawyers and trustees, this Article proposes a new but simple and expedient paradigm for eliminating this check-the-box Achilles' heel.

While seemingly simple and thorough, the regulations have attracted modern criticism. One modern critique argues the regulations fail in several important respects to reach their full promise.<sup>26</sup> The direction of this Article is different and indeed is based on an issue barely mentioned in the modern critique. This Article argues that the Achilles' heel of check-the-box Regulations was the failure to address the ancient but vitally important distinction between business trusts and ordinary trusts. The modern critique devotes scant attention to this significant oversight by merely reiterating that "it does seem appropriate not to subject the latter type of entity [ordinary trust] to a regime designed to tax businesses."<sup>27</sup>

There are two fundamental tax methods regarding the federal income taxation of business organizations. The corporate method generally taxes income to the entity and again to its owners when the remaining income is distributed (Entity Double Tax Model—Subchapter C).<sup>28</sup> The partnership method does not impose a tax at the entity level but rather taxes entity income directly to the owners regardless of whether distributed (Owner Single Tax Model—Subchapter K).<sup>29</sup>

The federal tax method applicable to trusts (Subchapter J) generally follows a modified Owner Single Tax Model where the trust owners and

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25. Treas. Reg. § 301.7701-2(a) (as amended by T.D. 8697, 1997-1 C.B. 215); Treas. Reg. § 301.7701-4(a) (as amended by T.D. 8697, 1997-1 C.B. 215).

26. See Field, *supra* note 6, at 523-24 (describing weakness of multi-regime taxation system).

27. *Id.* at 502.

28. See I.R.C. §§ 301-385 (2006) (corporate model). Corporations pay an entity-level income tax. See I.R.C. § 11(a) (2006). In some cases, corporate dividends are taxed to individual shareholders at a special capital gains rate. See I.R.C. § 1(h)(11) (2006). In addition, when that special rule does not apply, a second or "double tax" is imposed on corporate earnings actually distributed to shareholders in the form of a dividend. See I.R.C. § 301(c)(1) (2006). Nevertheless, the normally lower entity tax and the ability to manage the timing and tax rate on the second distribution tax works in favor of the corporate form.

29. See I.R.C. §§ 701-77 (2006) (reflecting the partnership model). Partnerships are not separate taxpaying entities; rather, partners include partnership income and loss directly in their returns. See I.R.C. § 701 (2006).

beneficiaries—rather than the trust—are taxed on trust income only when actually distributed.<sup>30</sup> However, when an ordinary trust assumes commercial-like purposes and characteristics and becomes a commercial trust, it forfeits the right to be taxed according to the ordinary trust system, and like other business organizations, must be taxed like a corporation or partnership. Prior to the adoption of the 1997 check-the-box Regulations, commercial trusts were frequently classified as associations and taxed like corporations under the then applicable 1960 *Kintner* Regulations.<sup>31</sup> The check-the-box Regulations radically altered this outcome by implementing a default classification for commercial trusts as partnerships.

While the 1997 classification changes were highly beneficial to commercial trusts, the regulations failed to consider the initial question of whether a particular trust should be classified as ordinary and subject to Subchapter J, or commercial and subject to Subchapter K. This Article argues that the failure to address this initial question violated the simplification policy goal of the check-the-box Regulations. The proposed fix is quite simple and elegant: the check-the-box Regulations should be amended to provide that all trusts, except statutory business trusts, are classified as ordinary unless the trust elects to be considered a business organization, in which case it would be classified as a commercial trust. Given the minor differences that exist in tax outcomes between ordinary and commercial trust classification under the check-the-box Regulations, the overwhelming complexity and uncertainty associated with the difference is no longer justified.

In order to provide the proper context for the proposal, Part II first considers the contorted and ancient history regarding the tax classification of trusts dating back to the late nineteenth century. Part III considers the second generation history of trust classification under the 1960 *Kintner* Regulations. Part IV considers the current tax classification of trusts under the check-the-box Regulations. Finally, Part V considers the merits of a specific proposal to revise and amend the check-the-box Regulations in order to further simplify the characterizations of all trusts as ordinary trusts regardless of the presence of commercial purposes.

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30. See I.R.C. §§ 641-92 (2006) (reflecting the trust model). A trust determines its taxable income on a calendar year basis and generally in the same manner as an individual. See I.R.C. §§ 641-46 (2006). Provided a trust is irrevocable and is required to distribute its income currently—a simple trust—the income will be taxed to the beneficiaries and not the trust itself. I.R.C. §§ 651-52. However, where trust income may be accumulated—a complex trust—the income is initially taxed to the trust and then ultimately to the beneficiary when actually distributed (with a deduction to the trust and a credit to the beneficiary). I.R.C. §§ 661-68. Special rules apply which treat a grantor, rather than the trust or the beneficiaries, as taxable on trust income because of the grantor's retention of dominion or control over the trust (e.g., significant reversionary interests, beneficial use of trust income, revocability, and control over the enjoyment). I.R.C. §§ 671-79. Finally, in rare cases, a person other than the trust, beneficiary, or grantor will be taxed on trust income where that person has been given the sole power to vest trust corpus or income in himself. I.R.C. § 678.

31. The 1960 regulations were based on *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), and hence are referred to as the “*Kintner* Regulations.” The *Kintner* case is discussed in detail in Part III below.

## II. THE HISTORY OF ASSOCIATION STATUS

The check-the-box Regulations were not intended to change the determination of when a trust is an ordinary trust versus a commercial trust.<sup>32</sup> The principal function of the regulations, as related to trusts, was to change the classification of commercial trusts from associations taxable as corporations (under the 1960 *Kintner* Regulations) to partnerships (under the check-the-box Regulations).<sup>33</sup> As a result, the entire legislative, regulatory, and judicial history regarding the classification of trusts prior to the 1997 adoption and repeal of the 1960 *Kintner* Regulations remains applicable and highly relevant to the initial classification question of whether a trust is ordinary or commercial. This history reveals the evolution of entity classification as it pertains to the classification of an *association* as a corporation or partnership.

### A. Corporate Taxation of Associations

One might initially wonder why any unincorporated association could or would be taxed like an incorporated entity. The formative years of the federal income tax system in the latter part of the nineteenth century is the storm-centre about which this early controversy raged. The controversy began with the Revenue Act of 1894 which imposed a federal income tax on both individuals and “corporations or associations” but specifically excluded an income tax on partnerships.<sup>34</sup> When the 1894 Act was later declared unconstitutional,<sup>35</sup> the

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32. The preamble to the final check-the-box Regulations makes clear that all organizations recognized as separate entities are considered either a trust or a business entity. Preamble, Prop. Treas. Reg. §§ 310.7701-1 to -6, 61 Fed. Reg. 66584-01 (Dec. 18, 1996). However, the distinctions between trusts and business entities, while restated, were not changed by the new regulations. *Id.*

33. An association possesses several characteristics that distinguish it from a partnership. Unlike a partnership, the death, insanity, bankruptcy, retirement, resignation, expulsion, or other dissociation of an owner does not cause the dissolution of the entity. *See* Treas. Reg. § 301.7701-2(b)(1) (1960). Additionally, one or more persons (managers) in an association have exclusive authority to make business decisions without ratification by the owners of the organization. *See* Treas. Reg. § 301.7701-2(c)(3)-(4) (1960). Also, unlike a partnership, an association’s owners do not have any liability, beyond their investment in the entity, for the debts and obligations of the entity under local law. *See* Treas. Reg. § 301.7701-2(d)(1) (1960). Lastly, in an association, substantially all the owners have the power to transfer their entire ownership interest to non-owners without the consent of any other owner. *See* Treas. Reg. § 301.7701-2(e) (1960). An association could possess limited free transferability if an owner was free to transfer their entire interest to a non-owner only after offering such interest for sale at fair market value to all other owners (first right of refusal). *See* Treas. Reg. § 301.7701-2(e)(2) (1960).

34. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (declared unconstitutional 1895). In pertinent part, the Revenue Act of 1894 requires

[t]hat there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income . . . of all banks, banking institutions, trust companies, savings institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric light, gas, water, street railway companies, and all other corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, *but not including partnerships.*”

controversy sizzled until the enactment of the Corporate Excise Tax Act of 1909, which imposed a tax on the income of every “corporation, joint-stock company or association.”<sup>36</sup> Two Supreme Court cases which followed declared the 1909 Act constitutional and clarified that the term “association” was not an independent term but rather a subset of the phrase “joint stock company.”<sup>37</sup> As a result, the tax did not apply to non-statutory entities such as trusts.<sup>38</sup>

Following the adoption of the Sixteenth Amendment in 1913,<sup>39</sup> the Revenue Act of 1913 again imposed a tax on the income of every “corporation, joint-stock company or association.”<sup>40</sup> The 1913 Act borrowed the term “association” from the Revenue Act of 1909, but it reflected two minor modifications—one relating to operating for profit and with capital stock.<sup>41</sup> In 1924, the Supreme Court focused on the two changes and concluded that the term “association” was no longer a mere subset form of a statutory joint-stock company but was rather intended to include a separate non-statutory entity

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*Id.* (emphasis added). At that time, “associations” were thought to be a specific species of “joint-stock associations”. Terse regulations relating to the 1894 Act were released and required that a two percent tax be imposed on specific corporations and “all other corporations, companies, or associations . . . no matter how created or organized, but not including partnerships.” Treas. Reg. No. 21, § 32, Treas. Dep’t. Doc. 1736 (1894). Early Treasury regulations were released in a numbered series but not sequential, and many other non-income tax regulations normally intervened. Early regulatory series directed toward the income tax included: No. 21 (1894), No. 33 (1914), No. 45 (1919), No. 62 (1922), and No. 65 (1924). See Treas. Reg. No. 21, Treas. Dep’t. Doc. 1736 (1894); Treas. Reg. No. 33, T.D. 1944, 16 Treas. Dec. Int. Rev. 26(a) (1914) (relating to Income Tax imposed by Section 2 of the Act of October 3, 1913); Treas. Reg. No. 45, T.D. 2831, 21 Treas. Dec. Int. Rev. 184-186 (1919) (relating to Income Tax under the Revenue Act of 1918); Treas. Reg. No. 62, T.D. 3295, 24 Treas. Dec. Int. Rev. 207 (1922) (relating to Income Tax under the Revenue Act of 1921); Treas. Reg. No. 65, T.D. 3640, 26 Treas. Dec. Int. Rev. 745 (1924) (relating to Income Tax under the Revenue Act of 1924). See generally Patrick E. Hobbs, *Entity Classification: The One Hundred Year Debate*, 44 CATH. U. L. REV. 437, 450 (1995) (discussing debate leading up to enactment of Revenue Act of 1894).

35. See *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, 586 (1895) (declaring Revenue Act of 1894 unconstitutional). Much of the language of the Act was again utilized in the Revenue Act of 1913 after the passage of the Sixteenth Amendment. See generally Revenue Act of 1913, 38 Stat. 114 (1913).

36. Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112. The 1909 Act added joint-stock companies to the 1894 Act’s taxation of corporations and associations. This introduction fueled a controversy as to whether associations were a form of joint-stock companies or corporations—an odd interpretation given that the 1894 Act failed to even mention joint-stock companies. The controversy was perpetuated when the Treasury released regulations in 1909 applicable to “corporations, joint stock companies, associations, and insurance companies.” Treas. Reg. No. 31, T.D. 1571, 12 Treas. Dec. Int. Rev. 131 (1909). The use of a comma to separate associations from joint stock companies continued the controversy as to whether associations were a subset of that group or rather a group of its own. See Hobbs, *supra*, note 34, at 455-56 (discussing confusion among Congress, the Treasury Department, and the Supreme Court over inclusion of “association”).

37. *Eliot v. Freeman*, 220 U.S. 178, 187 (1911) (holding assessment of tax on non-statutory entities without non-common-law benefits against congressional intent); *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911) (holding Corporate Excise Tax of 1909 constitutional on various grounds).

38. *Eliot*, 220 U.S. at 185-87 (rejecting application of excise tax to common-law Massachusetts trust).

39. U.S. CONST. amend. XVI.

40. Revenue Act of 1913, ch. 16, § II (g)(a), 38 Stat. 114, 172.

41. The 1913 Act deleted the phrase “organized for profit and having capital stock represented by shares.” It also changed the insurance company language from “now or hereafter organized under the laws of the United States” to “organized in the United States, no matter how created or organized.” *Id.*

class.<sup>42</sup>

Like its predecessors in 1909 and 1913, the Revenue Act of 1916 also contained language that the tax would be imposed on the income of “every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized but not including partnerships.”<sup>43</sup> However, the Revenue Act of 1918 ended the debate over whether “association” was a mere expansion of the term “joint-stock company”.<sup>44</sup> The Act accomplished this important distinction by adding a definition section which defined corporations as including “associations, joint-stock companies, and insurance companies.”<sup>45</sup>

### *B. Regulatory Development of Associations*

Given the legislative shift in the 1918 Act that defined the term corporation to include associations, it is not surprising that the burden shifted to Treasury regulations to develop the full meaning of the term. In 1919, Regulation 45 was released, the first comprehensive attempt to interpret the 1918 Act term “associations”.<sup>46</sup> Regulation 45 developed the corporate resemblance test later

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42. *Hecht v. Malley*, 265 U.S. 144, 151-52 (1924) (listing corporation, joint stock company, and association as separate entities). The Court determined the 1913 Act was applicable to a common-law Massachusetts real estate trust, despite reaching an opposite result under the 1909 Act. *See id.* at 157; *Eliot*, 220 U.S. at 187 (stating real estate trusts not within terms of 1909 Act). In a related case interpreting the reach of the 1913 Act, the Court determined the tax did not apply to a Massachusetts trust because it was not a joint stock association (a term that “association” was then deemed a part). *Crocker v. Malley*, 249 U.S. 223, 233-34 (1919). However, *Crocker* also added (by way of dictum) that even if this were not so, it would be difficult to title the beneficiaries a joint stock association because they were not partners in any sense, had no joint action or interest, and had no control over the fund. *Id.* This was not a determination (even by way of dictum) that if control were present, an association or joint stock association would exist. This interpretation was later confirmed in *Hecht* when the Court (interpreting the Revenue Act of 1918 with the same language as the 1913 Act) rejected the taxpayer argument that *Crocker* had determined that slight beneficiary control meant an entity could not be taxed as an association. *See Hecht*, 265 U.S. at 160-61. In this case, the Court determined the scope and purpose of the *Hecht* trust was far broader than the narrower *Crocker* liquidating trust. It is questionable whether the 1913 Act intended to expand the tax to another non-statutory entity class of “associations.” *See Hobbs*, *supra* note 34, at 460-63.

43. Revenue Act of 1916, ch. 463, § 10, 39 Stat. 756, 765.

44. Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1058 (defining corporation as including associations, joint stock companies and insurance companies).

45. *Id.* at § 1. Interestingly, Congress would not alter its definition of the term “corporations” until 1987 when it expanded the phrase to include publicly traded partnerships within its reach. *See I.R.C.* § 7704 (enacted as part of the Omnibus Budget Reconciliation Act of 1987); *Hobbs*, *supra* note 34, at 510.

46. Treas. Reg. 45, § 1, art. 1502, T.D. 3146, 23 Treas. Dec. Int. Rev. 352 (1920 ed. 1921). “Associations and joint-stock companies include associations, common-law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise . . .” *Id.* The 1921 Regulations were similar to earlier regulations in defining the term corporations and in providing that any business entity could be classified as an association for federal tax purposes regardless of how organized under state law. Treas. Reg. 33, T.D. 1944, 16 Treas. Dec. Int. Rev. 26a (1914); *see also* Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 655-57 (1965) (discussing characteristics of associations).

applied in *Morrissey v. Commissioner*,<sup>47</sup> and classified a trust as an “association” if the trust engaged in a business activity and the trust beneficiaries had control over the conduct of that business through the right to periodically elect trustees or otherwise.<sup>48</sup>

Contrary to Regulation 45, the Supreme Court in *Hecht v. Malley* clarified that beneficiary control was not a necessary element of the term “association” and that it was only necessary for the trust to be engaged in an active business.<sup>49</sup> As a result of the Court’s decision, Regulation 65 was quickly released in 1924, expounding that an operating trust would be considered an “association” under the 1918 Act when the trust is authorized to conduct an active business (e.g., the trustees do more than merely collect funds and make payments to the beneficiaries) regardless of the level of beneficial control over trust activities.<sup>50</sup>

47. 296 U.S. 344, 375 (1936); see also *infra* Part II.C (discussing impact of the *Morrissey* case).

48. The first sentence of Article 1504 provides a trust will not be considered an association as long as the trustees do not conduct any business beyond merely holding real estate subject to a lease and distributing income to beneficiaries, and the beneficiaries have no control over trust matters other than the right to fill trustee vacancies and consent to modifications of the terms of the trust. Treas. Reg. 45, art. 1504, T.D. 3146, 23 Treas. Dec. Int. Rev. 352 (1920 ed. 1921). This “safe trust” was remarkably similar to the liquidating trust the Supreme Court earlier declared was taxable as a trust and not as an association. See *Crocker v. Malley*, 249 U.S. 223, 232-33 (1919). The resemblance between the two trusts and proximity in time prompted speculation that the “safe trust” regulation was drafted in response to the *Crocker* case. See Scallen, *supra* note 46, at 656. While the 1921 Regulations may have been drafted in response to *Crocker*, and clearly extended beyond the *Crocker* declaration that little control was not enough to classify the trust as an association, they were no doubt a valid exercise of the Treasury Department’s interpretative authority. See Hobbs, *supra* note 34, at 407.

49. 265 U.S. 144, 160-61 (1924). The trustees in *Hecht* had cited the earlier *Crocker* case for the proposition that in order have an association, the trustees must be grouped with the beneficiaries through the control of the beneficiaries over the trust—a factor lacking in their case. The *Hecht* Court simply determined that the trust in *Crocker* was radically different. See *Hecht*, 265 U.S. at 161. The first *Crocker* trust was a passive liquidating trust, whereas the *Hecht* trust was a very active business trust. Thus, the Court determined that a trust conducting an active business would be classified as an association even though the beneficiaries had no control over the trust business. *Id.* at 161-62.

50. Treas. Reg. 65, T.D. 3640, 26 Treas. Dec. Int. Rev. 745, 1003 (1924). Article 1504 was completely rewritten to provide as follows:

Associations Distinguished From Trust. Holding trusts, in which the trustees are merely holding property for the collection of the income and its distribution among beneficiaries, and are not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business, are not associations within the meaning of the law. The trust and the beneficiaries thereof will be subject to tax as provided in articles 341-347. Operating trusts, whether or not of the Massachusetts type, in which the trustees are not restricted to the mere collection of funds and their payments to the beneficiaries, but are associated together in much the same manner as directors in a corporation, for the purpose of carrying on some business enterprise, are to be deemed associations within the meaning of the Act, regardless of the control exercised by the beneficiaries.

*Id.* art. 1504. The regulatory language “not merely trustees for collecting funds and paying them over” was borrowed precisely from *Hecht v. Malley*. 265 U.S. 144, 161 (1924); Treas. Reg. 65, art. 1504, T.D. 3640, 26 Treas. Dec. Int. Rev. 745, 1003 (1924). Thus, the 1924 Regulations gave the Treasury authority to classify trusts as corporations when the trust operated a business. Treasury Regulation 62 (1921) preceded the release of Regulation 65 (1924) but made no changes to the classification provisions of Regulation 45 (1921) (quoted above at note 46) except to add a single sentence to the definition of “association” as follows:

In 1925, the Treasury amended the 1924 Regulations to add back the “beneficiary control” test—which was eliminated as a requisite by the 1924 Regulations—but not as a requirement for classification.<sup>51</sup> Thus, under the 1925 Regulations, the Treasury could classify trusts as corporations if either the beneficiaries had positive control over the trust—even if the trust was not conducting a business—or, even in the absence of beneficiary control, where the trustee was not restricted to mere collection of funds but rather could carry on a trade or business.<sup>52</sup>

The next major revision occurred in the 1935 Regulations<sup>53</sup> which interpreted the Revenue Act of 1934.<sup>54</sup> The 1935 Regulations dictated that a trust would be classified as an “association” when the trust instrument granted the trustee business powers, i.e., powers greater than those traditionally necessary to merely protect and conserve trust property.<sup>55</sup> Importantly, the

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[a] corporation which has ceased to exist in contemplation of law but continues its business in corporate form is an association or corporation within the meaning of section 2, but if it continues its business in the form of a trust, it becomes subject to the provisions of section 219.

Treas. Reg. 62, art 1502, T.D. 3295, 24 Treas. Dec. Int. Rev. 207 (1921). In *Morrissey v. Comm’r*, the Supreme Court determined that the 1924 Regulation amendments were a valid exercise of discretion in eliminating the beneficiary control test. 296 U.S. 344, 355 (1936).

51. Treas. Reg. 65, T.D. 3748, 27 Treas. Dec. Int. Rev. 462 (1925).

52. *Id.*

53. See Treas. Reg. 86 (1935), in 140 U.S. REVENUE ACTS: 1909-1950 THE LAWS, LEGISLATIVE HISTORIES & ADMIN. DOCUMENTS, (B. Reams, Jr., ed.) (1979).

54. Revenue Act of 1934, ch. 277, 48 Stat. 680.

55. The 1935 Regulations also made clear that state law labels were not controlling for federal tax classification purposes. See Treas. Reg. 86 (1935), in 140 U.S. REVENUE ACTS: 1909-1950 THE LAWS, LEGISLATIVE HISTORIES & ADMIN. DOCUMENTS, (B. Reams, Jr., ed.) (1979).

Article 801-3 (Trust versus Associations) provided, inter alia:

The term “trust,” as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts . . . . Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object. As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages. If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation . . . . [The] advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as “quasi-

1935 Regulations included substantial detail not previously included in the regulations and were the genesis of much of the direction found in the 1960 *Kintner* Regulations as well as the check-the-box Regulations. For example, for the first time the regulations described the characteristics of an ordinary trust taxable under Subchapter J of the Internal Revenue Code, and described an investment trust, confirming that association status would result if the trust was designed for a business purpose, regardless of whether the beneficiaries appointed or controlled the trustees.<sup>56</sup> Additionally, it confirmed that the presence of beneficiary control was not a necessary element to the classification of a trust as an association.<sup>57</sup>

### C. The Impact of the *Morrissey* Case

Judicial activity regarding the Treasury Department's regulatory efforts to classify trusts is reflected in two identifiable segments. The first reflects the saga of *Morrissey v. Commissioner*, a 1935 case firmly entrenching the use of two business factors to distinguish ordinary trusts from commercial trusts, and four corporate resemblance factors to distinguish commercial trusts from corporations.<sup>58</sup> The second segment is contained in *United States v. Kintner*,<sup>59</sup> a 1954 case extending the reach of the *Morrissey* rationale to unincorporated

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corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form itself. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust. The mere size or amount of capital invested in the trust is of no importance . . . . The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

*Id.* at Art. 801-3; *see also* Treas. Reg. 86, Art. 801-1 and Art. 801-2 (1935), in 140 U.S. REVENUE ACTS: 1909-1950 THE LAWS, LEGISLATIVE HISTORIES & ADMIN. DOCUMENTS, (B. Reams, Jr., ed.) (1979) (describing the attributes of "associations" under the Revenue Act of 1934).

56. Treas. Reg. 86, Art. 801-3 (1935), in 140 U.S. REVENUE ACTS: 1909-1950 THE LAWS, LEGISLATIVE HISTORIES & ADMIN. DOCUMENTS, (B. Reams, Jr. ed., 1979) (describing ordinary trust as trust where trustees take title to property to protect and conserve it on behalf of beneficiaries).

57. *Id.* The 1935 Regulations, however, did not confirm the 1925 Regulation's assertion that beneficial control alone was adequate to classify a trust as an association, regardless of whether the trust was engaged in a business. Thus, the 1935 Regulations, like the 1924 *Hecht* case stresses that the business activity of the trust was the touchstone of classification.

58. 296 U.S. 344, 359-60 (1935).

59. 216 F.2d 418 (9th Cir. 1954).

professional partnership associations.

In the famous *Morrissey* case, the Supreme Court applied the 1935 Regulations to a Los Angeles real estate trust named the Western Avenue Golf Club.<sup>60</sup> The trustees were fully empowered to perform all acts required or necessary to purchase land, construct, and operate a golf course and club house.<sup>61</sup> Trust beneficiaries were issued transferable certificates of beneficial interests and had the right to make recommendations to the trustees concerning business operations and ventures, but could not force the trustees to take action.<sup>62</sup> The trustees argued that a commercial trust such as the Western Avenue Golf Club could not be classified as an association—taxable as a corporation—unless the beneficiaries had some voice in trust management, control over the trustees, and the right to exercise the trustee control by a vote at trust meetings.<sup>63</sup>

While Chief Justice Hughes utilized prior precedents to easily reject the trustee's arguments, the Court acknowledged that the association concept was indefinite.<sup>64</sup> As a result, the Court set a course to define the term "association," especially as it applied to trusts.<sup>65</sup> Borrowing heavily from the language of the 1935 Regulations,<sup>66</sup> Chief Justice Hughes first determined that the term "association" implies the presence of associates—trust beneficiaries who enter into a commercial trust arrangement at the formation of the trust or later—for a joint business enterprise in order to conduct a business and share gains.<sup>67</sup> However, beneficiaries of an ordinary trust do not plan a common effort or enter into a combination for the conduct of a business enterprise.<sup>68</sup> Thus, the Court placed the critical focus on the nature and purpose of trust business activities rather than on the degree of beneficiary control over that activity. Once that commercial purpose was established, the associate's level of control was satisfied by merely becoming a beneficiary.

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60. *Morrissey v. Comm'r*, 296 U.S. 344 (1935).

61. *Id.* at 347.

62. *Id.*

63. *Id.* at 348-49.

64. See *Morrissey*, 296 U.S. at 356. The beneficiary control test had been previously rejected in *Hecht* and was no longer required by Treasury Regulations after 1925. *Hecht v. Malley*, 265 U.S. 144, 161 (1924). Because the Court rejected the argument that "beneficiary control" over the trust was a necessary element of a trust being classified as an association, it did not consider the level of control that might violate the classification standards if it were a factor. See *Morrissey*, 296 U.S. at 356. Rather, the Court focused on the business activities of the trust in making its determination. *Id.* at 360. However, subsequent amendments to the Treasury Regulations reinstated the issue of quantum of beneficiary control. See *supra* notes 50-55 (discussing 1924 and 1925 Treasury Regulations).

65. *Morrissey*, 296 U.S. at 356-58.

66. See *supra* note 55 (quoting 1935 Treasury Regulations).

67. *Morrissey v. Comm'r*, 296 U.S. 356-57 (1935). Unlike ordinary trusts, commercial trusts provide the medium for conducting a business and sharing gains. Associates join commercial trusts to share in the advantages of joining their interests in a common enterprise. This establishes two tests in classifying a commercial trust: A business purpose, and associates sharing gains therefrom.

68. *Id.*

The Court further articulated that once a trust is classified as a commercial trust rather than an ordinary trust by the presence of a business purpose and associates, it is necessary to determine whether the commercial trust will be classified as a partnership or an association taxable as a corporation. In a famous quote, Chief Justice Hughes revealed that the inclusion of associations with corporations in the same taxation group “implies resemblance; but it is resemblance and not identity.”<sup>69</sup> As such, resemblance does not require statutory existence (allowing recognition of common-law trusts). Regulatory provisions of the trust instrument may easily replace by-laws, and the absence of control by beneficiaries as is commonly exercised by corporate stockholders is not essential.<sup>70</sup>

With that background, Chief Justice Hughes addressed the salient features of a trust created and maintained to carry on a business enterprise that make it analogous to, and therefore taxable as, a corporation.<sup>71</sup> The relevant criteria were those factors that both a properly organized trust and a corporation shared, thus distinguishing them from a partnership. The factors, as applied to a trust, included: a trustee empowered to hold title; provisions allowing the trust to continue, notwithstanding the death of a beneficiary or if a beneficiary transfers their interest in the trust; centralized management by trustees; and limitation of the liability of participants to their portion of the trust property.<sup>72</sup>

When determining whether the Western Avenue Golf Club commercial trust should be considered an association taxable as a corporation rather than a partnership, the Court noted the trust was created to develop real estate and operate a golf course and club, thus satisfying the business test. Also, the beneficiaries became associated in this common undertaking to produce and divide gains and profit therefrom, thus satisfying the associates test. The trust also possessed all of the other common corporate characteristics, including centralized management, continuity of life, limited liability and transferability of interests; accordingly, the Court considered the Western Avenue Golf Club trust an association taxable as a corporation rather than as an ordinary trust or a partnership.<sup>73</sup>

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69. *Id.* at 357.

70. *Id.* at 358.

71. *Morrissey*, 296 U.S. at 359.

72. *Id.* at 359-60. The Court specifically referred to these criteria as those which trusts and corporations share and which therefore help distinguish them both from partnerships. The first criteria (holding title to property) has been eroded by the Uniform Partnership Act, which tends to treat partnerships as an entity (like corporations and trustees) for purposes of holding title to real and personal property. *See* UNIF. P'SHIP ACT § 28 (1914), 6 U.L.A. Pt. II 341 (2001) (noting partnership entity status and ownership of real property by partnership). Under common law, partnerships were considered a pure aggregate of its members and thus had no independent power to hold title on behalf of the partners. As a consequence of this development, the enduring “partnership” distinguishing criteria include the free transferability of interests, limited liability, continuity of life, and centralized management. *See Morrissey*, 296 U.S. at 360.

73. *Morrissey*, 296 U.S. at 360. Interestingly, the Court briefly distinguished this trust from a liquidating trust. *Id.* at 361.

#### D. *The Impact of the Kintner Case*

In 1936, shortly after the release of the *Morrissey* opinion, the Seventh Circuit decided *Pelton v. Commissioner*.<sup>74</sup> Citing the recent *Morrissey* case, *Pelton* determined that state law characterizations no longer controlled the federal tax classification of business entities or association status.<sup>75</sup> *Pelton* was a huge victory for professional practitioners because unincorporated, corporate-styled associations would be taxed as corporations and thus able to take advantage of tax-favored corporate pension plans and lower marginal tax rates on retained income.<sup>76</sup> Consequently, taxpayers, including the infamous Dr. Kintner, flocked to this style of organization.<sup>77</sup>

In 1948, the partners of Western Montana Clinic, including Dr. Kintner, dissolved the clinic and executed an agreement to become an unincorporated medical association operating under the same name.<sup>78</sup> The agreement was styled as an “Articles of Association.” It provided the association with the “attributes of a corporation,” established a pension plan, and indicated that the entity was “to be treated as a corporation for the purposes of taxation.”<sup>79</sup> The United States District Court for the District of Montana determined that the association possessed the corporate characteristics of holding title to entity property, continuity of life, and centralized management, and thus should be classified as a corporation for federal tax purposes.<sup>80</sup>

On appeal to the Ninth Circuit, the Service adopted the taxpayer’s argument in *Pelton* that the Montana association, by force of state law, could not practice medicine because such practice was personal to licensed physicians.<sup>81</sup> The Ninth Circuit refused to allow the Service to use the state law as a sword to

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74. 82 F.2d 473 (7th Cir. 1936). In *Pelton*, a group of Illinois physicians sharing office space and expenses jointly organized the Pelton Clinic under an Illinois trust agreement that provided each physician with a transferable ownership interest and limited liability. *Id.* at 474. Although the partners shared office space, they did not share profits and therefore were not partners. *Id.* The effort was to obtain corporate-style benefits for a professional practice in a state that prohibited professionals from forming a corporation. In *Pelton*, the Service argued that the trust arrangement was an association taxable as a corporation. The taxpayers argued that because Illinois law prevented physicians from practicing medicine as a corporation, their trust arrangement was precluded by state law from being classified as a corporation under federal law. *Id.* at 476. Essentially, the taxpayers sought to use state law as a shield to avoid corporate status for the Illinois trust. *Id.*

75. *Id.* at 476 (determining trust was association). The Court reasoned that because the trust’s associates carried on a business enterprise and it possessed substantial resemblance to a corporation—through continuity, centralized management, and limited liability—it should be classified as an association even though under state law it was technically a partnership. *Id.*

76. See Hobbs, *supra* note 34, at 482 (explaining taxpayers realized benefits and burdens of corporate status).

77. See *United States v. Kintner*, 216 F.2d 418, 419 (9th Cir. 1954). Dr. Kintner practiced medicine in Montana for many years as a partner of a partnership doing business as the Western Montana Clinic. *Id.*

78. *Id.* at 419-20. The clinic assets and liabilities were absorbed by the association which carried on the clinic’s activities. Only two clinic employees were not similarly employed by the association.

79. *Id.* at 420.

80. *Kintner v. United States*, 107 F. Supp. 976, 979 (D. Mont. 1952), *aff’d*, 216 F.2d 418 (9th Cir. 1954).

81. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). Contrary to its position in the earlier *Pelton* case, the Service in *Kintner* argued that this association of medical physicians was a partnership. *Id.* at 422.

create partnership status, especially given the *Morrissey* case and the Service's own regulations indicating that state law was not relevant to the classification question.<sup>82</sup> Rather, like the Seventh Circuit in *Pelton*, the Ninth Circuit relied upon the *Morrissey* corporate resemblance tests to determine that the association was more like a corporation rather than a partnership.<sup>83</sup>

The Service later challenged the *Kintner* holding in Revenue Ruling 56-23, opining that a group of physicians forming an association to achieve corporate tax status in order to derive pension plan benefits will be classified as a partnership.<sup>84</sup> Oddly, the ruling concluded that the association would be classified as a partnership only if it attempted to adopt a pension plan, otherwise it would be classified as a corporation. The ruling was short-lived however, and in a hasty retreat, presumably to avoid a nullifying court decision, Revenue Ruling 57-546<sup>85</sup> revoked the pension plan test set forth in Revenue Ruling 56-23. Although Revenue Ruling 57-546 reinstated the *Morrissey* resemblance test, the Service signaled that a revised test would soon be released regarding the classification of medical associations.<sup>86</sup>

The revised test was released in 1959, when the Service proposed new association classification regulations based upon *Kintner v. United States*, thus dubbed the "*Kintner* Regulations."<sup>87</sup> The regulations were finalized in 1960<sup>88</sup> and in general reversed the *Kintner* classification outcome by mandating that unincorporated associations would only be classified as corporations when they possessed more corporate criteria than non-corporate criteria.<sup>89</sup> The regulations completely altered the classification landscape by making it infinitely more difficult for an association to be classified as a corporation.<sup>90</sup>

### III. THE KINTNER REGULATIONS

The *Kintner* Regulations classified all unincorporated organizations in three categories: associations (taxable as corporations), partnerships, and trusts.<sup>91</sup>

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82. See Treas. Reg. 86, Art. 801-1 (1935), in 140 U.S. REVENUE ACTS: 1909-1950 THE LAWS, LEGISLATIVE HISTORIES & ADMIN. DOCUMENTS (B. Reams, Jr., ed.) (1979); see also *United States v. Kintner*, 216 F.2d 418, 422 (9th Cir. 1954).

83. See *Kintner*, 216 F.2d at 422.

84. Rev. Rul. 56-23, 1956-1 C.B. 598, modified by Rev. Rul. 57-546, 1957-2 C.B. 886.

85. Rev. Rul. 57-546, 1957-2 C.B. 886.

86. The retreat was well designed as the Service suffered another classification defeat prior to releasing a new revised classification standard. See *Galt v. United States*, 175 F. Supp. 360, 362 (N.D. Tex. 1959) (determining Texas medical association, similar to association in *Kintner*, taxable as corporation).

87. Prop. Treas. Reg. §§ 301.7701-1 to -3, 24 Fed. Reg. 10450, 10451-54 (Dec. 23, 1959).

88. Treas. Reg. §§ 301.7701-1 to -11 (as amended by T.D. 6503, 1960-2 C.B. 409).

89. Treas. Reg. § 301.7701-2(a)(3) (1960).

90. While the regulations were clearly designed to reverse the Service's loss in the *Kintner* case and make it more difficult for medical associations to adopt pension plans, the Service would soon learn that its own regulations would be used against it to permit limited partnerships embracing various tax shelter schemes to continue partnership tax status.

91. Treas. Reg. § 301.7701-1(b) (1960).

Under the regulations, state law is referenced to determine the relationship among the owners and with the public at large, but the federal classification standards determine the meaning of those relationships for federal tax purposes.<sup>92</sup> An organization might be formed as a trust under state law but be classified as an association taxable as a corporation for federal tax purposes.<sup>93</sup> Similarly, the term “association” refers to unincorporated organizations classified as either partnerships or trusts under applicable state law.<sup>94</sup>

While retaining the same resemblance tests enunciated in *Morrissey*, the *Kintner* Regulations made it more difficult for unincorporated associations to be classified as corporations. A trust or partnership will only be classified as a corporation if these factors indicate that the organization more closely resembles a corporation than a partnership or trust.<sup>95</sup> Generally, this requires that the organization possess a preponderance of the six corporate characteristics.<sup>96</sup> Because a trust and a corporation generally share continuity of life, centralized management, liability, and free transferability of interests, these corporate characteristics are ignored for determining whether an ordinary trust is considered a commercial trust, but are relevant when determining whether a commercial trust is a partnership or a corporation.<sup>97</sup> Thus, a trust is a commercial trust only if it possesses both associates, and an objective to carry on a business and divide the gains therefrom.<sup>98</sup> Conversely, a trust is an ordinary trust only if it does not possess either associates, or an objective to

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92. Treas. Reg. § 301.7701-1(c) (1960). Interestingly, the regulations reversed the role of state law under prior regulations. Under the prior regulations, state law was irrelevant, a factor that the taxpayer used to defeat the Service in the *Kintner* case. See *United States v. Kintner*, 216 F.2d 418, 422 (9th Cir. 1954).

93. See *Kintner*, 216 F.2d at 422. Thus, the term “corporation” is not limited to organizations formed as corporations under state law but may also include trusts classified as associations. *Id.* at 422-23.

94. Treas. Reg. § 301.7701-2(a)(1) (1960).

95. *Id.*

96. Treas. Reg. § 301.7701-2(a)(3) (1960). As originally delineated in the *Morrissey* case, six corporate characteristics distinguish true corporations from associations such as partnerships and trusts: associates, an objective to carry on a business and divide the gains therefrom, continuity of life, centralized management, limited liability for corporate debts limited to corporate property, and free transferability of interests. See *Morrissey v. Comm’r*, 296 U.S. 344, 360 (1935). Each factor has equal weight in this test although an early case suggested that limited liability might be a “super factor.” See *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969) (suggesting that “economic stability” of limited liability may denote greater significance among *Morrissey* factors). The regulations also indicate that “other factors” beyond the delineated six factors may be significant in classifying an organization as an association. Treas. Reg. § 301.7701-2(a)(1) (1960). Also, an example in the regulations discussing the classification of a limited partnership suggests that “other factors” may be relevant. Treas. Reg. 301.7701-2(a)(3) (1960). However, seven “other factors” were judicially rejected in a case deciding that the six criteria constituted the exclusive tests (with equal weight) and the Service later acquiesced in that case. See *Larson v. Comm’r*, 66 T.C. 159, 184-85 (1976), *acq.* 1979-1 C.B. 1 (refusing to give “other characteristics” controlling weight in interest of predictability of results). On January 5, 1977, the Service attempted to reverse the *Kintner* preponderance test, but the proposed amendment was withdrawn two days later as too controversial. Prop. Reg. § 301.7001-1 to -3, 42 Fed. Reg. 1038 (Jan. 5, 1977). In Rev. Rul. 79-106, the Service finally “conceded” that the six factors had equal weight and no “other factors” would be considered in a classification decision. Rev. Rul. 79-106, 1979-1 C.B. 448.

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

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

carry on a business and divide the gains therefrom.<sup>99</sup>

#### A. Classification Developments Under the Kintner Regulations

The *Kintner* Regulations were effective in blocking medical associations from being classified as corporations and thus enabling them to adopt pension plans—at least in that form. State law regarded most medical associations as general partnerships, and under the *Kintner* Regulations a general partnership was never classified as an association because it always lacked at least three of the relevant corporate characteristics: continuity of life, centralized management, and limited liability.<sup>100</sup> Physicians responded by petitioning their state legislators to conform state law to the regulations, and by 1963 more than thirty states had enacted specific legislation permitting professionals to incorporate and adopt pension plans.<sup>101</sup> In 1965, the Service made a bold final attempt to deny corporate status to the new professional corporations by amending its regulations.<sup>102</sup> Several courts declared the amendments invalid as arbitrary and discriminatory, leading the Service to acknowledge defeat and classify professional corporations as corporations.<sup>103</sup>

Over the next thirty years, various entity classification battles ensued as revenue loss and tax abuse schemes proliferated. The classification of limited partnerships,<sup>104</sup> publicly traded partnerships,<sup>105</sup> and limited liability

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

100. Treas. Reg. §§ 301.7701-2(b)(3), (c)(4), (d)(1) (1960).

101. See Hobbs, *supra* note 34, at 489; see also Berrien C. Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1, 9 (1967); Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

102. Prop. Treas. Reg. §§ 301.7701-1(d) to 301.7701-2(g) and (h), 28 Fed. Reg. 13,750 (1965) (approved Treas. Dec. 6797, 1965-1 C.B. 553). See Hobbs, *supra* note 34, at 489-91 (discussing modification amendments). In general, the modifications would have reduced reliance on the effect of local law in the classification area; redefined continuity of life to exclude the special relationship between a professional and a professional corporation; redefined centralized management to exclude the effect of corporate management in a professional corporation where each physician retained professional liability and responsibility for management of patient care; eliminated limited liability unless each professional could establish that his or her liability was no greater than that of a shareholder-employee in a normal corporation (nearly impossible because of the patient responsibility); and eliminated free transferability unless each professional could freely transfer their right to ownership and employment to another physician without the consent of any other member. Prop. Treas. Reg. §§ 301.7701-1(d) to 301.7701-2(g) and (h), 28 Fed. Reg. 13,750 (1965) (approved Treas. Dec. 6797, 1965-1 C.B. 553).

103. See *Kurzner v. United States*, 413 F.2d 97, 111 (5th Cir. 1969) (holding treasury regulation classifying professional service organizations as partnerships discriminatory); see also Rev. Rul. 70-101, 1970-1 C.B. 278.

104. The Revenue Act of 1894 excluded “partnerships” from taxation but failed to distinguish between general and limited partnerships. See Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509; see also Hobbs, *supra* note 34 (describing relevant aspects of 1894 Act). Income tax regulations treated limited partnerships as associations taxable as corporations from 1913 until 1918, when the release of Regulation 45 first categorized limited partnerships as subsets of partnerships rather than corporations, provided the law of the state of formation did not limit the liability of all partners (versus merely the limited partners), did not permit free transferability, and the partnership dissolved upon the dissociation of the general partner. See Treas. Reg. 45, T.D. 3146, 23 Treas. Dec. Int. Rev. 352 (1920 ed. 1921); see also *supra* note 46 (discussing Regulation 45);

companies,<sup>106</sup> were heated issues of contention. All these battles ultimately weakened the spirit of the Service which finally capitulated in 1997 by repealing the 1960 *Kintner* Regulations and declaring that all future classification disputes would be resolved simply by allowing taxpayers to freely choose the most beneficial entity tax classification—the check-the-box Regulations. Notwithstanding the tortured development of most unincorporated organizations under the *Morrissey*, *Kintner*, and check-the-box Regulations, the classification of trusts has been a more stable question.<sup>107</sup>

### B. The Business Objective Standard

The *Morrissey*<sup>108</sup> case is largely credited with the introduction of the

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Hobbs, *supra* note 34, at 491-93. Following the 1935 release of the *Morrissey* case, the classification criteria shifted to continuity of life and centralized management and thus moved classification toward corporate status. See Hobbs, *supra* note 34, at 494 (discussing Regulation 103 released in 1940). In *Glensder Textile Co. v. Comm'r*, the Board of Tax Appeals relied heavily on the *Morrissey* case, classifying a New York limited partnership as a partnership even though it possessed limited liability because it lacked free transferability of interests, continuity of life, and centralized management. 46 B.T.A. 176, 187 (1942), *acq.*, 1942-1 C.B. 8. The later 1960 *Kintner* Regulations used the reasoning from *Morrissey* and *Glensder* to fashion the tests for limited partnerships. See Hobbs, *supra* note 34, at 497. After the 1960 *Kintner* Regulations were released, taxpayers began to utilize limited partnerships as tax shelter partnerships. The Service attempted to classify such limited partnerships as associations but was unsuccessful. See *Larson v. Comm'r*, 66 T.C. 159 (1976); Hobbs, *supra* note 34, at 499-500 (discussing effect of *Larson*). As a result of its loss in *Larson*, the Service proposed a 1977 amendment to the *Kintner* Regulations that would have classified most tax shelter limited partnerships as associations. See Prop. Treas. Reg. §§ 301.7701-1 to -3, 42 Fed. Reg. 1038-1044 (Jan. 5, 1977). The regulations, however, were withdrawn only two days later after a firestorm of complaints by angry practitioners. See Fed. Reg. 1489, 1489 (Jan. 7, 1977).

105. Recognizing the limitations of its regulatory powers, the Service sought and obtained the enactment of Internal Revenue Code § 7704 as part of the Omnibus Budget Reconciliation Act of 1987 which treated publicly-traded limited partnerships as corporations. See 26 I.R.C. § 7704; Hobbs, *supra* note 34, at 502-10.

106. Limited liability companies are a hybrid form of business entity combining a corporate liability shield with federal partnership tax classification status under the 1960 *Kintner* Regulations. See CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES TAX AND BUSINESS LAW ¶ 1.01[1]. While early tax classification battles raged over whether an entity with corporate-styled limited liability should be classified as a partnership, the Service released Revenue Ruling 88-76 concluding that a Wyoming limited liability company would be classified as a partnership. See Rev. Rul. 88-76, 1988-2 C.B. 360, (obsoleted by Rev. Rul. 98-37, 1998-2 C.B. 133); BISHOP & KLEINBERGER, *supra*, at ¶ 1.01. Eventually, every state adopted limited liability company legislation, but because each statute was slightly unique, every state sought and normally obtained a qualifying ruling similar to Revenue Ruling 88-76. *Id.* at ¶ 1.01[3]. The burden and recognized futility of this process lead to the inevitable “check-the-box” Regulations, where the Service essentially conceded that any unincorporated entity would be classified as a partnership unless it elected to be classified as a corporation. See *id.* at ¶ 2.01.

107. Treas. Reg. § 301.7701-2(a)(1) (1960). In order for a trust to be classified as a commercial trust, the regulations required the presence of both an objective to carry on a business and division of gains therefrom. *Id.* Conversely, a trust lacking either or both of these criteria was classified as an ordinary trust. *Id.*

108. *Morrissey v. Comm'r*, 296 U.S. 344 (1935). In *Hecht v. Malley* and *Crocker v. Malley*, the Supreme Court considered the classification of trusts as associations well before *Morrissey*, but each case was based on the unique language of the then current tax regulations interpreting the term “association” and the trust language terminology. See *Hecht v. Malley*, 265 U.S. 144 (1924); *Crocker v. Malley*, 249 U.S. 223 (1919). In *Crocker*, the Court determined that a liquidating trust established merely to enable a corporate liquidation and not to conduct business was a trust and not an association taxable as a corporation. *Crocker*, 249 U.S. at 232-33. Later, in *Hecht*, the Court determined that several common-law Massachusetts real estate trusts were to be

corporate resemblance tests reflected in the 1960 *Kintner* Regulations,<sup>109</sup> including the associates and business objective tests.<sup>110</sup> *Morrissey* was the first in a series of four Supreme Court cases applying these standards.<sup>111</sup> Interestingly, all four cases classified the relevant trust as an association taxable as a corporation because the Court determined the trusts were all formed for a clear business purpose and objective, and were not formed for the limited purpose of protecting and conserving the trust property on behalf of the beneficiaries. Accordingly, the beneficiaries were all considered associates because they created or acquired beneficial interests with a common purpose to share in the fruits of the business development.

Two years after these four early cases, the Court revisited the matter in *A.A. Lewis & Co. v. Commissioner* and reached the opposite result, declining to classify a particular trust as an association.<sup>112</sup> In *A.A. Lewis & Co.*, the individual owner of a large tract of land transferred the land to a trust and granted a corporate trustee broad powers to subdivide and sell the land.<sup>113</sup> The trust instrument specifically provided that the trustee was to have no management power over the affairs of the trust, but was merely to hold title to the real estate transferred to it and to collect and distribute proceeds from the sale of the lots.<sup>114</sup> The Court noted that, absent the trust relationship, the mere appointment of a sales agent to subdivide and sell lots would not constitute an association of any kind, and, further, the presence of a trustee to merely hold title and collect and distribute proceeds would not alter this conclusion.<sup>115</sup>

Following the rationale in *Morrissey*,<sup>116</sup> the Court determined that this trust relationship was closer to an ordinary trust than a corporate enterprise.<sup>117</sup>

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classified as associations taxable as corporation because, unlike the *Crocker* liquidating trust, these trusts were organized and operated to conduct an active real estate business. *Hecht*, 265 U.S. at 161. In yet another earlier case, interpreting an earlier set of tax regulations, the Court determined that a Massachusetts common-law real estate trust was not an association taxable as corporation because the trust was not organized under a statute. *See Eliot v. Freeman*, 220 U.S. 178, 186-87 (1911).

109. Indeed, at the end of the regulation setting forth the six corporate classification criteria, the language provides: “*See Morrissey et al v. Comm’r* (1935) 296 U.S. 344.” Treas. Reg. § 301.7701-2(a)(1) (1960).

110. *See supra* Part II.C for discussion of *Morrissey*.

111. *See Helvering v. Coleman-Gilbert Associates*, 296 U.S. 369, 370, 372-73 (1935) (concluding trust taxable as corporation due to presence of associates and business objective); *Helvering v. Combs*, 296 U.S. 365, 366, 368-69 (1935) (determining trust taxable as corporation despite failure of beneficiaries to exercise control over trustees); *Swanson v. Comm’r*, 296 U.S. 362, 363, 365 (1935) (articulating trust taxable as corporation because trust instrument extended broad business management to trustees); *Morrissey v. Comm’r*, 296 U.S. 344, 361 (1935) (introducing corporate resemblance test).

112. *A. A. Lewis & Co. v. Comm’r*, 301 U.S. 385 (1937).

113. *Id.* at 386.

114. *Id.* at 387. Lewis, an experienced real estate developer, was named as a beneficiary, in addition to the grantor, was given the exclusive selling rights for the subdivided lots, and was named the general manager of the trust. *Id.* at 386.

115. *Id.*

116. The Court noted that it was applying the standards developed in *Morrissey* and the three companion cases immediately following (*Swanson*, *Combs*, and *Coleman-Gilbert Associates*). *See supra* note 111.

117. *Id.* at 389; *see also Wyman Building Trust v. Comm’r*, 45 B.T.A. 155 (1941). The *Wyman* case

Significantly, the trustee's powers were carefully limited to prevent the trustee from engaging in any business activity and were carefully conscribed to permit only the collection and distribution of proceeds from land sales.<sup>118</sup> In these circumstances, the subsequent transfer of the grantor's interest was irrelevant—even though the trust certificate was freely transferable.<sup>119</sup>

Later cases reflect the notion that only modest conservation trusts will pass the classification muster. In *Sears v. Hassett*,<sup>120</sup> the First Circuit considered the classification of a Massachusetts real estate trust established to facilitate the disposition land in the Boston area. The trust instrument granted the trustee broad managerial powers but the beneficiaries had no power to control the trustee except to veto proposed amendments to the trust instrument.<sup>121</sup> A few weeks after the trust was implemented, the primary trust property was leased for fifty years and by 1925 the remaining properties had been sold, such that the duties of the trustee were relegated to collecting the rent and distributing the proceeds—a relatively benign and passive role.<sup>122</sup> Nonetheless, the Court classified the trust as an “association” based on the broad powers conferred by the trust instrument—even when not exercised by the trustee—because the applicable *Morrissey* test is not determined from the creator's intentions or from the powers actually exercised by the trustee but rather from the “purposes and potential activities as disclosed on the face of the trust instrument.”<sup>123</sup>

In Revenue Ruling 78-371, the Service classified the applicable trust as an association and not as an investment trust because of the presence of broad trustee powers to acquire additional property, sell existing property, erect buildings and to otherwise manage the trust property for the beneficiaries.<sup>124</sup> The heirs to a number of contiguous parcels of real property subject to a net lease created the trust to collect the net income and distribute the same quarterly. The trust instrument, however, provided that the trustee could acquire or sell additional or existing contiguous property in order to “protect or conserve” existing trust property and values. Any sales proceeds not invested in contiguous property could only be invested in liquid non-volatile assets like certificates of deposit. Consequently, the Service classified the trust as an association. This ruling was further clarified by Revenue Ruling 79-77, which

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granted a narrow reprieve from the *Morrissey* broad “trust instrument powers” test classifying a trust not as an association where the trust dealt only with a single property, the trustee was not authorized to deal with any other property, the only change in beneficiaries occurred through death, and the trust property was rented to the same tenant with no changes in the lease. 45 B.T.A. at 157.

118. *A.A. Lewis & Co. v. Comm'r*, 301 U.S. 385, 388-89 (1937). The only purpose of the trust was to facilitate execution of deeds and thus the trustee functions were purely ministerial. *Id.*

119. *Id.* at 389 (discussing terms of trust). The initial beneficiaries were only the grantor and the real estate agent. *Id.* Additionally, there was no limitation of personal liability of the beneficiaries. *Id.*

120. *Sears v. Hassett*, 111 F.2d 961 (1st Cir. 1940).

121. *Id.* at 962.

122. *Id.*

123. *Id.* at 963.

124. Rev. Rul. 78-371, 1978-2 C.B. 344.

determined a trust was an ordinary trust rather than an association where the trustee was only authorized to deal with a single piece of trust property subject to a long-term net lease and not otherwise empowered to sell or otherwise transfer the trust property.<sup>125</sup>

### C. The Development of the Associates Standard

*Elm Street Realty Trust v. Commissioner*<sup>126</sup> is a relatively modern case specifically considering the classification of a trust as an association under the *Kintner* Regulations. The Tax Court determined that a trust created with a business objective but lacking associates was not an association, and thus was taxable as an ordinary trust under Subchapter J. The trust was created by two businessmen to hold recently purchased real estate that had been leased to a business customer.<sup>127</sup> The Court acknowledged that the beneficiaries did not intend the trust to engage in business and indeed the trust had never engaged in any business.<sup>128</sup> However, the trust declaration contained broad powers and did not limit the trustee's power or discretion to merely protecting and conserving the trust property.<sup>129</sup> Following the *Morrissey* lead focusing on the trust instrument powers,<sup>130</sup> the Court found a business objective in the breadth of powers designed to provide flexibility to the trustee.<sup>131</sup> Accordingly, the trust

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125. Rev. Rul. 79-77, 1979-1 C.B. 448. The ruling involved a commercial building owned by three individuals as tenants in common who transferred the building to a bank trustee naming themselves as beneficiaries. *Id.*

126. 76 T.C. 803 (1981), *acq.* 1981-2 C.B. 1. The Service later acquiesced to the *Elm Street Realty* case view of the term "associates" because the beneficiaries did not create the trust, did not participate in the control of the trust, and was similar in result and facts to *Curt Teich Trust No. One v. Comm'r.* See 25 T.C. 884 (1956), *acq.* 1956-2 C.B. 8; *Elm St. Realty Trust v. Comm'r.*, 76 T.C. 803 (1981), *action on dec.*, 1981-153 (Oct. 15, 1981)

127. *Elm St. Realty*, 76 T.C. at 805. The two settlors were the initial beneficiaries but each transferred their respective fifty percent beneficial trust interests to their children who made other transfers of the interests. *Id.* at 808. The trust property consisted exclusively of real estate subject to a net lease and an independent trustee (the settlors' lawyer) immediately executed an eleven-year net lease. *Id.* at 805, 808. The trust was created to "acquire, hold, improve, manage and deal in real estate," including the current net lease property and any other thereafter added. *Id.* The settlor testified that it was his intention for the trust to be passive and that the trustee was not to purchase additional property even though the trust instrument allowed for that contingency. *Id.* at 808.

128. *Id.* at 810.

129. *Id.* at 813.

130. The court cited the landmark *Morrissey* case as authority for the proposition that the business purpose is determined from the powers present in the trust declaration regardless of whether the powers are actually exercised. *Morrissey v. Comm'r.*, 296 U.S. 344, 361 (1935).

131. *Elm St. Realty Trust v. Comm'r.*, 76 T.C. 803, 813 (1981).

Nonetheless, the form of petitioner's governing instrument indicates that petitioner had the potential to operate a business and the courts have consistently given substantial weight to the actual powers contained in an entity's organizing document, particularly where, as in article Sixth, they are of the type or scope which in our judgment go beyond the powers which normally involve the doing only of such business acts as traditionally and generally have been recognized as being incidents in the administration of an "ordinary" (*vis-à-vis* "business") trust.

was deemed to possess a business objective under the *Kintner* Regulations.<sup>132</sup> Importantly, the Tax Court determined that notwithstanding the presence of a corporate business objective, the trust was not classified as an association because the trust lacked associates.

In this sense, *Elm Street Realty* added little to the notion that a trust's business objective is determined from the breadth of powers granted to the trustee in the trust instrument—not the actual intent of the settlors, the intent of the beneficiaries, or the presence or absence of past actual business activity of the trust. Relying on *Morrissey*, the Tax Court indicated that “associates” is a term referencing those individuals associated together in a common business effort who possess a beneficial interest in the entity.<sup>133</sup> Thus, the term “associates” in this context requires some concerted, purposeful and voluntary effort by the beneficiaries to either plan or join a pre-existing business enterprise for the purpose of sharing the fruits of its business activities.<sup>134</sup> Ordinarily, this may be gleaned either from the conduct of the beneficiaries in creating the trust or in joining it later when they seek to share the advantages of a common business enterprise.<sup>135</sup> When the beneficiaries do not create the trust but receive their interests by gift, as in *Elm Street Realty*, some further act on their part is necessary to satisfy the associates requirement.<sup>136</sup> Accordingly, the optimal way to avoid being labeled as an “associate” is to make certain that the ongoing beneficiaries do not create the trust, and that the trust instrument expressly prohibits the beneficiaries from sharing any responsibility over trust management and matters with the trustee.<sup>137</sup>

In *Bedell v. Commissioner*, the Tax Court also determined that a business trust lacked associates and was classified as trust and not as an association.<sup>138</sup> The Service contended that the trust was an association taxable as a corporation

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*Id.* at 810-11.

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

133. *Elm St. Realty Trust*, 76 T.C. at 813 (citing *Morrissey*, 296 U.S. 356-57).

134. *Id.*

135. *Id.* at 814.

136. See 76 T.C. at 816-18 (discussing status of trust beneficiary). *But see* *Howard v. United States*, 5 Cl. Ct. 334, 336-37 (1984) (declaring when trust clearly contains a business purpose, trust beneficiaries who did not create trust will become associates if they purchase their beneficial interest which are freely transferable). In *Howard*, the court reasoned that the lack of beneficiary control over trust business activities is only important where the beneficiaries took no part in the creation of the trust in the first instance. *Howard*, 5 Cl. Ct. at 342. Moreover, citing *Morrissey*, the court reasoned that merely taking or acquiring beneficial interests may constitute adequate participation even when control is vested exclusively in the trustees. *Id.*; see also *Joseph v. Sliskovich & Stewart S. Karlinsky, Tax Classification of Trusts: The Howard Case and Other Current Developments*, 19 LOY. L.A. L. REV. 803, 815 (1986).

137. See Carl Radom & Michael Yuhas, *Excess Beneficiary Involvement Can Cost Trust Its Tax Status*, 21 TAX'N FOR LAW. 17, 18 (1992).

138. 86 T.C. 1207, 1218 (1986), *acq.* 1987-2 C.B. 1. The testamentary trust was created for the benefit of the decedent's spouse, three children and six grandchildren. *Id.* at 1209-10. The beneficial interests were considered too personal to be freely transferable. *Id.* at 1220.

because it had an obvious business objective and three beneficiaries participated in the control and management of the business by virtue of being trustees.<sup>139</sup> The Court disagreed based on the holdings of *Morrissey* and *Elm Street Realty*. First, because the trust was testamentary, the beneficiaries had not personally created or planned either the trust or any of its business activities and had not purchased any interest therein but had merely received a gratuitous trust interest under decedent's will.<sup>140</sup> This fact strongly suggested the beneficiaries had not planned a common enterprise. Further, even though the beneficiaries had received their interests by will, the decedent had provided that those beneficial interests were not freely transferable, thus indicating preservation of property purposes rather than a common joint business undertaking.<sup>141</sup> Finally, the Court determined that the participation in the control by only a few of the beneficiaries did not make all the beneficiaries associates.<sup>142</sup>

The court in *Bedell* made clear that its conclusion was reached on the basis of the record as a whole and not on the basis of any one factor, thus reducing the predictability of the case.<sup>143</sup> Nonetheless, the Service later acquiesced in the case, in result only, arguing the court had improperly ignored that beneficiaries may become associates even though they did not plan or purchase their beneficial interests because *Morrissey* merely requires that the beneficiaries "freely accept and retain their interests."<sup>144</sup>

A few years after the *Bedell* opinion, the Service released a 1993 Field Service Advisory regarding the effect of a few, but not all, beneficiaries becoming involved in trust management as trustees.<sup>145</sup> Although reiterating its view that the status of a beneficiary should not shield an operating business from being classified as an association taxable as a corporation,<sup>146</sup> the Service set forth four criteria, based on *Bedell*, it would consider in classifying trust beneficiaries as associates: first, whether the beneficiaries planned a common effort or entered into a combination for the conduct of a business enterprise; second, whether the beneficiaries affirmatively entered into the enterprise

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139. The three children were named as trustees with complete management power, but a son-in-law was employed as the actual manager of trust property which included a family manufacturing business and several real estate parcels. *Bedell v. Comm'r*, 86 T.C. 1207, 1212 (1986), *acq.* 1987-2 C.B. 1. The trustees met only occasionally, and then only informally, to discuss trust matters and no formal votes or actions were taken. *Id.*

140. *Id.* at 1219.

141. *Id.* at 1220.

142. In this case, only decedent's three children were trustees out of a group of ten beneficiaries (with more grandchildren possible) and those trustees delegated most management to decedent's son-in-law who had been employed in the business prior to decedent's death. *Id.* at 1220-21.

143. *Bedell*, 86 T.C. at 1222.

144. See *Bedell v. Comm'r*, 86 T.C. 1207 (1986), *acq. in result*, 1987-2 C.B. 1; *Bedell v. Comm'r*, 86 T.C. 1207 (1986), *action on dec.*, 1987-001 (June 15, 1987).

145. I.R.S. Field Service Advisory, 1993 WL 1470195. The Service noted the term "associates" does not require plurality and thus even one beneficiary could cause a trust to have "associates." See *Hynes v. Comm'r*, 74 T.C. 1266, 1280 (1980).

146. A similar view was expressed in *Bedell*. See *Bedell v. Comm'r*, 86 T.C. 1207, 1221, n.9 (1986).

through purchase of their beneficial interests; third, whether the beneficiaries were restricted against assigning their interest in the trust; and fourth, whether the beneficiaries could control the trust. The Field Service Advisory classified the trust beneficiaries in the example as associates because they satisfied the first two criteria and because the applicable trust was not established as a testamentary trust to preserve and protect a decedent's estate, rather the trust was established by a business to operate a business.

While *Bedell* may be viewed as a “safe harbor” allowing up to 30% of beneficiaries to be involved in a trust business as trustees,<sup>147</sup> the Service clearly views the result as suspect and not applicable beyond the context of limited family business testamentary trusts.<sup>148</sup> In other cases, naming beneficiaries as trustees may be more problematic even when there is less than complete overlap between beneficiary and trustee designation.<sup>149</sup>

#### *D. Avoiding Associates and a Business Objective*

The above cases and rulings are instructive in establishing certain parameters for classifying any trust as an association taxable as a corporation. The trust must have both associates and an objective to carry on a business. Moreover, the business objective is determined from an examination of the trust instrument and the breadth of the trustee powers—not the former or current activity level of the trustee. Importantly, the presence of associates cannot be determined if the requisite business objective is not present. Because most trust instruments grant trustees broad powers to engage in various “business-styled activities” in order to protect or conserve trust property and maximize returns, and the *Morrissey* test looks to the terms of the trust instrument to determine whether there is a “business objective”, it is likely that courts will find a business objective in most trust instruments.

##### *1. Negating a Business Objective*

Negating a business objective requires careful drafting of the trust instrument to expressly restrict trustee powers to only those necessary to

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147. See Radom & Yuhas, *supra* note 137, at 19 (explaining *Bedell* as “safe harbor” for beneficiaries acting as trustees); see also Lisa Afarin, *Taxation of Testamentary Trusts* *Bedell v. Comm’r*, 4 AKRON TAX J. 49, 51 (1987) (discussing *Bedell* analysis).

148. See Colleen Doolin, Note, *Determining The Taxable Status of Trusts That Run Businesses*, 70 CORNELL L. REV. 1143, 1156 (1985).

149. See *Curt Teich Trust No. One v. Comm’r*, 25 T.C. 884, 891 (1956), *acq.*, 1956-2 C.B. 4 (holding trust at issue an “ordinary trust”). In *Curt Teich Trust*, a husband and wife created an inter vivos trust with a transfer of real estate for the benefit of the wife and four children, with two of the children as trustees. *Id.* at 885. The Tax Court held the beneficiaries were not “associates” because the trust was created by parents for the benefits of their children and to avoid their spendthrift habits. *Id.* at 891. Although the operation of the properties clearly constituted an operating business, the Court did not consider that the beneficiaries voluntarily associated themselves in the conduct of the business, but rather simply carried out the estate planning objectives of the parents and noted that the beneficial interests were not transferable. *Id.*

conserve and protect the trust property. This may, and often does, unduly restrict the freedom of the trustee to engage in activity necessary to protect trust property to the fullest degree and hence may be undesirable.

Only a few cases have determined a trust in question did not reflect a business objective. In *A. A. Lewis & Co*, the court found the trust lacked a business objective because the trustee's powers were carefully limited to prevent the trustee from engaging in any business activity and were conscribed to permit only the collection and distribution of proceeds from land sales.<sup>150</sup> Similarly, in *Wyman Building Trust v. Commissioner*, where the trust instrument confined trustee activity to managing the rental of a single property, the Tax Court determined the trust lacked a business objective.<sup>151</sup> Finally, Revenue Ruling 79-77 determined a trust was an ordinary trust rather than an association because the trustee was specifically directed by the terms of the trust to enter into a long-term net lease of the property to a specific corporate tenant and not otherwise empowered to sell or otherwise transfer the trust property.<sup>152</sup> These cases emphasize the importance of carefully limiting the powers of the trustee in the governing instrument.

## 2. Negating the Presence of Associates

When a business objective is required or prudent because the trustee must be given broad powers, the trust instrument must be carefully drafted in order to prevent the presence of associates. While this standard is somewhat easier to satisfy, as with the business objective test, there are really very few cases following *Morrissey* that satisfy this standard. The safest drafting strategy involves a situation where the beneficiaries were not involved with the creation of the trust, the trust instrument specifically prohibits all beneficiaries from participating in the trustee's broad powers, and the trust instrument expressly prevents trust units from being freely transferable. Cases actually satisfying these standards are rare.

In *Elm Street Realty*, the Tax Court indicated that the term "associates" requires some concerted, purposeful and voluntary effort of the beneficiaries to either plan or join a pre-existing business activity for the purpose of sharing the fruits of its business activities.<sup>153</sup> Ordinarily, this may be gleaned either from the conduct of the beneficiaries in creating the trust or joining it later when they seek to share the advantages of a common business enterprise.<sup>154</sup> When the beneficiaries do not create the trust but receive their interests by gift, some

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150. *Id.* at 388. The settlor was the initial beneficiary and the trust certificates were freely transferable, so under the *Morrissey* and *Howard* cases, the trust clearly had associates. See notes 112-119 and accompanying text for full discussion of *A.A. Lewis & Co.* case.

151. 45 B.T.A. 155, 156 (1941); see also *supra* note 117 (discussing *Wyman* case).

152. See *supra* note 125 and accompanying text.

153. *Elm St. Realty Trust v. Comm'r*, 76 T.C. 803, 815 (1981), *acq.* 1981-2 C.B. 1.

154. *Elm St. Realty Trust*, 76 T.C. at 814, *acq.* 1981-2 C.B. 1.

further act on their part is necessary to satisfy the associates requirement. Because the *Elm Street Realty* beneficiaries did not create the trust, received their interests as gifts, and had no voice over trust matters, they were not deemed “associates” even though the trust possessed a business objective. Similarly, in *Bedell v. Commissioner*,<sup>155</sup> the Tax Court determined that a business trust lacked associates because the beneficiaries did not create or plan the testamentary trust, the interests were not freely transferable and only three of ten beneficiaries could participate in the control.<sup>156</sup>

In both instances where the Tax Court indicated the trusts lacked associates, two relevant criteria were present. First, the beneficiaries did not create the trust, and second, the beneficiaries participated in less than 30% of the control of the trust. The fact that *Bedell* was a testamentary trust is presumably favorable as it negates the beneficiaries’ participation in the creation of the trust. However, the lack of any participation in the trustee control is clearly superior in *Elm Street Realty* to the partial control participation in *Bedell*.<sup>157</sup>

#### IV. THE CHECK-THE-BOX REGULATIONS

As with the *Kintner* Regulations, the check-the-box Regulations carefully differentiate between ordinary trusts and other business or commercial trusts—including special analysis for investment trusts, liquidating trusts, and environmental remediation trusts.<sup>158</sup> In large part, these provisions were not designed to make any significant classification changes from the *Kintner* Regulations.<sup>159</sup> As a result, these regulations enshrine years of doctrine that is not useful.

##### A. Business Trusts

The check-the-box Regulations contrast ordinary trusts, taxable under Subchapter J, with commercial trusts, which are business entities subject to classification with other business entities.<sup>160</sup> While an ordinary trust is created to protect or conserve trust property on behalf of trust beneficiaries, a

155. *Bedell v. Comm’r*, 86 T.C. 1207 (1986), *acq.* 1987-2 C.B. 1.

156. *Id.* at 1220-21.

157. Indeed, although the Service acquiesced in its loss in *Bedell*, a few years later it released a 1993 Service Advisory indicating that it would consider the partial beneficial control to establish the associates element. *See Bedell*, 86 T.C. 1207 (1986), *acq.* 1987-2 C.B. 1; *see also Hynes v. Comm’r*, 74 T.C. 1266, 1280 (1980); I.R.S. Field Service Advisory, 1993 WL 1470195.

158. Treas. Reg. § 301.7701-4 (a)-(e) (as amended by T.D. 8697, 1997-1 C.B. 215) (differentiating ordinary, commercial, investment, liquidating, and environmental remediation trusts) (as amended in 1997); *see infra* Part IV.

159. The preamble to the final check-the-box Regulations makes clear that all organizations recognized as separate entities are considered either a trust or a business entity, and the distinctions between trusts and business entities, while restated, were not changed by the new regulations. *See* preamble, T.D. 8697, 1997-1 C.B. 215.

160. Treas. Reg. § 301.7701-4 (a)-(b) (as amended by T.D. 8697, 1997-1 C.B. 215).

commercial trust is created simply as a device to carry on a profit-making business which otherwise would have been carried on through a business organizations such as a corporation or partnership.<sup>161</sup>

The regulations dictate the classification of a commercial trust is determined by whether the trust was created for a business purpose.<sup>162</sup> The case law is not as broad.<sup>163</sup> The *Morrissey* case and its progeny clearly require the presence of both associates and a business objective.<sup>164</sup> While the commercial trust regulation acknowledges that ordinarily a business trust is created by its beneficiaries, thus satisfying the *Morrissey* standard; the same regulation further declares that the absence of beneficiary participation in the creation of the trust does not necessarily shield a business objective. Likewise, although it is generally true that a trust with freely transferable units may have associates, the regulatory description is quite abbreviated and otherwise incomplete.<sup>165</sup>

### B. Investment Trusts

An investment trust is a trust created to facilitate *direct investment* in the assets of the trust through a pooling arrangement that creates the opportunity to diversify investments.<sup>166</sup> In effect, each certificate holder beneficiary transfers money to a transfer agent who uses a pool of funds contributed by like-minded beneficiaries to purchase shares in several companies. The shares are then transferred to a trustee who holds the stocks for the limited purpose of collecting and distributing revenue from the stocks. The certificate holder's investment is diversified because the pool purchases shares in many more stocks than each separate beneficiary could, and each beneficiary owns a proportionate part of all trust assets. Ordinarily, the trust certificates are freely transferable, and as a result, the trust possesses the *Morrissey* associate

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161. Treas. Reg. § 301.7701-4(b) (as amended by T.D. 8697, 1997-1 C.B. 215).

162. The regulations note that while beneficiaries of an ordinary trust do not ordinarily create the trust, the fact that they do so will not prevent the trust from being classified as an ordinary trust, provided the primary purpose test continues to be satisfied. Treas. Reg. § 301.7701-4(a) (as amended by T.D. 8697, 1997-1 C.B. 215). Similarly, while the beneficiaries of a business trust ordinarily create the trust, a trust will still be considered a business trust, even when this is not the case, provided the business purpose test continues to be satisfied. Treas. Reg. § 301.7701-4(b) (as amended by T.D. 8697, 1997-1 C.B. 215). Accordingly, regardless of who creates a particular trust, the primary purpose test is overriding and focuses on whether the trust was created to "conserve or protect" or rather to "carry on a business." Treas. Reg. §§ 301.7701-4(a)-(b) (as amended by T.D. 8697, 1997-1 C.B. 215); *see also supra* Part III (discussing *Kintner* Regulations' use of primary purpose test).

163. Only rarely will a trust with a commercial objective fail to be classified as a business trust and thus be classified as a partnership. *See* Rev. Rul. 64-220, 1964-2 C.B. 335 (considering Illinois land trust mere title holder and thus ordinary trust but presence of broad commercial powers negates this finding). Even more rare is the determination that a trust is a mere agency for federal tax purpose. *See* A.A. Lewis & Co. v. Comm'r, 301 U.S. 385 (1937) (finding nominee status for purposes of subdividing land); Guaranty Employees Ass'n v. United States, 241 F.2d 565 (5th Cir. 1957) (holding credit union operated like agency).

164. *See supra* Part III.B and Part III.C (discussing *Morrissey* tests).

165. *See generally* Howard v. United States, 5 Cl. Ct. 334 (1984).

166. Treas. Reg. § 301.7701-4(c)(1) (as amended by T.D. 8697, 1997-1 C.B. 215).

characteristic. Thus, an investment trust's classification as an ordinary trust depends upon the presence or absence of a business objective which, in turn, depends critically upon the nature of the trustee's powers.

Generally, the trustee's limited power to merely collect and distribute earnings from trust assets mandate that such trusts be classified as ordinary trusts created by the beneficiaries to preserve and protect their investment.<sup>167</sup> Predictably, when the trustee's powers expand beyond this limited scope, the check-the-box Regulations declare that an investment trust will not be classified as an ordinary trust—specifically, if the trustee has the power under the trust instrument to vary the investment of the beneficiaries.<sup>168</sup> Moreover, an investment trust with multiple classes of ownership interests will normally be classified as a business entity unless the existence of the multiple classes is purely incidental to the protection and conservation function of the trust.<sup>169</sup> In these cases, the issue becomes whether risk shifting between the various classes significantly alters the characteristics of a direct investment in the trust assets.<sup>170</sup>

### C. Liquidating Trusts

Both the *Kintner* and check-the-box Regulations contain the same provision governing when a liquidating trust will be classified as an ordinary trust, taxable under Subchapter J as a grantor trust.<sup>171</sup> A liquidating trust is a trust formed for the primary purpose of liquidating a business and distributing the

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167. Treas. Reg. § 301.7701-4(a) (as amended by T.D. 8697, 1997-1 C.B. 215); *see also* Rev. Rul. 92-32, 1992-1 C.B. 434 (addressing sale of second subordinated securities class that pools debt securities); Rev. Rul. 90-63, 1990-2 C.B. 270 (discussing power to preserve credit rating); Rev. Rul. 89-129, 1989-2 C.B. 262 (permitting limited power to transfer substantially identical securities for short period); Rev. Rul. 86-92, 1986-2 C.B. 214 (addressing limited trustee power to substitute investments); Rev. Rul. 81-238, 1981-2 C.B. 248 (evaluating fixed investment trust with automatic reinvestment plan); Rev. Rul. 75-192, 1975-1 C.B. 384 (discussing fixed investment trust with mortgages); Rev. Rul. 73-460, 1973-2 C.B. 424 (considering fixed investment trust with ownership units); Rev. Rul. 61-175, 1961-2 C.B. 128 (reviewing corporate fund established by several banks with retained proportional income interest); I.R.S. Priv. Ltr. Rul. 9839001 (May 29, 1998) (deciding transfer of loans to trust, which sold portion to public, represented financing, not sale because of retained control).

168. Treas. Reg. § 301.7701-4(c)(1) (as amended by T.D. 8697, 1997-1 C.B. 215).

169. Treas. Reg. § 301.7701-4(c)(1) (as amended by T.D. 8697, 1997-1 C.B. 215). The examples provide an illustration of a multiple class mortgage pool where the pool shifts the risk of pre-payment from one class to the other and thus the trust is not an ordinary trust as this feature is not incidental. *See* Treas. Reg. § 301.7701-4(c)(2) (as amended by T.D. 8697, 1997-1 C.B. 215) (Example 1).

170. *See* Treas. Reg. § 301.7701-4(c)(2) (as amended by T.D. 8697, 1997-1 C.B. 215) (Example 1 and Example 3).

171. *See* Treas. Reg. §§ 301.7701-4(a), (d) (as amended by T.D. 8697, 1997-1 C.B. 215); *see also* I.R.C. §§ 671-679 (2006) (containing Subchapter J, subpart E); *Bixby v. Comm'r*, 58 T.C. 757 (1972); Rev. Rul. 80-150, 1980-1 C.B. 316; Rev. Rul. 72-137, 1972-1 C.B. 101; Rev. Proc. 94-45, § 3.03, 1994-2 C.B. 684. In effect, the Subchapter J trust tax rules disregard the separate tax status of the trust. Consequently, items of trust income and expense are included directly in the income of the owner beneficiaries and not by the trust on a Form 1041 (however, the items are shown on a separate statement to be attached to Form 1041). *See* Treas. Reg. § 1.671-4.

assets transferred to the trust and all the activities that are reasonably necessary to accomplish that objective.<sup>172</sup> A liquidating trust is generally not a business entity because it possesses only a liquidation objective and lacks a business objective.<sup>173</sup> However, if the existence of the trust is unreasonably prolonged, or the liquidation purpose becomes obscured or abandoned by business activities, the trust will become a commercial trust.<sup>174</sup>

The determination of whether the liquidation and distribution of trust assets is unreasonably prolonged is not based solely on the ultimate duration of the trust. Rather, the declared liquidation purpose is compared with the nature of trust assets and the business related contingency the trust was formed to solve. The most problematic situations involve a delayed distribution and liquidation; therefore, the reason for the delay will be closely scrutinized. Because the unanticipated delay problems occur long after the trust is formed, administrative rulings are not useful sources for expected parameters.<sup>175</sup>

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172. Treas. Reg. § 301.7701-4(d) (as amended by T.D. 8697, 1997-1 C.B. 215). As with other types of trusts, the organization test is applied by examining the language of the trust instrument. *See* Nee v. Main St. Bank, 174 F.2d 425, 429 (8th Cir. 1949). The trust instrument should declare that the trust is formed for the sole or dominant purpose of liquidating and distributing trust assets. *Id.* The trust instrument should only set forth additional business powers which are necessary for the protection of the specific trust property and are ordinarily recognized as incidental. *Id.*

173. Treas. Reg. § 301.7701-4(d) (as amended by T.D. 8697, 1997-1 C.B. 215). Liquidating trusts have been used to resolve nearly unlimited business contingencies and still have been classified as trusts. *See* Holywell Corp. v. Smith, 503 U.S. 47, 55-56 (1992) (creating liquidating trust as part of Chapter 11 bankruptcy to liquidate debtor's estate); Cebrian v. U.S., 181 F. Supp. 412 (Ct. Cl. 1960) (liquidating trust established by creditors); Rev. Rul. 80-150, 1980-1 C.B. 316; Rev. Rul. 75-379, 1975-2 C.B. 505; Rev. Rul. 57-607, 1957-2 C.B. 887; Rev. Proc. 94-45, 1994-2 C.B. 684 (outlining criteria for liquidating trust created as part of Chapter 11 bankruptcy to receive advance ruling classifying it as a trust).

174. Treas. Reg. § 301.7701-4(d) (as amended by T.D. 8697, 1997-1 C.B. 215). Thus, even trusts initially classified as liquidating trusts may later be reclassified as business entities by virtue of the trust operations. *See* Anderson v. Lamb, 222 F.2d 176 (8th Cir. 1955) (reclassifying liquidating trust as association taxable as corporation).

175. For advance ruling purposes, the trust instrument of a liquidating trust created pursuant to a Chapter 11 bankruptcy plan must state a fixed termination date that is generally not more than five years from the date the trust was created. *See* Rev. Proc. 94-45, § 3.06, 1994-2 C.B. 684. (similar to requirements for issuance of advance ruling set forth in Rev. Proc. 82-58). For liquidating trusts created outside bankruptcy, the fixed period is three years. Rev. Proc. 82-58, § 4.02, 1982-2 C.B. 847. Generally, an advance ruling will be issued that a liquidating trust created outside bankruptcy qualifies as a trust rather than a business entity if the following conditions are satisfied: the primary purpose of the trust is to liquidate the assets transferred to it and there is no objective to continue or engage in the conduct of a trade or business and the governing instrument so provides; the trust instrument contains a fixed or determinable termination date that is generally not more than three years from the date of creation of the trust (or, if longer, the period of the term of installment obligation held by the trust, reasonably based on all of the facts and circumstances); in the case of a trust created incident to a corporate liquidation, the trustee must be selected by the shareholders of record or a court of competent jurisdiction and due notice must be given, in accordance with local law for shareholders that are not located nearby; the investment powers of the trustee must be limited to powers to invest in demand and time deposits in financial institutions or temporary investments in short-term certificates of deposit or treasury bills; the trust does not receive transfers of any listed stocks or securities, readily marketable assets or operating assets of a going business; the trust does not receive transfers of any unlisted stock of a single issue or that represents 80% or more of its outstanding stock and it does not receive transfers of partnership interests; the trust is required to distribute at least annually to known shareholders sales proceeds or income from investments; and the trustee

Courts, however, are quite liberal in accepting extended liquidation periods which can span nearly forty years when circumstances do not permit an earlier prudent liquidation.<sup>176</sup>

While liquidating trusts are usually formed to hold title to assets pending resolution of some business-related contingency, such as the resolution of third-party claims or the disposition of hard-to-sell property,<sup>177</sup> the administration of the trust will nearly always involve carrying on some business activities.<sup>178</sup> The issue then becomes whether the business activities are merely “incidental and necessary” to the declared liquidation purpose.<sup>179</sup> If so, the trust will be classified as a liquidating trust under the check-the-box Regulations.<sup>180</sup> If not, unless the trust elects to be treated as a corporation, it will be classified as either a partnership or a disregarded entity, depending on the number of beneficiaries.<sup>181</sup> While such classification is most often desirable, there are circumstances when grantor trust status may be preferable.<sup>182</sup> Consequently, the issue remains relevant even after the adoption of the check-the-box Regulations.

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must represent in a ruling request that it will make continuing efforts to dispose of the trust assets in a timely manner. *Id.* at §§ 4.01-4.08.

176. *Wilson Syndicate Trust v. Comm’r*, 1 T.C.M. (CCH) 377 (1943) (allowing liquidating trust to dispose of substantial land holdings still in existence after twenty years). The *Wilson* case cited with approval four other cases involving liquidating trusts with extended administration. *See Helvering v. Washburn*, 99 F.2d 478 (8th Cir. 1938) (thirty-seven years); *Paine v. United States*, 32 F. Supp. 672 (D. Mass. 1940) (twenty-three years); *Fidelity Nat’l Bank & Trust Co. v. Comm’r*, 37 B.T.A. 473 (1938) (ten years); and *Pitzman v. Comm’r*, 36 B.T.A. 81 (1937) (eighteen years); *see also Cebrian v. United States*, 181 F. Supp. 412 (Ct. Cl. 1960) (twenty-eight years).

177. Sheldon Banoff, *Non-qualifying Liquidating Trusts: Soft Landing?*, 95 J. TAX’N 59 (2001).

178. *Helvering v. Washburn*, 99 F.2d 478, 481 (8th Cir. 1938) (quoting *Comm’r v. Morriss Realty Co. Trust*, 68 F.2d 648, 651 (7th Cir. 1934)).

179. *See id.* “If there is a purpose of immediate liquidation as soon as circumstances will permit, and the carrying on the business is only *incidental and necessary* for the preservation of the property, no taxable association has resulted.” *Id.* (emphasis added); *see also Walker v. United States*, 194 F. Supp. 522, 527-28 (D. Mass. 1961). “There was undoubtedly considerable business activity on the part of the trustees in this case, but it does not appear to have involved more than what was required to conserve the value of the property and obtain a satisfactory price for it.” *Walker*, 194 F. Supp. at 527-28.

180. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 200213020 (March 29, 2002); I.R.S. Priv. Ltr. Rul. 200119019 (May 11, 2001); I.R.S. Priv. Ltr. Rul. 200034022 (August 25, 2000); I.R.S. Priv. Ltr. Rul. 9836024 (September 4, 1998); I.R.S. Priv. Ltr. Rul. 9801033 (January 5, 1998); Priv. Ltr. Rul. 9801035 (January 5, 1998); and Priv. Ltr. Rul. 9752039 (December 29, 1997) (examples of trusts classified as liquidating trusts under the check-the-box Regulations). To date, no post-check-the-box rulings have classified a liquidating trust as a business entity.

181. The check-the-box default rule changes the prior classification of most failed liquidation trusts which were generally classified as corporations rather than partnership because they possessed at least three of the traditional four corporate characteristics: centralized management (through the trustee), continuity of life (death or other dissociation by a beneficiary does not terminate the trust), and limited liability (for all beneficiaries). *See Banoff, supra* note 177.

182. *See* 26 U.S.C. § 731(c)(6) (1997) (noting partnership distributions of marketable securities treated as distributions of cash); 26 U.S.C. § 7704 (1997) (declaring all publically traded partnerships taxed like corporations); Banoff, *supra* note 177 (providing some states exempt grantor trusts from partnership-level income or franchise taxes).

#### D. Environmental Remediation Trusts

The regulatory provisions relating to environmental remediation trusts are new to the check-the-box Regulations and were not found in the *Kintner* Regulations.<sup>183</sup> An environmental remediation trust will be classified as an ordinary trust taxable under Subchapter J as a grantor trust,<sup>184</sup> provided it is organized and operated for the primary purpose of collecting and disbursing amounts for environmental remediation of an existing waste site.<sup>185</sup> Consequently, environmental remediation trusts, like liquidating trusts and other ordinary trusts taxable under Subchapter J, cannot carry on a profit-making activity.<sup>186</sup>

In order to qualify as an environmental remediation trust under the check-the-box Regulations, the trust must be organized under state law as a trust; its primary purpose must be the collection and disbursement of amounts for the environmental remediation of an existing waste site; the remediation must be necessary to deal with the liability or potential liability of persons under federal, state or local environmental laws; all contributors to the trust must have, at the time of contribution and later “actual or potential liability or a reasonable expectation of liability, under federal, state or local environmental laws for remediation of that waste site”; and the trust must not be a qualified settlement fund.<sup>187</sup> The phrase “environmental remediation” is defined to include the “costs of assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, and collecting amounts from persons liable or potentially liable for the costs of these

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183. Treas. Reg. § 301.7701-4(e) (as amended by T.D. 8697, 1997-1 C.B. 215).

184. Treas. Reg. § 301.7701-4(e)(2) (as amended by T.D. 8697, 1997-1 C.B. 215); I.R.C. §§ 671-679. Consequently, each contributor-grantor is treated as the owner of the portion of the trust contributed by that grantor. As such, items of trust income and expense are included directly in the income of the owner beneficiaries and not by the trust on a Form 1041 (however, the items are shown on a separate statement to be attached to Form 1041). See Treas. Reg. § 1.671-4; Treas. Reg. § 301.7701-4(e)(2) (as amended by T.D. 8697, 1997-1 C.B. 215). The trustee must furnish each grantor with a statement setting forth that grantor's reportable tax items. Each grantor will be entitled to expense or capitalize the portion of their contribution expended by the trustee and would likewise be required to include the earnings from the investment relative to the unexpended portion of the contribution. Special rules apply to “cash-out” grantor-contributors, who are not treated as the owner of a portion of the trust as soon as the contributed portion and its earnings are expended for remediation. See Treas. Reg. § 301.7701-4(e)(3) (as amended by T.D. 8697, 1997-1 C.B. 215). A “cash-out” grantor is a contributor making a lump-sum payment to the trust in satisfaction of its entire remediation obligation with the other trust contributors (although the agreement is not binding on federal or state authorities).

185. Treas. Reg. § 301.7701-4(e)(1) (as amended by T.D. 8697, 1997-1 C.B. 215).

186. *Id.*

187. *Id.* A “qualified settlement fund” in this connection includes a trust established under governmental authority to resolve or satisfy claims arising under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). Treas. Reg. § 1.468B-1(a) (as amended in 2006). For purposes of current deductibility, economic performance is deemed to occur as payments are made to the trust. I.R.C. § 468B(a) (2000).

activities.”<sup>188</sup> For this purpose, persons have potential, or a reasonable expectation, of remediation liability if there is authority under a federal, state, or local law that “requires or could reasonably be expected to require such persons to satisfy all or a portion of the costs of the environmental remediation.”<sup>189</sup>

An environmental remediation trust would ordinarily be utilized when a qualified settlement fund trust is inappropriate or unavailable. While payments to a qualified settlement fund trust are deductible when paid into the trust, deductions for contribution to an environmental remediation trust may be delayed until the trust actually expends the trust funds.<sup>190</sup> Thus, when a taxpayer has no use for a current tax deduction relative to appropriate and mandated remediation expenses, this trust may be appropriate. Conversely, the remediation liability may be contingent such as with a contaminated site that one might reasonably expect potential liability to arise in the future. In such cases, the parties merely desire to clean up the site to avoid future litigation and controversy. An environmental remediation trust allows this to be accomplished by permitting the parties to contribute their respective share of the total remediation expenses to the trust, with the trustee making payments as needed on the project. The primary purpose for using such a trust is to provide for the collection and disbursement of funds for the remediation project—not to advance or enhance the current deductibility of remediation payments.

An environmental remediation trust may be classified as a partnership or corporation because of the significant trust administration activity level when the trust instrument empowers the trustee to do more than simply preserve or conserve trust property for its beneficiaries. In Private Letter Ruling 9108025, the Service arrived at just such a conclusion when considering the tax classification of an environmental remediation trust.<sup>191</sup> After the Environmental Protection Agency notified several parties that they were potentially responsible parties liable for the clean-up of a superfund hazardous waste site, forty-two parties formed a trust to receive and manage contributions for the remediation of the site.<sup>192</sup> The trust document provided that the exclusive purposes of the trust were for the collection, preservation, interim investment, and disbursement of funds necessary to satisfy the remediation obligations of the forty-two grantors.<sup>193</sup>

The Service first concluded that the remediation trust was not an ordinary trust taxable under Subchapter J but rather an association possessing both

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188. Treas. Reg. § 301.7701-4(e)(1) (as amended by T.D. 8697, 1997-1 C.B. 215).

189. *Id.*

190. See generally Sheldon D. Pollack, *Tax Treatment of Environmental Transactions*, 52 TAX LAW. 81 (1998).

191. I.R.S. Priv. Ltr. Rul. 9108025 (Nov. 26, 1991).

192. *Id.* Trust interests were not assignable and each grantor remained personally liable under local law for the remediation obligations of the trust. *Id.*

193. *Id.*

critical corporate characteristics: associates and an objective to carry on a business.<sup>194</sup> The Service further classified the trust as a partnership because it lacked the corporate characteristics of limited liability and free transferability of interests.<sup>195</sup> The Service later reversed its view on remediation trusts when it adopted Treasury Regulation 301.7701-4(e), an addition to the *Kintner* Regulations, specifically addressing the classification of environmental remediation trusts.<sup>196</sup> Under the regulation, an environmental remediation trust is classified as a trust and not as a business entity. An environmental trust may differ from a traditional trust, in which trustees take title to property solely for the purpose of protecting or conserving it for the beneficiaries; however, because its purpose is to pay the costs of environmental remediation of an existing waste site and not to carry on a for-profit business, it is classified as an ordinary trust.<sup>197</sup>

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194. *Id.* The Service determined that the trust had associates because either the trust beneficiaries (the grantors) voluntarily associated themselves in the remediation enterprise or actively participated in its operation. *Id.* (citing *Elm St. Realty Trust v. Comm'r*, 76 T.C. 803, 815 (1981)). The Service determined that the trust had an objective to carry on a business even though the trust was not engaged in a business for profit, because it nevertheless engaged in activities designed to further the purposes for which the trust was formed. These activities were well beyond the concept of accepting title for the purpose of protecting it for the beneficiaries. *Id.*; *see also Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369 (1935). *Coleman-Gilbert* stands for the proposition that the “business objective test” is determined from an examination of the trust document for the “power” to engage in such activities—regardless of whether those purposes are exercised. *See* 296 U.S. at 373-74.

195. *See* I.R.S. Priv. Ltr. Rul. 91-08-025 (Feb. 22, 1991). The Service noted that partnership associations were distinguished from corporate associations by the presence of four corporate characteristics: continuity of life, pursuant to Treas. Reg. § 301.7701-2(b)(1960); centralized management, pursuant to Treas. Reg. § 301.7701-2(c)(1960); limited liability, pursuant to Treas. Reg. § 301.7701-2(d)(1960); and free transferability of interests, pursuant to Treas. Reg. § 301.7701-2(e)(1960). *See* Treas. Reg. § 301.7701-2(a)(2) (1960) (noting corporations and partnerships share characteristics and must be distinguished by above-referenced factors). Associations are classified as corporations if they possessed more corporate characteristics than non-corporate characteristics. Treas. Reg. § 301.7701-2(a)(3) (1960). Because the trust in question lacked two corporate characteristics (limited liability and free transferability of interests), the Service classified it as a partnership. *See* I.R.S. Priv. Ltr. Rul. 91-08-025 (Feb. 22, 1991). The Service determined that the trust lacked corporate-styled limited liability because the grantors represented that each continued to be liable for the trust’s remediation obligations under local law. *Id.* Curiously, this result was based on a representation without explanation other than the fact that the trust was formed as a “business trust” and therefore the grantor-beneficiaries were personally liable for the trust’s obligations. *Id.* Whether a trust beneficiary has any personal liability for the trust obligations through beneficial ownership depends upon state law. *See generally* CHARLES E. ROUNDS, LORING: A TRUSTEE’S HANDBOOK § 9.6 (2000). Some states treat the trust as a “partnership” and the beneficiaries as general partners and thus jointly liable for the trust obligations. *Id.* Most states, however, regard the trust beneficial ownership as not imposing personal liability on the beneficiaries. *Id.*; *see also* BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 247 (3d ed. 2000). In any event, presumably the members’ continued liability under federal and state environmental law was not a factor in this representation. I.R.S. Priv. Ltr. Rul. 91-08-025 (Feb. 22, 1991). Also, because the trust instrument provided that the certificates of beneficial interest were not assignable, the Service determined that the trust lacked the corporate characteristic of free transferability of interest. *Id.*

196. T.D. 8668, 1996-1 C.B. 349. The environmental remediation trust provision was carried over to the check-the-box Regulations as were all other trust provisions. *See* Treas. Reg. §§ 301.7701-4 (as amended by T.D. 8697, 1997-1 C.B. 215).

197. Prop. Treas. Reg. § 301.7701-4(e), 60 Fed. Reg. 39903 (August 4, 1995).

## V. REFORM PROPOSAL

While generally laudatory, the 1997 check-the-box Regulations left much to be desired regarding the federal tax classification of trusts. By leaning too heavily upon the prior classification system, the regulations adopted their fatal flaw—an indecisive system based on years of indecisive case law.

*A. Comparison of Two Regulatory Approaches*

Under the 1960 *Kintner* Regulations, trusts considered associations were further classified as either corporations or partnerships on the basis of an awkward and unwieldy corporate resemblance test developed from the *Morrissey* case.<sup>198</sup> Under this scheme, commercial purpose trusts were generally classified as associations taxable as corporations.<sup>199</sup> Under the check-the-box Regulations, trusts considered business entities are automatically classified as partnerships or disregarded entities, depending on the number of owners, unless the trust elects to be taxed as a corporation.<sup>200</sup> This check-the-box convention is both highly desirable and useful because it defaults out of the double-tax regime applicable to corporations and into the partnership tax regime.<sup>201</sup>

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198. Treas. Reg. § 301.7701-2(a)(1) (1960). The regulations classified an association as a corporation rather than a partnership only if it possessed more corporate characteristics than partnership characteristics. Because the regulations utilized four corporate criteria, an association would therefore only be classified as a corporation if it possessed at least three criteria. Treas. Reg. § 301.7701-2(a)(3) (1960); *see also* *Morrissey v. Comm'r*, 296 U.S. 344 (1936).

199. Generally, commercial trusts were thought to possess three corporate characteristics including centralized management (through the trustee), continuity of life (death or other dissociation by a beneficiary does not terminate the trust), and limited liability (for all beneficiaries). *See* Banoff, *supra* note 177. Accordingly, the commercial purpose trust more closely resembled a corporation rather than a partnership under the *Kintner* Regulations.

200. *See* Treas. Reg. §§ 301.7701-2(a), (c)(1), (c)(2) (as amended by T.D. 8697, 1997-1 C.B. 215); Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-1 C.B.); *see also* I.R.S. Priv. Ltr. Rul. 9835012 (Aug. 28, 1998) (interpreting state law business trust filing late election to be classified as association taxable as corporation).

201. The large volume of tax literature mostly assumes the corporate second tax on distributions to be fatal to the incorporation decision. In truth, the true tax cost of incorporation is not so simple. For the most part of history, the corporate tax rate has been lower than the individual rate. Thus, the corporate tax burden only occurs when the second tax is imposed—at the time of distributions of earnings in the form of a dividend. For those taxpayers willing to defer dividend distributions—because a corporate deductible salary withdraws adequate earnings, because the excess earnings are needed to finance small business expansion, or other reasons—the second tax is significantly postponed. This deferral drastically reduces the true cost of the second tax on distributions and when combined with the lower corporate entity tax often means the total tax cost of incorporation is less than the with other business forms with only one level of tax, such as partnerships, trusts, and limited liability companies. *See* Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 214 (1991). Moreover, the second tax may be further reduced by a lower capital gain rate available when an owner discontinues ownership, and may also be reduced by various forms of “self-integration” such as deductible interest on debt. In the cited article, the authors suggest that the additional corporate tax costs may be a profitable gamble. This view attempts to evaluate the risk of additional “control” over the timing and character of the second tax as a “choice” factor over choice of entity. Because the trust

### B. Reform Proposal Discussed

Unfortunately, neither the *Kintner* Regulations nor the check-the-box Regulations solved the initial trust classification conundrum. The proposed solution to this ancient riddle involves a modern convention derived from the check-the-box approach to classification. The check-the-box Regulations assume that all business entities favor the more preferable partnership tax regime, and therefore adopt a desirable convention that comports with what most well-informed persons would have adopted if they had the flexibility to do so.<sup>202</sup> A similar assumption can be applied to the earlier classification question—most well-informed persons, given the flexibility, would choose for their trusts to be classified as ordinary trusts taxable as such under Subchapter J. This desirable convention should be granted to all qualifying trusts unless otherwise indicated by the grantors or settlors of the trust. Because most common-law trusts are formed on the assumption that the trust will be classified as a trust and not as some other business entity inconsistent with the trust form, the ordinary trust classification assumption comports with the most normative default rule. Like the check-the-box regulatory assumption, however, it should only be a default rule, allowing the trust to elect to be taxed as another business form. This could be most easily accomplished by allowing the trust to elect to be governed by the check-the-box Regulations. The elect-in option would promote flexibility while at the same time providing certainty of results.

Statutory business trusts are different. Indeed, most are formed for a business purpose and some statutes expressly preclude a traditional common-law trust purpose.<sup>203</sup> Therefore, the rule for the statutory business trust should be opposite of the rule applicable to the common-law trust. Like an entity formed as a corporation, a statutory business trust should be classified as a business entity. Under the check-the-box Regulations, a statutory business trust would be classified as a partnership or disregarded entity, depending on the number of beneficial owners. Further, like other unincorporated business entities, a statutory business trust should be permitted to elect corporate classification.

This simple system would amend the current check-the-box Regulations by

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form offers more control (choice of entity tax in short term), it offers more control than the partnership tax form. *Id.* at 216. Of course, this promotes the counter-argument that the “managed” lower tax cost corporate form inefficiently promotes delayed distribution of earnings in order to reduce its tax impact. *Id.* at 227. It can be equally argued however that the often disparate tax rates and tax situations of various shareholders increases the agency cost associated with managing corporate distribution efficiently. In such situations, the second distribution tax tends to equalize the tax goals of the shareholders and thus reduces, to the extent possible, agency costs. *Id.* at 232-33.

202. See Randy Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821 (1992).

203. See generally UNIF. STAT. TRUST ENTITY ACT (Proposed Official Draft 2009), [http://www.law.upenn.edu/bll/archives/ulc/ubta/2009am\\_approved.pdf](http://www.law.upenn.edu/bll/archives/ulc/ubta/2009am_approved.pdf).

eliminating the separate provisions applicable to trusts.<sup>204</sup> The check-the-box business entity regime would only be applicable to common trusts that elect such status and automatically to statutory trusts. This would then permit common-law trusts to make a second election to be taxed like a corporation—the same elective right accorded other unincorporated business entities. Statutory trusts could make a single election if they desired to be taxed like a corporation. In order to continue similar treatment to such trusts, Section 7704 would need to be amended to assure that publicly-traded trusts are taxed like publicly-traded partnerships. In this event, all corporations, regardless of whether publicly-traded, all publicly-traded partnerships, and all publicly-traded trusts would be taxed the same. The common classification denominator among all unincorporated business entities would then be partnership taxation unless an election is filed, and even if not so filed, corporate status if publicly-traded. Given that so little tax revenue is at stake because even commercial trusts are classified as partnerships, little harm results.

#### VI. CONCLUSION

The check-the-box Regulations represent a clear advancement promoting certainty and simplicity. Section 7704 operates as an outer boundary to the classification conundrum by taxing all publicly-traded partnerships as corporations. This section could easily be extended to publicly-traded trusts. Given this common limitation theme, the presence of various other techniques to mitigate corporate tax in closely-held corporations and associations, the Bush proposals signaling an eventual attack on the corporate double tax regime even in public companies, and the fact that the check-the-box Regulations classify commercial trusts as partnerships, the complexity and expense remaining in the trust classification issue connected to whether a trust is an ordinary or commercial trust is both unwarranted and unnecessary. A simple check-the-box extension to trusts would further advance both the spirit and scope of the check-the-box Regulations and would presume every common-law trust will be classified as an ordinary trust subject to taxation under Subchapter J. Also, consistent with the check-the-box Regulations, every common-law trust should be permitted to elect to be treated as a commercial trust with the result that it would be presumed to be a partnership unless it also makes a further election to be taxed like a corporation. Further, every statutory business trust receives a slightly modified approach befitting the traditional uses of that business entity form. In both cases, the check-the-box Regulations become infinitely more complete.

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204. Treas. Reg. § 301.7701-4 would be eliminated as the regulatory “distinction” between ordinary trusts and commercial trusts would no longer be meaningful.