THE USE OF TRUSTS IN FINANCINGS OF BUSINESSES: CHARACTERIZATION OF THE ENTITY AND TAX CONSEQUENCES

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I. Introduction

(a) General: Over the years, business has been dominated by what are now referred to as “C” corporations. Then with the 1986 Tax Reform Act, partnerships, Limited Liability Companies (“LLCs”) and to some extent S Corporations played a much larger role. However, over the years trusts also have played a significant role in the business and investment world. This paper discusses the role of trusts in this context and without regard to their treatment for tax purposes.

(b) Definition: The Restatement on Trusts states as follows:

A trust, as the term is used in this Restatement when not qualified by the word “resulting” or “constructive,” is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee.

All of the entities discussed in this paper, whether family, business or investment trusts, generally will satisfy this definition. While, as will be discussed later, business trusts are not frequently subject to statutory requirements, this definition generally will be satisfied.

(c) Early Developments: Trusts were used extensively in the business world as operating entities because they provided limited liability, as well as flexibility not available to corporations. However, as contrasted to some other jurisdictions, the U.S. recognized that trusts were effectively no different than corporations and began treating them as associations taxable as corporations. This treatment subsequently led to regulations which drew distinctions between trusts established for different purposes. For example, trusts established for personal purposes are taxable as trusts, whereas business trusts are taxable as corporations and investment trusts can be taxable as trusts or business entities depending on the trusts activities.

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Initially, the Internal Revenue Service (“the Service”) argued that all trusts formed as investment vehicles were classifiable as associations because, like corporations, they were organized for profit. However, *Commissioner v. Chase National Bank*, 122 F.2d 540 (2d Cir. 1941) and *Commissioner v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1947) *cert. denied*, 314 U.S. 701 (1942), taken together held that unit trusts which were formed to make fixed investments with no power to vary such investments under the trust agreement would be treated as trusts for U.S. federal income tax purposes.

With the introduction of the “check the box” regulations, the rules for making the determination as to whether an entity is a trust or an association taxable as a corporation have changed. Under the present check-the-box regime, it first must be determined whether an entity is a trust or a business entity. If this query leads to the conclusion that the entity is a business entity, then the relevant question is whether it is an association, a partnership or disregarded entity.\(^1\)

II. **Categories of Trusts for Tax Purposes**

The regulations essentially divide trusts into three categories. These are (a) ordinary trusts which are of the type normally established for family reasons, (b) business trusts and (c) investment trusts:

(a) **Ordinary Trusts.** The regulations describe this entity as follows:

“In general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement.

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\(^1\) Treas. Reg. §301.7701-4(b) and (c) and 2(a). All section references are to the Internal Revenue Code of 1986, as amended (the “Code”) unless otherwise noted and to the treasury regulations promulgated thereunder.
However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them.\textsuperscript{2}

One text has used the term “family trusts” to describe this category of trusts. Family trusts are generally formed for the protection or conserving of assets of a family or other personal relationships on behalf of beneficiaries or even the grantor.\textsuperscript{3} This is the purpose for forming the trust as contrasted to being organized to conduct a business or to make investments.

(b) \textit{Business Trusts}. A distinction must be made between business trusts for tax purposes and business trusts for State law purposes. Business trusts under State law may or may not be business trusts for tax purposes.\textsuperscript{4}

1. Tax Definition.

In defining business trusts for U.S. federal income tax purposes the regulations state as follows:

“There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporation or partnerships under the Internal Revenue Code. However, the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for


\textsuperscript{3} Treas. Reg. §301.7701-4(a).

\textsuperscript{4} Noting this distinction, in 2002, the Delaware Business Trust Act was amended to change the Act’s name to the “Statutory Trust Act” and the name of trusts formed under the Act was changed to “statutory trusts” from “business trusts.” The purpose of this change was to avoid any implication that a trust formed under ... the Delaware Code constitutes a “business trust” within the meaning of [the Code].
classifying the arrangement as an ordinary trust rather than as an association or partnership.”

2. **State Law.**

The regulation discussed above, contemplates entities such as the early Massachusetts business trust. In this connection, one text observes:

“The “Massachusetts trust” or “business trust” has for some time been an organization alternative to the corporate form. These trust have been widely used in Massachusetts, but have been relatively uncommon in other states. Their main advantage has been avoidance of legal restrictions imposed on corporations.”

* * *

Certain states have adopted legislation specifically dealing with business trusts. Most notable is Delaware, which adopted the Delaware Business Trust Act in 1988. One text notes:

“Although the business trust has been implicitly recognized by the statutory laws of the State of Delaware, its legal existence was not expressly recognized under Delaware law until the passage of the Delaware Business Trust Act. The legislation represented a significant departure from the traditional form of business trust in that its provisions authorize a flexibility that permits virtually any trust arrangement to qualify as a business trust, regardless of whether the trust has corporate characteristics, partnership characteristics, or the characteristics of an ordinary common law trust.”

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5 Treas. Reg. §301.7701-4(b).

6 Fletcher Cyc. Corps. §8227 (Perm Ed.). In fact the Massachusetts business trusts were initially formed to own real property which at that time was not a permitted activity of corporations.

7 As noted at footnote 4 above, the Act was amended in 2002 and renamed the “Statutory Trust Act” and business trusts formed thereunder are now defined as statutory trusts.

The lengthy definition of “business trust” contained in Chapter 38, Title 12 Del. Code, §3801 recognizes the flexibility of business trusts over corporations. As one commentator notes, the “document creating the trust is the law of the trust”.⁹ This commentator further states:

This flexibility is consistent with Delaware’s fundamental policy of freedom of contract and may be the greatest advantage of the business trust over alternative forms of business organizations.¹⁰

3.  **State Business Trusts Not Business Trusts for Tax Purposes.**

Even if an entity is organized as a business trust, Federal tax rules do not require that it be treated as a business entity or for that matter even as an entity separate and distinct from its creators. For example, a business trust could be treated as a trust for tax purposes, rather than as a corporation if it makes passive investments¹¹ and, if such investments are “fixed” as described below. One text noting this, states:

Recently, business trusts have been formed under Delaware law in connection with the securitization of assets, which is the process of pledging income producing assets as collateral for the issuance of marketable securities. Many billions of dollars of collateralized mortgage obligations, credit card receivables, and other types of asset-backed securities have been issued by Delaware business trusts in public offerings that are registered with the Securities and Exchange Commissions.¹²

As noted above, instances exist where Delaware business trusts have been formed for the purpose of making and holding investments as contrasted to operating a business. Several Private Letter Rulings exist which ruled that the various “series” of Delaware business trusts

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¹¹ The Delaware Business Trust Act was amended in 1992 to clarify that such an entity may be organized ... for any lawful business activity ... (including, without limitation for the purpose of holding or otherwise taking title to property, whether in an active or custodial capacity).” §3801(a) of the Act.

¹² Balotti and Finkestein, *supra n.* 11.
themselves were each separate entities properly characterized as partnerships. Undoubtedly, the legal attributes of the Delaware business trust must have had an effect on the Services determination that each series is properly characterized as partnerships. However, it appears that the trust itself was not an entity for tax purposes.

4. **Trusts which must be Treated as Corporations.** Trusts which must be treated as corporations as business entities include:

   (A) *Real Estate Investment Trusts* ("REITs"). A REIT can be organized under local law as a trust, an LLC or a corporation. For U.S. federal income tax purposes, if a REIT election is made for the entity’s first year, the entity is treated as a corporation from inception, even if the entity is organized and treated as a trust for local law purposes. While the election to be treated as a REIT is made with the filing of the entity’s first tax return, where the entity is not by default a corporation or a trust, for example, where the entity is an LLC, an election on Form 8832 should be made as of the beginning of the entities first taxable year, since such an entity would not otherwise be a “corporation, trust or association” as required by Section 856(a) of the Code. Maryland, a preferred state for REITs, has enacted legislation specifically dealing with REIT’s as distinguished from other business trusts. Originally REIT’s were organized in Maryland as business trusts under what is now Title 12 of the Annotated Code of Maryland, Corporations Associations. Article 8 specifically deals with entities intending to be REITs for tax purposes. Business Trusts under Title 12 are used for other purposes, such as REMICs. One of the reasons for organizing a REIT as a trust rather than

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13 Priv. Ltr. Ruls. 9435015 (Sept. 2, 1994), 9435017 (Sept. 2, 1994), 9552022 (Dec. 29, 1995) and 9450030 (Dec. 16, 1994) all involve Delaware business trusts which serve as open-end management investment companies under The Investment Company Act of 1940. While these rulings were issued prior to the “check-the-box” regulations, each series still should constitute a partnership since they are domestic business entities with two or more members. Treas. Reg. § 301.7701-3(b)(1).
a corporation is avoidance of certain state corporate income taxes, in certain jurisdictions, for example, Massachusetts.

(B) Regulated Investment Companies (“RICs”). By definition a RIC must be a “domestic corporation.” According to the Code, a business trust or investment trust with the power to vary investments would be treated as a business entity under the code, such an entity must make an election on Form 8832 to be treated as a corporation for U.S. federal income tax purposes.15

(c) Investment Trusts.

1. In General. Treas. Reg. §301.7701-2(c) sets forth the following discussion on investment trusts:

An “investment” trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. See Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders. An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under §301.7701-2; however, an investment trust with multiple classes of ownership interests in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.16

14 Section 851(a) of the Code.

15 One commentator observes that many RICs are formed as business trusts, which generally eliminates the need to have annual shareholder meetings. Hervey, 740 T.M. Taxation of Regulated Investment Companies.

16 Interestingly, where no intention or desire exists to have the trustee exercise this power, the mere grant of this power under the trust agreement would seem to permit the entity to be a business entity, and therefore, an association taxable as a corporation. Instances in which this treatment could be more favorable than trust treatment would be where having a single non-U.S. corporate owner would be preferable to multiple owners for
An investment trust is formed to make investments on behalf of its beneficiaries or certificate holders. Essentially, under this regulation, business entity status is avoided and trust treatment is obtained if the trustee does not have the “power under the trust agreement to vary the investment of the certificate holder” and the tainted multiple classes of ownership is avoided.


The classic investment trust which is treated as a trust for the tax purposes is the so-called “fixed investment trust” which generally, but not always, has been determined to be a trust. A number of published and private rulings involving these trusts have been guidance as to when a trustee has the power to vary a trust’s investment.

(A) Revenue Rulings 70-544 and 70-545, while involving custodial rather than trustee arrangements, are some of the earliest instances where the tax treatment of certificate holders was first prescribed. Here, the certificate holders purchased “straight pass-through” mortgage backed certificates in pools of mortgages which were guaranteed by the Government National Mortgage Association ("GNMA"). Once a pool was established, no additional mortgages could be added. The custodian’s sole function was to hold the mortgages. It had no power of investment or reinvestment. In addition, the sponsor (a savings and loan association) and GNMA had a limited power of substitution of defective mortgages within four months of the issuance of GNMA’s guarantee. The Service held that each pool was not an

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U.S. withholding tax compliance purposes. Thus, obtaining one single Form W8-BEN is easier than multiple forms.

association taxable as a corporation but was classified as a trust of which the certificate holders are the owners under the grantor trust rules Subpart E of Subchapter J of the Code.

In Revenue Ruling 75-192,\textsuperscript{18} investment groups were formed for the purpose of investing in specified qualities of FHA and VA mortgages. The ruling gives a limited reinvestment power to the trustee. Specifically, during the period between the dates for quarterly distribution (of principal and interest), the trustee is required to invest cash on hand in short-term obligations of (or guaranteed by) the United States or any of its agencies or instrumentalities, which mature prior to the next obligation date. The trustee was required to hold such short-term obligations until maturity and to distribute all proceeds (mortgage payments, plus interest on the short-term obligations) on the next distribution date. The Service, in ruling that each investment group was a grantor trust, stated:

“...The short-term obligations in which the trustee may invest are subject to daily market fluctuations. In the instant case, however, the trustee is permitted to invest only in obligations that mature prior to the next distribution date and is required to hold such obligations until maturity. These requirements limit the trustee to a fixed return similar to that earned on a bank account and eliminate any opportunity to profit from market fluctuations.”

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The interests in the income from the trust have been reserved to the various investor-grantors in proportion to their respective contributions. Therefore, each investor-grantor will be treated, by reason of section 677(a) of the Code, as the owner of an aliquot portion of the trust, and all income, deductions and credits attributable to that portion are to be treated as those of the investor-grantor under section 671.

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\textsuperscript{18} 1975-1 C.B. 384.
In Revenue Ruling 1978-149, the trust went “over the line” and became an association taxable as a corporation. In that ruling, a fixed investment trust formed to invest in and hold municipal obligations was held to be an association, because the trustee had the power to reinvest funds received from bonds redeemed prior to maturity, even though reinvestment was required to be in the same kind of bond, (that is, grade, maturity, type of issuer, etc.). The Service viewed this level of investment discretion as the “power to vary the investment of the certificate holder”, thereby requiring the trust to be treated as a business entity.

Revenue Ruling 81-238 allowed certificate holders the election of reinvesting their distributions in another fixed investment trust pursuant to an automatic dividend reinvestment plan. The reinvestment decisions were not made by the trustee, but by the certificate holders, they were free to elect or not elect and the new trusts were truly separate. Under these facts, the Service ruled that the reinvestment powers provided to the certificate holders did not jeopardize trust treatment.

In Private Letter Ruling 813712 the trustee had broad discretion on the timing and pricing of sales. However, the Service distinguished the mere power to sell from the power to reinvest, and as such, trust status was allowed.

In another ruling where trust status was respected, the Service ruled that the trustee’s powers did not constitute the power to vary investments, where the trust sponsors, in

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19 1978-1 C.B. 448.

20 1981-2 C.B. 248

21 June 19, 1981.
cases where bonds were not issued as expected, were required to notify the trust of that fact, and within 20 days thereafter, the sponsors were required to purchase alternate bonds.\textsuperscript{22}

In Private Letter Ruling 9319028\textsuperscript{23} the Service ruled that a trustee’s power to vote for or against a proposed reorganization is not a power to vary the trusts investments, because the “power is incidental to the trustee’s maintenance and preservation of trust property”.

The power to vary the investments of a trust was found to exist, however, where the sponsor reserved the right to contribute new and different assets to the trust\textsuperscript{24}. Alternatively, the right to contribute additional but identical assets is not the power to vary investments\textsuperscript{25}.

(B) \textit{“The Power Under the Trust Agreement”}.

While no clear authority exist, in making the determination of whether a trust has the ability to vary its investments, it would seem that any documents which will govern the trust arrangement, particularly when executed simultaneously with the trust agreement will be viewed as part of the trust agreement. One commentary makes this observation referring to a “management agreement relating to trust investments, an asset purchase and sale agreement, or a subscription agreement for trust certificates ...” \textsuperscript{26}

One instance I have seen is an entity that was established as an ordinary trust. The trust acquired a 99% interest in a Delaware limited partnership which bought, sold

\begin{itemize}
\item \textsuperscript{22} Priv. Ltr. Rul. 850611 Nov. 7, 1984.
\item \textsuperscript{23} Feb. 11, 1993.
\item \textsuperscript{25} \textit{Commissioner v. Chase National Bank}, 122 F.2d 540 (2d cir. 1941).
\item \textsuperscript{26} \textit{See} Peaslee and Nirenberg, p. 179.
\end{itemize}
and reinvested in mortgage backed securities. Effectively, the limited partnership, was the trust's investment arm. The general partner in such limited partnership was an affiliate of the trust. The trustee did not have the power to reinvest proceeds and the trust made no other investments. Because the partnership was set up in tandem with the trust, any powers in the partnership may properly be treated as powers under the trust agreement. This situation also could result in denial of trust status under attribution of business activities discussed below.

3. Attribution of Business Activities or Reinvestment Powers From Other Entities.

Questions have arisen as to whether a fixed investment trust can still be a business entity. For example if a fixed investment trust were to invest in a partnership which conducts either an operating business or investment activities with the power to vary investments, would the partnership’s activities be imputed to the trust so that the trust would be treated as a business entity rather than as a Trust? In General Counsel Memorandum (“G.C.M.”) 3820127 such activities were not imputed to a trust which was a 10% limited partner in a limited partnership which was engaged in a trade or business activity.

This G.C.M. was written in response to a proposed revenue ruling which would have concluded that the business activities of a limited partnership should be attributed to a trust partner, thereby resulting in the trust being classified as an association taxable as a corporation (or today as a business entity) The G.C.M., while noting that the Federal income tax law typically attributes a partnership’s activities to its partners for purposes of determining the character and computational aspects of such partner’s income, it proceeds to state that such attribution will not be found as a matter of law. Rather, attribution of the partnerships activities

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to at trust partner will be based upon the purpose for which the trust holds such partnership interest, such as for the protection and conservation of trust assets.

“We do not agree, however, that as a matter of law all trust holding limited partnership interests in partnerships are engaged in the trades or businesses of the partnerships. We think many partnership interests merely represent investments in partnership businesses and are held by trusts solely for the purposes of protection and conservation. We see no basis for attributing the businesses of the partnerships to those trusts for purposes of the classification regulations.”

“Although we continue to believe that a partner is engaged in the trade or business of his partnership in the sense described above [see footnote 28], we believe that this fact has little bearing on the classification of an entity that holds a partnership interest. Subchapter K employs an aggregate theory in taxing the partners, but in other situations treats the partnership as an entity and the partnership interests as investments in the entity. See, e.g., sections 741 et seq. Moreover, as a practical matter, many partnership interests are held solely as investments with the partners taking no part in the management of the partnership’s trade or business. The question presented by the instant case is whether it is inconsistent with the status of a trust to hold a partnership interest.

We think that a trust cannot be considered a device or medium for carrying on a trade or business merely because the trust holds an interest in a partnership that engages in trade or business. We see no reason why a partnership interest could not be held by trustees for protection and

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28 The G.C.M. continues: “Although both section 875(1) and section 1402(a) result in a partner being treated the same as if he were directly engaged in the trade or business of his partnership, neither section lends significant support to the general premise that, as a matter of law, a partner is engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership. *** There have been a number of prior memoranda issued by this office in which we have said that a partner is deemed to be individually engaged in the trade or business of his partnership.
conservation, and when a partnership interest is held for this purpose, we see no basis for classifying the trust as an association for tax purposes.

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We think that the proposed revenue ruling is in error in not allowing consideration of the purpose for which a partnership interest is held in trust. By employing the analysis that a partner is engaged in the trade or business of his partnership, the ruling would mandate association classification in all cases. Thus, a trust holding a very small limited partnership interest in a very large syndicated partnership would be an association even though the trust’s investment was really no different than if it held corporate stock. Although the proposed ruling describes a fixed investment trust, its rationale would apply to any trust holding a partnership interest. The trust would be in the trade or business of the partnership, and would be classified as an association.”

When should trade or business activities be imputed from a partnership to a trust? Does the size of the interest in the partnership matter? For example, in G.C.M. 38201, the trust was a 10% limited partner. What about the use of trusts as partners of a family limited partnership or members of an LLC.29

In connection with Canadian income funds which are organized as fixed investment trusts (see Section V.(d) below), renewed discussion has arisen among some practitioners as to the meaning of the power to vary investments, some of which departs dramatically from tax law principles. One practitioner has posited that because a fund owns 100% of a Canadian corporation, investments made by such corporation (or an LLC or corporation controlled by it) should be attributed to the trust albeit the entity directly owned by the trust is a C corporation. Such a position is not based on defective corporate organization but on the premise that a corporation controlled by such fund is effectively reinvesting on behalf of the fund. I can find no support for this position. Moreover, the S corporation rules which

29 See the discussion of Peaslee and Nirenberg in which activities of a partnership are attributed to a general partner, p. 189, footnote 104.
present an even stronger case for attribution, permit certain trusts to own share of an S
corporation with no limit on the percentage of pass-through. Specifically, if attribution through a
corporation were possible the use of trusts as shareholders of S corporations as contemplated by
Section 1361(c)(2) of the Code would make no sense.

4. Multiple Classes of Ownership

Treas. Reg. §301.7701-4(c) in permitting trust treatment for investment trusts
generally prohibits “multiple classes of ownership.” An exception is made for an investment
trust with multiple classes of ownership interests “if the trust is formed to facilitate direct
investment in the assets of the trust and the existence of multiple classes of ownership interests is
incidental to that purpose.” The apparent reason for this restriction on multiple interests appears
to be is computational. Each certificate holder must be able to report its share of income and
expense under the operator trust rules, that is, it must be the owner of a portion of the trust’s
assets. A theme running through the four examples seems to be that where the multiple interests
still enable the trustee and certificate holders to determine what is “owned” by each certificate
holder.30

Treas. Reg. § 301.7701-4(c)(2) sets forth examples and interests that qualify and
do not qualify for such treatment. These regulations were introduced in the mid-1980s.
Commentary indicates that the amendments were partly directed at a trust sponsored by Sears
Mortgage Securities Corporation that issued “fast pay” and “slow pay” trust certificates.31

Example 1. Here, a corporation purchases a pool of mortgages and then transfers
them to a bank under a trust agreement. The bank issues certificates to the corporation which, it

30 See Peaslee and Nirenberg, p. 201.
31 See Peaslee and Nirenberg, p. 196.
then sells to the public. There is no power of reinvestment in the trustee. There are two classes of certificates, Class A and Class B. Class A is entitled to all mortgage principal payments, whether scheduled or prepaid. Only after Class A is entirely paid and retired are payments then made on the Class B certificates. This arrangement has the effect of providing the holders of the Class B certificates with “call protection.” Thus, according to the example, the trust creates interests in the mortgages that differ significantly from direct investments in the mortgages. As a consequence, the existence of multiple classes is not incidental to any purpose of the trust to facilitate direct investment. This apparently is based on the original Sears transaction.32

In Example 2, a corporation which originated a portfolio of mortgages formed a trust and transferred the mortgage to a bank as trustee of the trust. The trust has no power of reinvestment. The trust issues two classes of certificates to the corporation, the sponsor of the trust, in exchange for a pool of residential mortgages originated by the sponsor. The two classes are Class C and Class D. Class C is entitled to 90% of all payments of principal and interest. Class D also is entitled to 90% of all payments of principal and interest; the only difference is that Class D is subordinated to Class C in the event of a default on the underlying mortgages. The sponsor of the trust sells the Class C and retains the subordinated Class D. The Example concluded that while the trust has multiple classes of ownership interests, the interests of the certificate holders are substantially equivalent to (1) undivided interests in the pool of mortgages, coupled with (2) a limited recourse guarantee running from the sponsor, as holder of the subordinated class, to the holders of the senior class. In such circumstances, the existence of multiple classes is considered incidental to the trust purpose of facilitating direct investment in the mortgages.

32 See Peaslee and Nirenberg, p. 198.
Commentary notes that Example 2 is the authority for the position that a trust which is not a trust REMIC still may have senior and subordinated classes of pass-through certificates. While the example states that the sponsor of the trust retains the subordinated certificates, after initially adopting a contrary view, the Service subsequently ruled that subordinated certificates created under the authority of Example 2 could be freely transferred.

III. Instances in which entities other than Trusts can be treated as Trusts.

As noted above, the Service has held on several occasions that a custody arrangement (which is not, in itself, a trust under local law) would be treated as a trust for tax purposes even though legal title to the property was held by another person.

One commentator raises the question of whether entities could be treated as trusts if they are unincorporated (for example, an LLC), passive, and would be trusts if so organized. The commentator concludes that trust treatment “should not be assumed in the absence of further classification that an entity that is functionally a trust will be classified as one unless it is organized under local law as a trust or custody arrangement.”

IV. Why Trusts?

The principal advantages of using partnerships and trusts over corporations are (i) avoidance of an entity tax, and (ii) pass-through treatment for the investor. A significant benefit

33 See Priv. Ltr. Rul. 8929030 (April 21, 1989) (sale of a subordinated interest in a trust holding installment sale obligations lock the trust outside the purview of Example 2).

34 See Peaslee and Nirenberg 199, Rev. Rul. 92-32, 1992-1 C.B. 434; Priv. Ltr. Rul. 9244036 (Aug. 5, 1992) (same, except that transfers were limited and rights and obligations under an outside reserve fund were transferred along with the subordinated trust interest).

35 Rev. Rul. 70-544 and 70-545.

36 See Peaslee and Nirenberg, p. 170.
of a trust over a partnership is having a trust which permits each certificate holder to be the “owner” under subpart E of Subchapter J, of the Code. This enables each certificate holder to be a separate “person”, in effect disregarding the trust as a “person”.

Thus, for example, such a trust should not be “a related person” for purposes of Section 163(j)(4) of the Code (earnings stripping rules) and Section 871(h)(3) of the Code (denial of portfolio interest exemption to any “person” who owns 10% or more of the voting power of the debtor corporation). See the discussion addressing Canadian Income Funds at Section V.(d) below.

Additional factors favoring grantor trusts over partnerships are:

- Information reporting; no Schedule K-1’s are given to certificate holders.
- A grantor trust that is wholly owned by a state or a foreign government will be ignored, but a business entity owned by such persons will be a per se corporation.

V. Common Law Trusts and Their Use in the Tax Law.

(a) **Securitization Trust:** Entities that could be used for this purpose include Delaware statutory trusts, trusts by private agreement and partnerships. In order to sustain its position as a trust, however, the entity must not violate the power to vary and no multiple class of interests requirements.

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37 Interestingly, a Field Service Advisory issued on February 2, 1994 (1994 FSA LEXIS 430) indicates that for purposes of determining whether a “person” has a 10% or more voting interest in a corporation indebted to a partnership, the test is made at the partner rather than the partnership level.

38 Treas. Reg § 301.7701-3(b)(6).
(b) **REMIC’s**: These entities, governed by Sections 860A through 860G of the Code, are specifically exempted from entity tax and can be organized as corporations, partnerships or trusts under local law. Unlike trusts, REMIC’s, can issue different classes of interests, specifically, regular interests and residual interests.

(c) **FASIT’s**: A Financial Asset Securitization Investment trust (“FASIT”), governed by Sections 806H through L of the Code, may be organized as a corporation, partnerships or trust and is also not subject to an entity tax. Similar to REMIC’s, FASIT’s can have multiple classes of interests.

(d) **Canadian Income Funds**.

Canadian Income Funds are a good example of reliance on an arrangement being treated as a trust rather than as a partnership (or an association).

**Fact pattern:**

Assume, a Canadian mutual fund trust (“CMFT” or the “Fund”), similar to a U.S. regulated investment company or RIC, is subject to Canadian income tax unless (and to the extent) it distributes its income to its unitholders. Further assume that CMFT invests in shares of a Canadian corporation (“Holdco”) which conducts U.S. business through a Delaware or other U.S. operating corporation or LLC (“OPCO”). Holdco is capitalized by CMFT with equity and debt in a manner that satisfies the U.S. debt-to-equity ratio rules. A diagram of this structure is as follows:
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Under the facts presented, CMFT qualifies as a “mutual fund trust” for Canadian income tax purposes. In practice, achieving this status is very straightforward. In the context of U.S. business based transactions, the most important requirement is that the Fund must be resident in Canada and this means that a majority of the trustees must be resident in Canada.

Typically, the Fund will complete a public issuance of its units. The proceeds raised from the public, net of commissions and transaction expenses, will be used by the Fund to subscribe for common shares and subordinated debt of Canadian Holdco. The debt/equity ratio of Canadian Holdco will be 3 to 1. The subordinated debt of Canadian Holdco (“Notes”) will be the “usual” kind of subordinated debt that is a common feature of Canadian income fund structures. The interest rate on the Notes will be in the customary range of between 11% and 14% and will be payable monthly in cash.

The operating entity would distribute all of its “distributable cash” (generally, EBITDA less interest on third party or external debt, an estimated amount for certain other expenses/reserves) to its partners on a monthly basis. Canadian Holdco would receive its percentage interest of such distributions and would in turn distribute those amounts to the Fund as interest on its subordinated debt and dividends on its common shares. The interest rate and rate of dividends will generally be equal to the “yield” promised to the Fund and its unitholders. The Fund would in turn distribute such amounts to its unitholders as distributions on their units.

U.S. Tax Aspects:

In order to benefit from the expected tax treatment of payments made to unitholders through the Fund, the Fund must qualify under the principles described in Section II.(c).2. above
as a “fixed investment trust” which is a grantor trust under U.S. rules. That is, each unitholder
will be treated as owning a share of Fund assets and deriving directly a share of Fund income.

As noted above, the units of the Fund contain both debt and equity parts in Canadian
Holdco. A unit holder may separate and sell these parts or retain them separately but the units
would no longer be publicly traded. In examining the debt equity issue in this structure,
proportionality would seem to warrant the most discussion.

In determining whether an instrument is properly classified as debt or equity, an
instrument held by stockholders in identical or substantially identical proportions as the stock is
subject to close scrutiny. Proportionality alone is not, however, sufficient to recharacterize
purported debt as equity.

Proportionality may be accorded additional weight where the holders of the instrument do
not intend to enforce payment at maturity. An objective indication of a lack of intent to enforce
payment at maturity is the stapling of the stock and purported debt, either through a requirement
that the proportion be maintained in future advances, or a prohibition from transferring the

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39 See Piedmont Corp. v. Commissioner, 388 F.2d 886, 889 (4th Cir. 1968); see also I.R.C. § 385(b)(5).

40 See Piedmont, 388 F.2d at 889; P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 789 (3d Cir. 1962); J.S.
Britz, 387 F.2d 451 (8th Cir. ¶ 67)(proportionally alone cannot be determinative because “any loan or advance
made by a sole shareholder would be in proportion to his shareholding.”)

41 See Gooding Amusement Co. v. Commissioner, 23 T.C. 408, 419-21 (1954) (strict proportionality most
significant factor where the instruments were held by immediate family members and testimony indicates that the
family is indifferent as to whether principal amount is repaid.), aff’d. 236 F.2d 159 (6th Cir. 1956); 2554-58
Creston, 40 T.C. at 938-39 (proportionality is significant if it permits the Holders to be indifferent to repayment
and rely only on their status as shareholders to make a profit from the venture).

42 See Arlington Park Jockey Club v. Sauber, 164 F. Supp. 576, 585 (N.D. Ill. 1958), aff’d. 262 F.2d 902, 906 (7th
Cir. 1959).
stock and purported debt separately. However, even the stapling of purported debt and stock is only evidence that the intent to enforce is lacking and does not compel equity characterization.

Each of the Fund Unitholders and the Existing Investors that have retained an interest in SFG U.S. (collectively, the “Holders”) holds the Notes and SFG U.S. shares in a ratio of 3:1 (based on purchase price). The Holders therefore hold the Notes in identical proportions as the stock. This strict proportionality is a factor that supports, but does not require, equity treatment of the Notes.

The Notes are not legally stapled to the shares. A Fund unitholder may demand at any time to be redeemed by a distribution in specie and in such case, subject to regulatory approval, would receive a pro rata share of the Notes and shares (and a pro rata share of the cash and other property) held by the Fund, and would not be contractually prohibited from separately disposing of such Notes and shares.

As a practical matter, however, since there is no public market for the Notes by themselves or the shares, as there is for Units of the Fund, it is perhaps unlikely that any of these securities would be transferred separately. In this regard, the structure is analogous to a parent corporation lending to a wholly-owned subsidiary. The Notes held by the Fund also might be considered to be stapled to the shares in a practical sense to permit the Fund to qualify as a mutual fund trust under Canadian income tax laws, and as a fixed investment trust for U.S. federal income tax purposes. Additional advances to Canadian Holdco through the Fund must be

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43 See Universal Castings Corp. v. Commissioner, 37 T.C. 107, 113, 115 (1961), aff’d 303 F.2d 620 (7th Cir. 1962).

44 See Scriptomatic, Inc. v. United States, 555 F.2d 364, 372 (3d Cir. 1977) (instrument stapled to stock is still debt); see also Gilbert, 248 F.2d at 407 (debt stapled to stock is indicative of equity because court could not conceive of any reason to staple stock and debt, unless the debt is risk capital and repayment is uncertain).

45 See Piedmont, 388 F.2d at 889.
made in the same proportion as the Fund’s original investment to permit the Fund to continue to qualify as a fixed investment trust.

While the stapling of purported debt to stock is usually indicative of a lack of intent to enforce the debt, that implication may be negated in the present case (assuming for the sake of argument that the notes and shares are stapled in some practical sense) by (1) the subjective intent of the parties to create a debt, and (2) the fact that the effective stapling is required to preserve the Fund's status under both Canadian and United States income tax laws.

As mentioned above, even absent stapling of the stock and purported debt, any instrument held by stockholders in identical or substantially identical proportions as the stock is subject to close scrutiny. In *Fin Hay Realty Co. v. Commissioner*, the court addressed the issue of proportionality of ownership of debt and equity. There, the court stated that, if the property or funds are advanced in proportion to the shareholder’s equity interest, this is an indication that the advance would be considered equity. The court elaborated as follows:

In a corporation which has numerous shareholders with varying interests, the arm’s length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. Where the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will with no countervailing pull. This is particularly so where a shareholder can have the funds he advances to a corporation treated as corporate obligations instead of contributions to capital without affecting his proportionate equity interest.

In *Fin Hay*, the loans were demand notes in form, but at the time the notes were issued, the shareholders could not have reasonably expected payment of the notes for years to come because the proceeds were used to purchase real estate. There was also uncontradicted testimony

46 See *Fin Hay Realty Co.*, 398 F.2d at 697.
that mortgage financing (other than seller financing) was impossible to obtain at the time the
loans were made. Therefore, the Court reasoned that the advances represented a long-term
commitment dependent upon the future value of the real estate and the ability of the corporation
to sell or refinance it. Thus, the Court held that the substance of the transactions, rather than the
form, governed the tax treatment and recharacterized the debt as equity.

As an initial matter, numerous cases have held that debt owed to a shareholder is debt for
U.S. federal income tax purposes and that proportionality is not be determinative in a debt versus
equity analysis where other factors support debt treatment. In *J.S. Biritz Construction Co. v.
Commissioner*, the Court of Appeals for the Eighth Circuit reasoned that proportionality alone
cannot be determinative because “any loan or advance made by a sole shareholder would be in
proportion to his shareholdings.” Further, the court, citing a Ninth Circuit decision which dealt
with multiple shareholders who owned debt, indicated that: “It is not contended that a
corporation is without power to enter into a debtor-creditor relationship with its shareholders.
The intent of the parties as to the nature of the transaction controls.” Accordingly, the *Biritz*
decision supports the conclusion that proportionality is not determinative in and of itself.

In a recent case, *Delta Plastics, Inc. v. Commissioner*, the Tax Court examined a case
where each debenture holder was either a shareholder of petitioner (Delta Plastics) or was related
to a shareholder of petitioner. The debenture funds were transferred to petitioner by the
debenture holders, not in exact proportion, but in comparable proportion to the respective stock

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48 Id.
49 See Wilshire and Western Sandwiches v. Commissioner, 175 F.2d 718, 720 (9th Cir. 1949).
50 T.C. Memo 2003-54 (February 28, 2003).
interests of the debenture holders. The Tax Court rejected the Service’s contention that the debentures represented equity in the corporation rather than debt stating:

With regard to the debenture funds, credible trial testimony was offered that a debtor-creditor relationship was intended between petitioner and the debenture holders with regard to the debenture funds. The debenture notes were executed in favor of each of the debenture holders. The debenture holders expected repayment of the debenture funds. The fixed dates for the payment of principal and designated interest set forth by the debenture notes were honored by petitioner.

These cases indicate that where there is identity of interest between shareholders and creditors, a transaction will be subject to greater scrutiny. In such cases the intent of the holders, ability of the corporation to borrow from third parties and other relevant debt-equity factors will be examined closely. Accordingly, given the identity of interest between the holders of the Notes and shares, the other factors will be subject to greater scrutiny.

OPCO may be either a U.S. LLC or a U.S. Corporation. Where it is an LLC, Holdco reports and pays regular U.S. corporate taxes on its share of OPCO’s income after deductions, including interest expense on both Senior Debt and Notes held by the Fund. Additionally, this income will at some point be subject to a 5% branch profits tax under Article X(6) of the Treaty.

Alternatively, where OPCO is a U.S. corporation, it will pay regular U.S. corporate taxes on its earnings after deductions, including interest on the Senior Debt and Notes held by Fund. Dividends it pays to Holdco will be subject to a 5% tax under Article X(2)(a) of the Treaty.

Because the Income Fund is structured so that each of its unitholders is deemed to have an interest qualifying as a fixed investment trust and a grantor trust, the debt is not treated as being issued to a related party within the meaning of Code Section 163(j). Moreover, assuming one unitholder has 10% or more of the Income Fund, its interest paid will not qualify as “portfolio interest” under Code Section 871(h), so U.S. withholding tax will apply.
VI. Application of Treaties

Suppose an entity is organized as a Trust in a non-U.S. jurisdiction with which the United States is party to an income tax treaty. If this entity is a trust for U.S. tax purposes than some treaties would ordinarily provide benefits to the extent the income derived by the entity is “liable to tax” in its home state, either in its hands or the hands of its beneficiary. See Article IV, paragraph 1 of the Canada U.S. Income Tax Compensation. The characteristics of a trust under U.S. tax rules can, impact the U.S. Tax treatment under treaties.

Alternatively, assume that an entity while a trust in its home jurisdiction failed to qualify as a trust and was instead a business entity for U.S. federal income tax purposes. If the entity is a partnership under US tax rules, treaty benefits should apply to the extent the partner is a resident of the same state (or another treat state).

If the entity is not a trust, and does not elect to be treated as a partnership (which election would seem necessary since no certificate holder has unlimited liability), it would be a corporation under U.S. tax rules so that it have the benefit of the Treaty so long as it is an entity liable for tax in its home country. For example, because a CMFT is “liable to tax” in Canada, that is, it would be taxed on income not distributed to its grantor beneficiaries, it may claim the benefit of this treaty.

If an entity were organized as a trust under non-U.S. law, was a business entity under U.S. rules and were treated as a corporation because a partnership election was not made, but because of the nature of the trusts treatment under its local rules it was not liable to local tax (for example the income was directly taxable to its beneficiaries) then this non-U.S. “corporation” would presumably be denied treaty benefits.
(a) **Withholding Compliance:**

If the entity is a trust rather than a business entity than the further determination must be made as to whether the trust is a “complex trust” under Section 661 and 662 of the Code, a “simple trust” under Section 651 and 652 of the Code or a “grantor trust” under Subject E of Subchapter J. If the entity is a complex trust, the appropriate form to be submitted by the trustee to the U.S. withholding agent or qualified intermediary would be a Form W-8BEN. If the trust is a simple trust or grantor trust, than the trustee would provide a Form W-8IMY accompanied by Forms W-8BEN of the beneficiary or beneficiaries.

If trust is a partnership other than a tax withholding partnership, it would provide a Form W-8IMY and Forms W-8BEN of various partners and an allocation of income statement.

If the trust is a corporation, it would simply provide Form W-8BEN.

**Conclusion**

It would seem that the use of fixed investment trusts continues to be a viable, tax efficient means to facilitate investments. No other vehicle has been used to accomplish so many types of passive investments and despite the introduction of REMICs and FASITs it is still being widely used!