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## Tax Treatment of Revocable Trusts: Are They Associations Taxable as Corporations?

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## COMMENTS

### Tax Treatment of Revocable Trusts: Are They Associations Taxable As Corporations?

#### I. INTRODUCTION

Section 676 of the Internal Revenue Code<sup>1</sup> provides special rules for the taxation of revocable trusts.<sup>2</sup> That section classifies certain revocable trusts as “grantor trusts” because the grantor retains control over the property held by the trust sufficient to be deemed the owner of that property. The grantor is taxed on

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1. I.R.C. § 676(a) (1982). That section provides that “[t]he grantor shall be treated as the owner of any portion of a trust, . . . where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.” *Id.*

2. As used in this comment, the term “revocable trust” or “revocable grantor trust” refers to a trust arrangement in which the grantor creates a trust and he (or a party which is nonadverse to him) retains a revocation power over the property he transfers into the trust. The grantor or members of his immediate family are generally named as beneficiaries, and a power to remove the trustee is also retained. Revocable trusts are typically established as estate planning devices, often giving trustees broad discretionary powers in order to facilitate effective management of the wide array of assets placed in revocable trusts. The trustee is charged with the duty of protecting and conserving the trust assets for the benefit of the beneficiaries, and these discretionary powers are granted so that the trustee may effectively protect and conserve the trust assets.

Revocable trusts can be a useful and desirable planning tool in several different contexts, including: (1) current or future management of the grantor’s assets, especially when there is a significant possibility that the grantor may become incompetent or disabled at some future date; (2) defeating the elective rights of the grantor’s spouse or children against his estate; (3) limiting or defeating the rights of certain creditors of the grantor against his estate; (4) avoiding probate because of the desire to avoid publicity or administration of certain types of assets; and (5) selecting the situs for administration of certain assets, thus widening the selection of fiduciaries and governing law. *See Grantor Trusts: §§ 671-679, [452 Estates, Gifts, and Trusts] Tax Mgmt. (BNA) A-39 (1983).*

In addition, grantor trusts can be very effective devices for estate tax planning. Revocable trusts are also commonly used as probate avoidance devices, especially in jurisdictions where the Uniform Probate Code has not been adopted. A revocable trust can maximize flexibility and convenience in distributing the assets of the grantor upon death, functioning effectively as a will substitute in these jurisdictions and avoiding the expensive and often lengthy probate process.

the trust income as if he actually owned the trust property himself—in effect, the trust is treated as an extension of the grantor.

Section 7701 of the Internal Revenue Code<sup>3</sup> includes “associations” within the definition of “corporations” for federal income tax purposes. The regulations pertaining to that section<sup>4</sup> establish a framework for evaluating an entity’s organizational characteristics for the purpose of determining the taxable status of that entity. Under these provisions, an entity which is a partnership or trust under state law may be reclassified as an association and be subject to taxation as a corporation. This reclassification of an entity’s form may produce an inequitable and undesirable result when the entity in question is a revocable trust.

Recent developments in the application of these provisions have highlighted a potential conflict between sections 676 and 7701. The conflict arises where a grantor establishes a revocable trust for personal estate planning purposes, granting the trustee broad business powers in the trust instrument in order to facilitate the preservation of the trust assets by the trustee. Section 676 would classify the revocable trust as a grantor trust, disregarding the trust as a taxable entity and taxing the income of the trust only to the grantor.<sup>5</sup> However, a rigid application of section 7701 and its related regulations could potentially classify the trust as an association taxable as a corporation, resulting in taxation of trust income at both the trust and beneficiary level. The Internal Revenue Service [Service] recently issued a General Counsel Memorandum [GCM]<sup>6</sup> which dealt with this potential conflict by ruling that a revocable trust in which the trustee was granted broad discretionary powers was neither a trust nor an association, but merely an agent of the grantor. The trust income was thus taxed only once, to the grantor, but because the trust arrangement was ignored, section 676 never entered into the Service’s analysis.

This comment examines the relevant code sections and regulations as they apply in the grantor trust context. It then dis-

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3. I.R.C. § 7701(a)(3) (1982).

4. Treas. Reg. §§ 301.7701-1 to -4 (as amended in 1983).

5. See *infra* notes 7-8 and accompanying text.

6. Gen. Couns. Mem. 39,395 (Aug. 22, 1985) [hereinafter GCM]. General Counsel Memoranda are similar to private letter rulings, in that they act as little more than windsocks to show the direction of the Service’s leanings on a particular subject. I.R.C. § 6110(j)(3) (1982). That section states that unless otherwise provided, “a written determination may not be used or cited as precedent.” *Id.*

cusses the analysis used in the GCM, addressing a number of policy concerns related to whether revocable grantor trusts should be classified as associations. This comment then postulates that revocable trusts should be recognized as trusts rather than associations, with trust income taxed to the grantor under section 676. It concludes with a proposed approach for classifying revocable trusts under section 7701 which is in harmony with the policies underlying that section and section 676.

## II. SECTION 676

An ordinary trust is normally taxed on the income which the property held in trust produces. The trust is, however, allowed a deduction for amounts distributed or required to be distributed to beneficiaries during the taxable year.<sup>7</sup> Thus, the ordinary trust functions as a conduit with respect to amounts paid to beneficiaries during the year, and as a separate taxable entity for amounts retained during the year.

A trust classified as a grantor trust under section 676 is effectively deemed to be a mere extension of the grantor for income tax purposes; as a result, the grantor is taxed on the income of the trust as though he owned the trust property—he is the beneficial owner of the property.<sup>8</sup> However, the trust is recognized as a valid entity under state law. No deduction is allowed for amounts distributed or distributable to beneficiaries during the year, and each payment to a beneficiary other than the grantor is treated as a gift from the grantor to that beneficiary in the year of the distribution.<sup>9</sup>

## III. REVOCABLE TRUSTS AND THE ASSOCIATION RULES

In evaluating whether a revocable trust should be classified as an association taxable as a corporation, the inquiry is essentially whether the entity more closely resembles a trust than a corporation. The Regulations incorporate six characteristics, first set out in *Morrissey v. Commissioner*,<sup>10</sup> which are used to evaluate an entity in order to determine its taxable status: (1) associates, (2) business purpose, (3) continuity of life, (4) cen-

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7. I.R.C. §§ 651(a), 661(a) (1982).

8. I.R.C. § 676 (1982).

9. See, e.g., J. DUKEMINIER & S. JOHANSON, *WILLS, TRUSTS, AND ESTATES* 529 (3d ed. 1984).

10. 296 U.S. 344 (1935).

tralized management, (5) free transferability of interests, and (6) limited liability.<sup>11</sup> The first two factors are especially important: “ ‘[a]ssociation’ implies *associates* [and] the entering into of a joint enterprise . . . for the *transaction of business*.”<sup>12</sup> Thus, in order to reach the point of examining the other four *Morrissey* characteristics, the entity must first be found to possess *both associates and a business purpose*.<sup>13</sup>

### A. Associates

Whether an organization has “associates” depends upon whether the beneficiaries voluntarily associated themselves with the entity (including whether they created it) and whether the beneficiaries have participated actively in the affairs of the entity.<sup>14</sup> The existence of either of these attributes is enough to classify the beneficiaries as associates.<sup>15</sup> In distinguishing ordinary trust beneficiaries from beneficiaries which are considered associates, the *Morrissey* Court stated that “[trust] beneficiaries

11. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983). These six factors are derived from the holding in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), and the regulations incorporating them are commonly known as the “*Morrissey* regulations.”

12. *Morrissey*, 296 U.S. at 356 (emphasis added).

13. The Regulations provide that in examining these six factors,

[c]haracteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association. . . . [S]ince centralization of management, continuity of life, free transferability of interests, and limited liability are *generally* common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom.

Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983) (emphasis added); see *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803 (1981); Note, *Determining the Taxable Status of Trusts that Run Businesses*, 70 CORNELL L. REV. 1143, 1145 & n.16 (1985).

Thus, the inquiry into whether associates and a business purpose are present necessarily assumes that the trust *does* possess the other four corporate characteristics, because the Regulations require a trust to have “more corporate characteristics than noncorporate characteristics” after *eliminating* the characteristics *common* to both corporations and trusts. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983). Those characteristics common to trusts and corporations are eliminated in analyzing the taxable status of the entity, Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983), on the assumption that the entity in question possesses them. The language of the Regulations quoted above, especially the words emphasized, seems to indicate that a further inquiry is necessary when the entity does *not* possess the other four characteristics which are normally common to both trusts and corporations.

14. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983).

15. See Note, *supra* note 13, at 1149.

do not ordinarily . . . plan a common effort or enter into a combination for the conduct of a business enterprise."<sup>16</sup>

A revocable grantor trust normally has associates because the grantor voluntarily associates himself with the trust by creating it, retaining control over it, naming himself as a beneficiary, and (usually) participating actively in trust affairs by controlling the actions of the trustee. Although the word "associates" implies more than one beneficial interest holder, an organization may have "associates" even if only one person qualifies as an associate.<sup>17</sup> Thus, even a revocable trust in which the grantor is the sole beneficiary may be deemed to have associates.

### B. Business Purpose

An entity has a business purpose when "the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing [of] gains."<sup>18</sup> A business purpose in a trust is essentially a purpose to do more than preserve and maintain the trust assets. The test traditionally applied by the courts as to the existence of a business purpose focuses on the terms of the trust instrument. If the trust instrument confers discretionary powers on the trustee beyond those traditionally associated with protecting and conserving trust assets, under the traditional business purpose analysis the trust is normally held to possess a business purpose, whether or not the trustee has actually exercised those discretionary "business" powers.<sup>19</sup>

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16. *Morrissey*, 296 U.S. at 357.

17. *Lombard Trustees, Ltd. v. Commissioner*, 136 F.2d 22, 23 (9th Cir. 1943).

18. *Morrissey*, 296 U.S. at 357.

19. The Regulations provide that:

Generally speaking, an arrangement will be treated as a trust . . . if it can be shown that the purpose of the arrangement is to vest in trustees *responsibility for the protection and conservation* of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Treas. Reg. § 301.7701-4(a) (as amended in 1986) (emphasis added). See *Morrissey*, 296 U.S. at 361; *Helvering v. Coleman-Gilbert Assoc.*, 296 U.S. 369, 374 (1935) ("The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted."); *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803, 811 (1981); see also *Fletcher v. Clark*, 150 F.2d 239, 241 (10th Cir.), cert. denied, 326 U.S. 763 (1945).

### C. *The Other Four Factors*

If the revocable grantor trust lacks either associates or a business purpose, the inquiry goes no further and the entity is not an association.<sup>20</sup> However, even if the revocable trust is deemed to have associates and a business purpose, according to the Service it must still possess at least three of the four remaining *Morrissey* factors to be classified as an association: (1) continuity of life; (2) centralized management; (3) free transferability of interests; and (4) limited liability.<sup>21</sup>

#### 1. *Continuity of life*

The Regulations provide that "[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization."<sup>22</sup> The Regulations further provide that "if, notwithstanding [any agreement establishing an entity under local law], any member has the power under local law to dissolve the organization, the organization lacks continuity of life."<sup>23</sup> Revocable trusts normally do not possess continuity of life because the grantor can terminate the trust at will. Corporations, on the other hand, normally have continuity of life because, with the exception of sole-shareholder corporations, no one member has the power under state law to dissolve the organization. Interestingly, sole-shareholder corporations have routinely been held by the Service to have continuity of life,<sup>24</sup> even though one

20. See *supra* note 13.

21. See GCM, *supra* note 6, at 5513. A trust which has both associates and a business purpose is not necessarily an association. In a 1975 Revenue Ruling, Rev. Rul. 75-258, 1975-2 C.B. 503, a family estate trust was determined to be an association taxable as a corporation. In that ruling, the trust was found to have associates and a business purpose. Although this finding was necessary in order to continue the inquiry into whether the trust was an association, it was not sufficient in and of itself to justify classifying the trust as an association. The status of the trust was said to depend upon whether it had a preponderance of the other four corporate characteristics. The ruling cited § 301.7701-2(a) of the Regulations in support of its finding. *Id.* at 505. However, that section of the Regulations does not specifically discuss the method to be used in determining which of the six factors to examine, leaving one to conclude that, at least in the Service's view, if the entity possesses both associates and a business purpose, a further inquiry into whether the trust possesses at least three of the other four corporate characteristics must be undertaken.

22. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1983).

23. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1983).

24. See, e.g., GCM, *supra* note 6, at 5514.

member (the shareholder) has the power to dissolve the corporation under local law.

By the same rationale, a revocable trust could conceivably be held to possess continuity of life, in that the entity is valid under state law, but the beneficial interest holder (the grantor) can dissolve the organization at will. However, the Service maintains that continuity of life exists in a sole-shareholder corporation but not in a revocable trust. The distinction is based on the notion that sole-shareholder corporations are corporations "per se" and their taxable status does not depend upon the association rules contained in the Regulations.<sup>25</sup> Applying the same logic in the revocable trust context, all trusts valid under state law would be deemed trusts "per se," and would presumably not be subject to reclassification under the association rules.

While the Service's use of this distinction between the sole-shareholder corporation and revocable trusts seems logically weak, it probably obtains the correct policy result with respect to revocable trusts. The revocable trust, by definition, can be dissolved at the whim of the grantor with very few formalities. The distinction may reflect an implicit decision by the Service to give more deference to the corporate form of organization than to the revocable trust, possibly because of the degree of formality required to dissolve a corporation compared to that required to revoke a revocable trust. At any rate, revocable trusts normally do not possess continuity of life in the traditional sense.

## 2. *Centralized Management*

Regarding the centralized management characteristic, the Regulations focus on whether management power is concentrated in a representative group which has "continuing exclusive authority to make management decisions."<sup>26</sup> The representative must possess real management powers to "make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus,

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25. *Id.*

26. Treas. Reg. § 301.7701-2(c)(2) (as amended in 1983). The Regulations provide:

An organization has centralized management if any person . . . has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation.

Treas. Reg. § 301.7701-2(c)(1) (as amended in 1983).



there is [no] centralized management when the centralized authority . . . merely . . . perform[s] ministerial acts as an agent at the direction of a principal."<sup>27</sup>

The grantor of a revocable trust usually maintains control over the trustee and the trust property. The trustee, then, could be characterized as merely performing ministerial tasks under the direction of the grantor.<sup>28</sup> Such a trustee does not have exclusive management control as a representative of the beneficiaries, because the grantor also has management control. Thus, where the grantor exercises significant control over the trustee, the typical revocable trust will probably not possess centralization of management.

### 3. *Free transferability of interests*

The typical revocable trust normally possesses free transferability of interests. The Regulations provide:

An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of [the] other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of the other members, to confer upon his substitute all the attributes of his interest in the organization.<sup>29</sup>

The typical revocable trust instrument normally contains no restrictions on the transfer of trust interests. The grantor normally may transfer his ownership interest in the trust without obtaining any other person's consent. As a result, revocable

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27. Treas. Reg. § 301.7701-2(c)(3) (as amended in 1983).

28. This situation is analogous to the limited partnership context, where the "limited" partners exercise sufficient control over the "general" partners that they—the "limited" partners—lose their limited liability. In such instances, the limited partnership is deemed to be in effect a general partnership, and centralization of management does not exist because a representative group does not hold exclusive management authority.

Similarly, in a corporation where shareholders exercise excessive control over the decisions of the directors of the corporation, the corporate veil may be pierced, subjecting the shareholders to personal liability for the corporate management's actions. Centralization of management is lacking in this situation because the representative group, the directors, does not have exclusive management authority.

29. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1983).

trusts normally possess the characteristic of free transferability of interests.

#### 4. *Limited liability*

According to the Regulations, “[a]n organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization.”<sup>30</sup> Revocable trusts normally do not have limited liability if the grantor exercises significant control over the trustee. The general rule in most states is that trust beneficiaries are not liable for debts incurred by an ordinary trust.<sup>31</sup> However, “where the beneficiaries have power to control the conduct of the trustees to such an extent that the trustees are their agents, the beneficiaries are personally liable as principals.”<sup>32</sup> If the beneficiaries “have power to control the conduct of the trustees in detail, [or] if they have power to substitute new trustees, they are liable as principals.”<sup>33</sup> When a “sufficient power of control over the trustees [exists] so that there is an agency relationship and not merely a trust, the beneficiaries are liable as partners. . . .”<sup>34</sup>

The limited partnership context is analogous here, as is the corporate context. In a limited partnership, when the level of control exercised by the limited partners over the general partners becomes such that an agency relationship is established, the limited partners lose their limited liability and become liable for the debts of the organization. In the corporate setting, when shareholders exercise control sufficient to establish the officers and directors of the corporation as the agents of the shareholders, courts will pierce the corporate veil and hold the shareholders personally liable for the actions of the corporate management. Similarly, when a trustee becomes the agent of the grantor because of the degree of control exercised over the trustee’s actions, the grantor becomes liable as a principal for the debts of the trust.<sup>35</sup>

The grantor in a revocable grantor trust normally can exercise sufficient control over the trustee to establish an agency re-

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30. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1983).

31. 3A A. SCOTT, *THE LAW OF TRUSTS*, § 274 at 519-20 (4th ed. 1988).

32. *Id.* § 274.1 at 521.

33. *Id.*

34. *Id.*

35. See *supra* note 28.

lationship. He will normally have power to appoint a new trustee, and in practical terms will be able to direct the activities of the trustee in detail. The trustee in effect is the agent of the grantor because of the control the grantor retains over the trust property.<sup>36</sup> Thus, the typical revocable trust lacks the corporate characteristic of limited liability.

#### IV. THE GCM AGENCY ANALYSIS

In a recent General Counsel Memorandum,<sup>37</sup> a revocable trust was held to have both associates and a business purpose, and therefore not to be a trust. However, because the entity also lacked two of the other four *Morrissey* factors, it was held not to be an association. Instead, the trust was classified as being "an arrangement along the lines of [an agency relationship]"<sup>38</sup> between the grantor and the trustee. Although the grantor was held to be taxable on the income of the trust, the provisions of section 676 could not apply because the entity was held not to be a trust.<sup>39</sup>

The GCM first discusses whether the particular trust organization more closely resembled a trust or a corporation by examining whether the trust had associates and a business objective.<sup>40</sup> The Service found that the organization did have associates and a business objective because the "trustee ha[d] broad discretion in dealing with the trust property" and the trust was not formed "for the limited purpose of protecting or conserving" the assets of the trust.<sup>41</sup> The GCM points out that

it does not follow from the above analysis that the organization in question is necessarily an association. [W]e did not consider the four characteristics common to trusts and corporations [be-

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36. Section 676 operates to classify most revocable trusts as grantor trusts for this reason. The grantor is taxed as though he still owned the trust property. See *supra* notes 7-8 and accompanying text.

37. Gen. Couns. Mem. 39,395 (Aug. 22, 1985). See *supra* note 6.

38. *Id.* at 5513.

39. *Id.*; see also *infra* note 65.

40. The trust agreement gave the trustee typically broad management powers over the corpus of the trust, including the power to reinvest the principal, purchase other assets, and to manage, develop, operate, lease, improve or otherwise deal with any real property in the trust. The grantor was the sole beneficiary of the trust, and reserved the right in himself to amend or revoke the trust and to request payments from income or corpus at any time. The trust instrument did not purport to limit the beneficiary's liability for trust debts, nor did it restrict the transferability of the beneficial interests. *Id.* at 5512.

41. GCM, *supra* note 6, at 5513.

cause] we assumed . . . that the organization has those four characteristics. . . . We believe the organization actually must possess at least three of those characteristics to be an association.<sup>42</sup>

Of the four corporate characteristics, centralization of management and free transferability of interests were found to be present in the organization, while limited liability and continuity of life was lacking.<sup>43</sup> According to the GCM, because the trust lacked two of these four corporate characteristics, it more closely resembled a partnership than an association.<sup>44</sup> However, "an organization with only a single member cannot be a partnership," and thus the organization was classified "as an arrangement along the lines of a sole proprietorship that conducts business through an agent (the trustee)."<sup>45</sup> Since the trustee was merely an agent of the grantor, the trust income was taxed to the grantor.

Thus, a revocable trust with terms similar to the trust described in GCM 39,395 would apparently be classified not as a trust or an association, but as an agency relationship. However, even though the GCM taxes the grantor on the trust income as section 676 would, it ignores the statutory purpose of section 676 and ignores a trust which is a valid entity under state law.

## V. ANALYSIS

Although the GCM reached the proper result in taxing the income of the trust only to the grantor, its analysis has two ma-

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42. *Id.*

43. *Id.* "[T]he beneficiaries are not personally liable if the trustees are merely trustees. But where the beneficiaries have the power to control the conduct of the trustees to such an extent that the trustees are their agents, the beneficiaries are personally liable as principals." 3A A. SCOTT, *supra* note 31, §274.1 at 521. The GCM points out that "in most states even if the trust instrument purports to limit a member's liability, the member will be liable for trust debts if the member has the express power to control the management of the trust." GCM, *supra* note 6, at 5515. See Treas. Reg. § 301.7701-2(d)(1) (as amended in 1983). Additionally, the GCM notes that there is a split of authority regarding what powers a member may hold which amount to practical control "so as to deprive a member of limited liability." GCM, *supra* note 6, at 5515. However, in the case of a grantor trust where the grantor is the sole beneficiary and retains significant control over the trustee, it is clear that the beneficiary will lack limited liability. The GCM noted that "despite the uncertainty of New York law on this question, there is a reasonable basis for concluding that the beneficiary could be held personally liable because of the powers reserved to it, irrespective of whether the trust instrument purports to limit its liability." *Id.*

44. GCM, *supra* note 6, at 5514.

45. *Id.* at 5513.

for flaws. The first is in its analysis of whether the trust possessed a business purpose. Although it followed the "traditional" business purpose test—that of merely determining whether the trust instrument granted the trustee broad discretionary powers—that "analysis" really begs the question of whether the trust *actually* has as its object the conduct of business. The second flaw in the GCM analysis arises when it disregards the grantor trust provisions of section 676 and unnecessarily ignores a trust which is a valid entity under state law.

#### A. *The "Business Purpose" Characteristic*

Under the Service's view articulated in the GCM, because a trust must possess associates and a business purpose as well as at least three of the four other corporate characteristics in order to be classified as an association,<sup>46</sup> the typical revocable trust will not be taxed as an association. However, in the GCM, the Service held that a revocable trust was not a trust because an ordinary trust normally does not have associates and a business purpose.<sup>47</sup> It makes little sense to say that a business purpose is present simply because the trustee has been granted broad discretionary powers which he has not exercised. It also seems inappropriate to impute a business purpose to a trust when broad powers are given to the trustee in order to facilitate the protection and conservation of the trust assets. In both cases, the trustee is doing no more than the trustee in an "ordinary" trust—protecting and conserving the trust assets. In such cases, a business purpose should not be deemed to be present, and the organization should be classified as a trust.

##### 1. *Similar Entities Ought to be Taxed Similarly*

The traditional business purpose analysis which the GCM used assumes that a business purpose is present in a trust simply because the trust instrument grants the trustee broad discretionary powers. Although the courts have generally refused to determine whether discretionary business powers were actually exercised by trustees who held those powers,<sup>48</sup> the language used by both the Regulations and the *Morrissey* Court certainly seem to allow, and even call for, an examination of the nature and

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46. *See id.*

47. *Id.*

48. *See cases cited supra* note 19.

extent of those trustee powers *actually exercised*. Both indicate that the *purpose* of the trust arrangement is the crucial inquiry. Under *Morrissey*, if an entity is not established "for the conduct of a business [for profit],"<sup>49</sup> it should not be classified as an association. Under the Regulations, a trust should not be classified as an association "if it was created for the purpose of protecting or conserving the trust property for beneficiaries . . . ."<sup>50</sup>

If the powers granted to the trustee go beyond the scope of protecting and conserving the trust's particular assets, a business purpose ought not be attributed to the trust if the trustee never exercises those powers. The actual purpose for which the grantor established and is operating the trust should be determined, rather than assuming a business objective merely because certain powers are granted to the trustee in the trust instrument. Two trusts which are nearly identical (except that one gives broader discretionary powers to its trustee) ought to be taxed similarly.

Additionally, a trust which is actually running a business ought to be taxed as a corporation before a trust which is not running a business is taxed as one. For example, *testamentary* trusts generally will not be classified as associations taxable as corporations.<sup>51</sup> Testamentary trusts generally lack associates because the beneficiaries, having been thrown together by the will of the decedent, probably will not have exercised sufficient volitional effort to associate with each other.<sup>52</sup> This lack of associates will preclude the trust from being classified as an association, even if the testamentary trust is actively engaged in the operation of a business. On the other hand, a revocable trust normally does possess associates, and, where the trustee is granted broad powers in the trust instrument, it could be deemed to have a business purpose even though the trust is not operating a business.<sup>53</sup> Thus, a testamentary trust which is operating a business could be taxed as a trust while a revocable trust with broad trustee powers could be classified as an association, even though it is not actually operating a business.<sup>54</sup> This result

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49. *Morrissey v. Commissioner*, 296 U.S. 344, 356 (1935).

50. Treas. Reg. § 301.7701-4(a) (as amended in 1986).

51. I.R.C. § 676 (1982); Ascher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 TAX L. REV. 253 (1986); see *supra* notes 20-36 and accompanying text.

52. See *supra* notes 14-16 and accompanying text.

53. See *supra* notes 18-19 and accompanying text.

54. However, a recent Tax Court case puts the taxable status of testamentary trusts

flows from both the traditional "associates" and "business purpose" analyses, and allows two virtually identical trusts to be taxed differently. This result exalts form over substance, and violates the policy of similar taxation for similarly situated entities. Therefore, in order to determine whether a business objective is present, the presence of "business" powers in the trust instrument should not alone be determinative.

2. *Broad trustee powers may be necessary to protect and conserve trust assets*

The object of the typical revocable trust is to "hold and conserve . . . property, with *incidental powers*."<sup>55</sup> The broad discretionary powers granted to the trustee may, in reality, be necessary for the effective protection and conservation of the assets of the trust. The nature of the trust assets may be such that in order to effectively protect and conserve them, the trustee must have broader powers than those traditionally associated with trust relationships. Thus, where discretionary powers vested in a trustee simply serve to *facilitate* the protection and conservation of the trust assets, a business purpose should not

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in some doubt. In *Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986), the Service attempted to classify as an association a testamentary trust which was continuing to operate the decedent's manufacturing business. The trust was held *not* to be an association, even though it had an obvious business purpose, because it lacked associates. The court found that the beneficiaries had not entered into a common effort for the conduct of a business and that there was not a "voluntary association of individuals for convenience and profit." *Id.* at 1220 (quoting *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930)). The court concluded:

What we have here is a unique family estate plan, involving a trust characterized by a dominant familial objective. We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

*Id.* at 1221. The interesting part of the opinion comes in dicta at the end of the opinion. The court stated:

A final note. We wish to emphasize . . . that [this] case should not be regarded as authority for the conclusion that no testamentary trust can be classified as an association. Nor do we consider any particular element relating to the trust herein as determinative. The result rests upon all the facts taken in the aggregate. We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business . . . . [But] [i]t is difficult to imagine a more unsuitable vehicle . . . for any such purpose . . . .

*Id.* at 1222. Thus, it seems that the Tax Court has not declared that testamentary trusts may never be classified as associations, and possibly believes that there is an appropriate situation for taxing a testamentary trust as an association.

55. *Morrissey v. Commissioner*, 296 U.S. 344, 357 (1935) (emphasis added).

be arrogated to the trust. The inquiry should be whether the trustee has actually exercised powers beyond the scope of protecting and conserving the trust assets, considering any unique attributes of the trust assets and any special powers which would normally be associated with protecting and conserving those assets.

There are circumstances in which a revocable trust which actually operates a business should not be classified as an association. For example, a sole proprietor may fear that he will become disabled or incompetent in the future, and unable to operate his business. By transferring his business into a revocable trust, the proprietor obtains the potential for an easy transition to professional management by the trustee when the proprietor becomes unable to manage the business. In the meantime, the proprietor maintains current control over the trustee and the operation of the business because of the revocability of the trust. In substance, there has been no change in the business or in the grantor's relationship to the business, and the arrangement should qualify under section 676 as a grantor trust, with the income taxed to the grantor as if the business were still a sole proprietorship. Applying the Service's logic, however, section 676 would not apply here because the revocable trust would be deemed to have both associates (because the grantor created the trust) and a business objective (because the trustee is involved in running a business), and would thus be classified as something other than a trust.<sup>56</sup> The Service would probably not classify the trust as an association, because limited liability and centralization of management would be absent.<sup>57</sup> Under the analysis used in the GCM, this arrangement would probably be treated as an agency relationship between the grantor and the trustee.

In this example, the tax outcome which seems most consistent with the policy of taxing similarly situated entities similarly is to disregard the trust as a taxable entity and attribute the income of the trust to the grantor. This could be done either by treating the trustee as an agent of the grantor, as the Service would do under the GCM analysis, or by classifying the arrangement as a grantor trust under section 676. The most desirable treatment would be to recognize the entity as a valid trust, but to classify it as a grantor trust under section 676. Then, even if

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56. See GCM, *supra* note 6, at 5513; see generally Note, *supra* note 13, at 1160.

57. See *supra* notes 20-36 and accompanying text.



the entity is deemed to have associates and a business purpose, it would still qualify as a trust under the section 676 grantor trust rules, provided that it does not possess at least three of the other four corporate characteristics.

Admittedly, the business purpose analysis advocated in this comment will require a more careful review of the powers and activities of the trustee by the Service and the courts. However, it is not likely to add significantly to the administrative time or expense which the Service already expends in attempting to reclassify revocable trusts. An inquiry into the nature of the entity and the actions of the trustee is already made in determining which corporate characteristics are present. Actually examining both the scope of trustee powers necessary to protect and conserve the trust assets and the extent to which trustee powers are exercised will lead to a more equitable, if less predictable, outcome.

### *B. Section 676 and the Agency Analysis*

When a revocable trust which would otherwise qualify as a grantor trust is held to be an association, the purpose of section 676 is partially defeated—the person who really controls and enjoys the benefit of the property in the trust is not taxed on the income which that property produces.<sup>58</sup> If a revocable trust is taxed as a corporation, and the trust retains the income the trust corpus earns, the grantor is not taxed on income from property which he beneficially owns—an outcome which section 676 was designed to prevent. Even absent the statutory grantor trust rules of section 676, the degree of control which the typical grantor exercises over the trustee of a revocable trust militates against a finding that the trust is an association taxable as a corporation. One of the fundamental policies underlying taxation of income from property is that income ought to be taxed to the owner of the property, and ownership is defined in terms of control and beneficial enjoyment of property.<sup>59</sup> Thus, the person who has control over property and the right to the beneficial enjoyment of the property should be taxed on income from the property.<sup>60</sup>

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58. See, e.g., Ascher, *supra* note 51, at 279 n.132; see also GCM, *supra* note 6, at 5513.

59. See generally *Lucas v. Earl*, 281 U.S. 111 (1930).

60. *Id.* However, a corporation can be taxed on income from property to which it

In the revocable trust situation, the grantor has control over the property in the trust because he has the power to revoke the trust at any time and obtain the property. Similarly, he has the right to the beneficial enjoyment of the property because he normally controls the trustee and can obtain the property at any time. Thus, the grantor is the de facto owner of the trust property for tax purposes, and should be taxed on the trust income. This is recognized in section 676.<sup>61</sup> To recognize the trust as a separate taxable entity and treat it as the actual owner of the trust property would be unrealistic, because the person with the power to revoke the trust at will and direct the actions of the trustee is the beneficial owner of the trust property in reality. Thus, from a policy standpoint, revocable grantor trusts should not be taxed as associations because the grantor retains the beneficial enjoyment and control, and thus the substantial ownership, of the trust property. The GCM recognized this to some extent by refusing to hold that the trust was an association. However, the GCM solution—treating the trustee as an agent of the grantor—ignores the effect of section 676, which was specifically designed to apply to revocable trusts. Also, by refusing to classify the trust as a trust for tax purposes, the GCM unnecessarily ignores the existence of the trust as a valid entity under state law.

The GCM held that an entity which possessed associates and a business purpose but lacked more than one of the other four corporate characteristics was neither a trust nor an association, but an agency relationship between the grantor and the trustee.<sup>62</sup> Thus, the income from the trust property was taxed to

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holds legal title even if the shareholder holds the equitable title to the property. In *Jones v. Commissioner*, 640 F.2d 745 (5th Cir. Mar. 1981), *cert. denied*, 454 U.S. 965 (1981), a limited partnership formed a corporation for the purpose of obtaining a loan without violating the state usury laws applicable to non-corporate borrowers. The court there refused to ignore the corporate entity, even though the corporate form was a mere formality and the partnership actually controlled the right to the beneficial enjoyment of the property.

By similar reasoning, a revocable trust could be deemed to be an association because it was established by the grantor himself. The grantor could be estopped from arguing to disregard the form he himself established by claiming that the revocable trust is not an association (in substance), even though (in form) broad business powers exist in the trust instrument. This analogy is somewhat persuasive, but because it goes to the issue of whether a business purpose exists solely because broad but unexercised discretionary powers are granted to the trustee, to accept it would be to condone an unsatisfactory policy result. See *supra* notes 48-54 and accompanying text.

61. See *supra* notes 7-8 and accompanying text.

62. See GCM, *supra* note 6, at 5513.

the grantor. While this result is similar to that which would have been reached had section 676 applied (taxing only the grantor on the income from the trust property), the Service's analysis unnecessarily ignores a trust which is valid under state law. More significantly, that analysis unnecessarily impinges on the intended scope of section 676, which was designed to apply to grantor trusts, and possibly results in the inequitable taxation of trust income to both the trust and grantor.

The end result of taxing the revocable trust as an agency relationship under section 676 is to tax the income from the trust property to the grantor. A trust deemed to be an association, on the other hand, is a separate taxable entity and is subject to taxation exactly as if it were a corporation—it is taxed at both the association (corporate) level and the beneficiary/associate level. It seems improbable that a revocable trust (which would otherwise qualify under the grantor trust provisions of section 676) could resemble a corporation so much that it should be taxed as one. However, because of the faulty traditional inquiry into the existence of a business purpose in the trust, once an entity is found to possess associates and a business purpose it is no longer considered to be a trust.<sup>63</sup> The GCM cites no authority for this proposition,<sup>64</sup> and indeed, it is with this very point that the the Service muddles its analysis and paints itself into a corner. If a revocable trust is not clearly an association under the *Morrissey* regulations, the Service ought to recognize the entity's state law classification for tax purposes. By holding that the entity is no longer a trust once associates and a business purpose are present, the Service unnecessarily complicates the problem by creating an "agency" quasi-category within the Regulations. As a result, the analysis to be applied to a revocable trust now becomes very unclear and unpredictable. Because section 676 applies only to trusts,<sup>65</sup> the grantor trust rules will not apply to a revocable trust, even though section 676 was clearly meant to apply to revocable trusts. Thus, although the GCM

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63. *Id.*

64. *Id.* The Service apparently relies on § 301.7701-4(a) of the Regulations, which states that "[g]enerally speaking, [a trust] will be treated as a trust [for income tax purposes] if [the] beneficiaries . . . are not associates in a joint enterprise for the conduct of business for profit."

65. I.R.C. § 676 (1982). The grantor trust rules and the association classification rules indicate that the two are mutually exclusive, i.e., a revocable trust cannot be both a grantor trust and an association at the same time, because for section 676 to apply, an entity must be a "trust," and an association is obviously not a "trust."

analysis reaches the proper policy result in that the income on the trust property is taxed only to the grantor of the trust, the analysis used by the Service impinges on the scope of section 676 and unnecessarily ignores an entity which is valid under state law.

## V. CONCLUSION

To be classified as an association, a revocable trust must possess both associates and a business purpose plus at least three of the other four corporate characteristics set out in *Morrissey*. If the trust possesses associates and a business purpose, but does not possess at least three of the other four characteristics, the Service has held that the entity is neither an association nor a trust, but an agency relationship between the grantor and the trustee.

When revocable trusts which would otherwise qualify as grantor trusts under section 676 are held to be associations or agency relationships, undesirable policy results occur. If the trust is classified as an association, the trust income is taxed twice, rather than once. Under present law, this will occur without an inquiry into the actual powers exercised by the trustee, thus violating the policy of taxing similar entities similarly. If the trust is classified as an agency relationship, as it was in the GCM, the scope of section 676 is impinged and a trust which is valid under state law is unnecessarily ignored.

An additional factor militating against taxing revocable trusts as associations is that to begin to do so now would destroy the expectation interests of many taxpayers who have established revocable trusts as estate planning devices in the past. Grantors may have established these trusts for legitimate personal estate planning purposes,<sup>66</sup> expecting them to be classified as grantor trusts and to have the income taxed only once—to the grantor, under the section 676 grantor trust provisions. To impose double taxation on these grantor trusts by classifying them as associations unfairly penalizes taxpayers who have, in reliance on the grantor trust provisions, used a legitimate and useful tool in estate planning.

To alleviate these undesirable results, in determining whether the trust possesses a business purpose, the inquiry should be whether the trustee has *actually exercised* powers be-

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66. See *supra* note 2.

yond the scope of protecting and conserving the trust assets, taking into account the nature of the assets in the trust. When broad discretionary powers have been exercised by the trustee to *facilitate* the effective protection and conservation of assets, and the trust was established primarily for estate planning reasons, a business objective should not be deemed to be present. Even if the trust does possess associates and a business purpose, but does not possess at least three of the other four corporate characteristics, it should be recognized as being a valid trust, in order that section 676 can apply to deem the entity to be a grantor trust. This interpretation would give a result consistent with the policies underlying both the grantor trust rules and the association rules.

The reasoning of the Service in the GCM is not clearly articulated, leaving some doubt as to exactly what the Service's position is on the income taxation of revocable trusts. Thus, the taxable status of revocable trusts is in doubt, both because of the uncertainty inherent in the reasoning of the GCM, and because taxpayers are unable to rely on General Counsel Memoranda as precedent.<sup>67</sup> As a result, the usefulness of the revocable trust as an estate planning device is somewhat diminished. Attorneys unwilling to risk the potential double taxation which could result from the trust being taxed as a corporation must find other ways to accomplish their client's objectives, at least until there is a definitive ruling by the courts or the Service on this issue.

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67. See *supra* note 6.