REPORT #802

## TAX SECTION

# New York State Bar Association

State/Federal Conformity in
Trust Classification

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# New York State Bar Association



August 19, 1994

The Honorable James W. Wetzler
Commissioner of Taxation and Finance
Building 9, W. A. Harriman Campus
Albany, New York 12227-1215

Re: <u>State/Federal Conformity in Trust Classification</u>

Dear Commissioner Wetzler:

As you know, the Tax Section strongly supports conformity between the Federal and State tax systems. We have recently run across a significant issue relating to the respective Federal and State tax classifications of trusts engaged in a business (referred to herein as business trusts). The problem arises because a business trust may be classified for Federal income tax purposes as either a corporation, partnership, or trust, but under a very literal application of the regulations under the Tax Law such a trust appears to be taxable as a corporation for State purposes in all these circumstances.

Business trusts classified as partnerships for Federal income tax purposes (and therefore exempt from Federal income tax) are not uncommon, and are often used to create off-balance sheet financing or to be "bankruptcy-remote" entities in lending transactions. As is illustrated below, if such trusts were treated for State purposes as corporations subject to the franchise tax, the resulting lack of conformity in tax classification would give rise to results that are somewhat bizarre and, we believe, completely unexpected by the taxpayer and unintended under the Tax Law. These results (including an immediate double taxation of trust income) would essentially prevent such trusts from carrying on their activities in the State.

We believe the potential for these adverse results can and should be eliminated by an amendment to the State tax regulations clarifying that business trusts will be classified (as corporations, partnerships or trusts) in the same manner that they are classified for Federal income tax purposes. Such an amendment would be consistent with (1) the existing State personal income tax law, which only taxes trusts that are treated as trusts for Federal income tax purposes, and (2) the recently enacted limited liability company (LLC) legislation, which classifies an LLC for State income and franchise tax purposes the same way (i.e., as a corporation or partnership) that it is classified for Federal income tax purposes.

The problem arises for the following reason. Under § 208.1 of the Tax Law, for purposes of the corporate franchise tax a “corporation” includes:

(i) an “association” within the meaning of § 7701(a)(3) of the Internal Revenue Code (the “Code”),

(ii) a publicly traded partnership taxable as a corporation under § 7704 of the Code, and

(iii) “any business conducted by a trustee or trustees wherein interest or ownership is evidenced by certificate or other written instrument”.

Reg. § 1-2.5(b) expands on clause (iii) above to state that the quoted phrase includes but is not limited to an association commonly referred to as a business trust or Massachusetts trust, but that the mere investment of funds and collection of income thereon is not the conduct of a business for this purpose. Reg. § 1-2.6 defines a partnership in the same manner as under the Code, but goes on to state that a partnership does not include a corporation within the meaning of Reg. § 1-2.5(b). As a result, under a very literal reading of these regulations, a trust engaged in business and having certificates of ownership is always within the definition of a corporation, and is thus automatically excluded from the definition of partnership under the Tax Law even if classified as a partnership for Federal income tax purposes.

Treatment of business trusts as per se corporations for franchise tax purposes would be in sharp contrast to the treatment of business trusts under the Code. Under Code § 7701(a)(3), an "association" is always taxable as a corporation. Under Treas. Reg. § 301.7701-2,

(1) if a trust does not have both associates and an objective to carry on business for joint profit, the trust will be taxable as a trust, and

(2) if a trust does have both associates and an intention to carry on business, it will be treated (just as will an LLC) as either an association (and therefore a corporation) or partnership depending on whether it possesses certain other corporate factors (centralized management, continuity of life, free transferability of interests, and limited liability).

The problem we are concerned about can be broken down into three situations, based upon the classification of a trust for Federal purposes:

1. Consider first a trust taxable as a corporation for Federal purposes. The only route to such treatment under the Code is that the trust has associates, an intention to carry on business, and at least three of the four corporate factors specified in the regulations, with the result that the trust is an association

under Code § 7701(a)(3). As such an association, the trust will always properly be taxed as a corporation for State purposes under either clause (i) or clause (iii) above. In this situation the Tax Law and regulations reach the right result.

2. Consider next a business trust that is taxable as a partnership for Federal income tax purposes. Such a trust will have associates and an intention to carry on business, but will not have the corporate factors necessary to be an association. For Federal purposes, the trust is not subject to tax. Rather, the owners of the trust are partners, include the trust income in their taxable income as it is earned by the trust, and pay tax on the income.

The activities of such a trust might well cause real concern that it would be considered to be doing business in the State under the regulations quoted above. If so, under a literal reading of those regulations the trust would appear to be a corporation subject to State franchise tax on its income. Since the trust is a Federal tax partnership, its income is currently included in the taxable income of its partners for Federal income tax purposes, and under general conformity principles the partners would simultaneously pay current State income or franchise tax on the same income that is taxed directly to the trust. The result is an immediate double tax on all trust income, even if the income is not distributed.

This immediate double tax could not have been intended by the legislature. It is a far worse result than the double tax arising from the typical corporate form of doing business. In the latter case the corporation is taxed when the income is earned, but the shareholders are not taxed until the profits are distributed to them.

We are aware of no other situation in the Federal or State tax laws where income is subject to an immediate double tax by the same taxing jurisdiction. In a closely analogous situation presenting the potential for immediate double taxation by the State, namely a Federal S corporation that does not elect to be a State S corporation, §§ 612(c)(22) and (b)(20) of the Tax Law eliminate the problem by in effect taxing the S corporation shareholders on corporate earnings only when they are distributed.[1/]

The regulations that literally reach this result are based upon the Tax Law provision described in (iii) above, defining a corporation to include a trust engaged in business. This provision has been in the Tax Law since 1944. When adopted, that provision reflected the U.S. Supreme Court case of Morrissey v Comm'r, 296 U.S. 344 (1935), holding that a' trust holding and developing real estate was taxable as a corporation. For many years after that decision, it was generally believed that a business trust would generally be taxable as a corporation because it was centrally managed and it continued in existence following the death of an owner or another change in ownership.[2/]

Thus, clause (iii) when enacted was designed to increase Federal/State conformity. It was only subsequent developments in the law that gave rise to the concept that a business trust might be taxable as a partnership for Federal purposes. Those developments included the adoption of the present Code § 7701 regulations in 1960, the IRS acknowledgment in 1979 that those regulations should be read literally in testing an entity as a partnership

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[1/] Further illustrating the unexpected consequences of the lack of conformity in entity classification, even though the trust in question is a pass-through entity for Federal income tax purposes, it would never be eligible for a State S election. Such an election by its terms only applies to a corporation that becomes a pass-through entity by making a Federal Subchapter S election, not an entity already a pass-through entity for Federal purposes.

[2/] See McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners § 3.06[1] (2d Ed. 1990), describing 1953 Treasury Regulations that treated any entity with these two characteristics as an association taxable as a corporation.

or corporation [3/] and, most importantly, the issuance in 1988 of the first IRS ruling that an LLC could be taxable as a partnership.[4/]

Moreover, clauses (i) and (ii) described above were first added to § 208.1 in 1989 to further increase Federal/State conformity (by ensuring that all entities characterized as corporations for Federal purposes were characterized as corporations for franchise tax purposes). Likewise, as mentioned above, the recent LLC legislation is premised upon (and furthers) Federal/State conformity in entity classification.

In reality, we believe it was an oversight that clause (iii) was not repealed in 1989. Its original function of ensuring conformity in trust classification was obsolete, both because it was over-inclusive (by covering trusts by that time eligible to be taxable as partnerships for Federal purposes) and under-inclusive (by not covering non-trust entities taxable as corporations for Federal purposes). Its role of ensuring conformity was completely superseded by clauses (i) and (ii), which ensure conformity for any type of entity (including but not limited to a trust). The only role conceivably left for clause (iii) was to cause the imposition of corporate franchise tax on trusts that are not corporations for Federal purposes; this role could hardly have been intended by the legislature. As a result, we believe the regulations would be justified in adopting the more modern classification approach reflected in clauses (i) and (ii).

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[3/] See Rev. Rul. 79-106, 1979-1 C.B. 448 and the IRS acquiescence in Larson v Comm'r, 66 T.C. 159 (1976), acq., 1979-1 C.B. 1.

[4/] Rev. Rul. 88-76, 1988-2 C.B. 360.

We wish to emphasize that the taxation of trusts that are taxable as partnerships for Federal purposes as corporations under the franchise tax is a trap for the unwary and raises no significant revenue. No one would knowingly create a trust subject to this State tax regime. Moreover, we are aware of no tax avoidance possibilities that might arise from treating such trusts as partnerships for State purposes, because the result would be no different than that which would arise if a "real" partnership (or LLC taxable as a partnership) were utilized.

We therefore recommend that § 1-2.5(b) of the regulations be amended to provide that a corporation does not include a business trust taxable as a partnership for Federal income tax purposes.

3. Finally, consider a business trust that is taxable as a trust for Federal income tax purposes. Under Treas. Reg. § 301.7701-2, described above, this treatment arises if the trust does <u>not</u> have associates, but <u>is</u> engaged in business. The trust is subject to the normal tax rules for trusts, rather than for corporations or partnerships, for Federal purposes. This situation could arise, for example, with a testamentary trust that owns a rental building or otherwise carries on a business, since a testamentary trust would not normally be considered to have associates.

Turning to clause (iii) quoted above, interests in a testamentary trust would generally not be evidenced by certificates or other written instruments, in which case a trust of this type would not be taxable as a corporation for franchise tax purposes. However, if this exception did not apply, under a literal reading of the regulations quoted above the trust would be taxable as a corporation for franchise tax purposes.

As before, this tax result would be quite unexpected to the parties and would lead to a double State tax on trust income (compared to a single Federal tax):

(i) if trust income were required to be distributed currently to beneficiaries, (1) for Federal purposes the trust would be entitled to a deduction for the distributions (Code § 651) and only the beneficiaries would have taxable income, while (2) for State purposes the trust would apparently be considered to pay nondeductible dividends and thus be fully taxed on its income, and the beneficiaries would be taxed under Federal conformity, and

(ii) if income earned by the trust in one year were distributed in a later year, (1) for Federal purposes the trust would be taxed in the year the income was earned, but in the distribution year the beneficiaries' tax on the distribution would be reduced by a credit for the taxes previously paid by the trust (Code §§ 666 and 667), while (2) for State purposes the trust would likewise be taxed in the year the income was earned, but in the distribution year the beneficiaries would have a fully taxable dividend from a corporation.

We believe trusts that are classified as trusts for Federal purposes should be classified as trusts for State purposes. They would then be subject to taxation as trusts under the usual state personal income tax rules.

We acknowledge that this result might raise issues concerning the State taxation of trust income if there are nonresident beneficiaries of a business trust. This issue is not new, however, and has nothing to do with conformity. It would arise today for most testamentary trusts, since most do not have ownership interests evidenced by certificates or other written instruments. Nevertheless, if it was thought necessary, we would support a clarifying provision to the Tax Law or regulations to ensure that the State business income of a trust taxable as a trust is subject to State tax at some level.

We emphasize, however, that the issues discussed in the preceding paragraph do not arise if a trust carrying on business in the State is treated as a partnership under the Tax Law (item 2 above). The tax rules for nonresident partners of a partnership engaged in business in the State are well-established and are much more developed than are the rules for nonresident beneficiaries of a trust taxable as such and engaged in business in the State.

As a result, we believe that the regulations should be amended promptly to create conformity for business trusts taxable as partnerships for Federal purposes, even if further study is considered to be needed with respect to business trusts taxable as trusts for Federal purposes. We note that the great majority of affected trusts are in the former category, because most trusts in the latter category are already exempt from the franchise tax because they do not have written ownership interests.

We would be happy to work with you on the details of these proposals. Please let me know if we can be of further help in this matter.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: William F. Collins, Esq.