Chapter 3, Part B, C.2 (Entity Classification)

B. Overview of Entity Classification Regulations

The entity classification regulations (Treasury Regulation §§ 301.7701-2 through 301.7701-4) classify entities based on their activities and the rights and obligations of their owners. Although local law will determine for an entity the nature of its permitted activities and the rights and obligations of its equity holders—thereby influencing the entity's classification under the regulations—the status of an entity under local law (such as the fact that it is called a trust and is governed by the state law relating to fiduciaries) is not generally controlling.[1]

The regulations identify six major characteristics of a "pure corporation" that, taken together, distinguish it from other organizations. These are:

- Associates,
- An objective to carry on business and divide the gains therefrom.
- Continuity of life,
- Centralization of management,
- Liability for corporate debts limited to corporate property, and
- Free transferability of interest.

An unincorporated organization is treated as a corporation if, taking account of these factors, it more closely resembles a corporation than a partnership or trust.[2] An unincorporated organization

---

1 See Treasury Regulation § 301.7701-1(c). However, an organization formed as a domestic corporation may be automatically classified as a corporation, on the ground that the functional tests in the regulations apply only to "unincorporated organizations". See Treasury Regulation § 301.7701-2(a)(3); *O'Neil v. United States,* 401 F.2d 888 (6th Cir. 1969); *United States v. Empey,* 406 F.2d 157 (10th Cir. 1969; Revenue Ruling 70-101, 1970-1 C.B. 278; G.C.M. 37953 (May 14, 1979) and G.C.M. 37127 (May 18, 1977). This question would be relevant if, for example, the transferability of corporate shares were restricted and the shareholders assumed personal liability for corporate debts, as is allowed under some state corporation statutes. At present, as entity organized under foreign law is always considered an unincorporated organization for this purpose. See Revenue Ruling 88-8, 1988-1 C.B. 403. The earlier view was to the contrary, for this purpose. See G.C.M. 34376 (November 13, 1970): P.L.R. 8426031 (March 26, 1984). It is not clear why a distinction should be drawn between domestic and foreign organizations. The recent decision of the Service to classify domestic limited liability companies under the regulations (see footnote 4 below) may signal a loss of faith in *per se* classification approaches, although a limited liability company differs in some respects from a corporation (e.g., because it generally lacks continuity of life).

2 The regulations state that, in addition to the six major characteristics, in some cases, other factors may be found that are significant in classifying an organization. Nonetheless, most authorities applying the regulations focus primarily, if not exclusively, on the six major corporate characteristics. Cf. Revenue Ruling 79-106, 1979-1 C.B. 448 (lists a number of "minor" factors not given significance in classifying limited partnerships except insofar as they bear on the six major characteristics). At one point, the Service generally would not rule that an entity was a partnership if it had the corporate characteristic of limited liability. See Revenue Procedure 72-13, 1972-1 C.B. 735. This is no longer the case. See Announcement 88-118, I.R.B. 1988-37, 26, and Revenue Ruling 88-76, 1988-2 C.B. 360 (Wyoming limited liability company classified as a partnership).

that is classified as a corporation for federal income tax purposes is referred to as an *association taxable as a corporation, or association* for short.

Typically, the last four corporate characteristics just listed are also present in state law trusts, and thus are not relevant in distinguishing trusts from associations. A typical state law trust is classified as an association if any only if it has the two remaining corporate characteristics: associates and an objective to carry on business and divide the gains therefrom.[3] For convenience, these two characteristics will be referred to ere collectively as a *business objective*. A trust that engages in an active business would be considered to have a business objective. Special standards apply in determining whether an investment trust (generally a trust holding investment assets on behalf of a group of investors) has a business objective.

A business objective is common to corporations and partnerships. Thus, it is not a factor in distinguishing between them. An organization that has a business objective is classified as an association if it has three or four of the remaining four corporate characteristics; otherwise, it is classified as a partnership (assuming it has more than one owner).[4]

The Service has issued guidelines for obtaining private letter rulings that an entity is a partnership. No similar guidelines have been issued for investment trusts.[5]

Although issuers of mortgage-backed securities generally have more than one owner, a state law trust may be used to hold mortgages even where there is only a single investor. The trust could be formed for various reasons: to make the investment more liquid by issuing to the investor transferable trust certificates; to protect the investor from personal liability for claims against the trust; or , where the trust issues debt or other nonequity securities to third parties, to protect them from a bankruptcy of the investor. The requirement of "associates" would not prevent a single-owner trust from being classified as an association if it carries on a business and has at least three of the last four corporate characteristics.[6] A single-owner trust that conducts business and has two or fewer of those characteristics cannot be a partnership (because a partnership requires two or

---

3 See Treasury Regulation § 301.7701-2(a).

4 See Treasury Regulation § 301.7701-2(a).

5 The current partnership ruling guidelines are contained in Revenue Procedure 89-12, 1989-1 C.B. 798; Revenue Procedure 91-13, 1991-1 C.B. 477 (checklist for ruling requests); Revenue Procedure 92-33, 1992-1 C.B. 782 9transfers of "substantially all" interests); Revenue Procedure 92-35, 1992-1 C.B. 790 (continuity of life does not exist if remaining general partners or a majority in interest of limited partners can continue partnership after bankruptcy or retirement of general partner); Revenue Procedure 92-87, 1992-2 C.B. 496 (rulings not issued for limited partnerships formed under Uniform Limited Partnership Act (ULPA) that meet standards of Revenue Procedure 92-88); and Revenue Procedure 92-88, 1992-2 C.B. 496 (ruling guidelines for ULPC partnerships). Revenue Procedure 82-58, 1982-2 C.B. 847, amplified by Revenue Procedure 91-15, 1991-C.B. 484 (checklist for ruling requests), contains ruling guidelines for liquidating trusts (see Treasury Regulation § 301.7701-4(d)).

6 See *Hynes v. Comm'r,* 74 T.C. 1266 (1980); G.C.M. 38707 (May 1, 1981) (agreeing with result in *Hynes*, but indicating that "a non beneficiary trust should be classified as an association only when the facts of the case clearly warrant such treatment"). See also P.L.R. 8552010 (September 25, 1985) (trust with a single beneficiary was classified as an association because it possessed centralized management, continuity of life, and limited liability).

more partners). Instead, the trust would be ignored (i.e., it would not be recognized to be an entity and its activities would be attributed to the owner).[7]

***

C.2. Classification of Trusts with a Business Objective

As explained above, if an investment trust has a business objective, it will be classified as a corporation only if has at least three or the following four corporate characteristics: continuity of life, centralized management, limited liability and free transferability of interests. A typical pass-through trust would possess all of these characteristics except possible centralized management, and would therefore be classified as an association if it has a business objective.

The balance of this discussion of trusts with business objectives begins by reviewing some aspects of the four corporate factors that are particularly relevant to investment trusts. The discussion is not intended to be comprehensive. [8] The next section outlines an election that can sometimes be made under section 761 to avoid certain of the complexities of partnership taxation for investment trusts that are classified as partnerships. The discussion concludes by describing how the four-factor test is typically applied to owner trusts, whole loan participation arrangements, trusts with outside reserve funds, and issuers of pass-through debt certificates.

a. **General**. Two points should be kept in mind in applying the four-factor test to investment trusts. First, whether the factors are present in a particular trust depends on the specific terms of the trust documents and the effect of those terms under local law. Thus, the ability to manipulate the factors depends on the body of law governing the trust. It is important to check that provisions in a trust agreement designed to achieve a particular tax result will be given effect as desired under local law.[9]

b. Second, the entity classification tests are based on the rights and obligations, of "members" of an organization. For example, an organization will lack limited liability only if a "member" is personally liable for debts of the organization. Care should be taken to identify those persons whose status as a member is significant and to ensure that they have a sufficient equity stake to be recognized as members.[10]

---

7 See G.C.M. 39395 (June 24, 1983); P.L.R. 8533003 (May 7, 1985). In P.L.R. 8852017 (September 27, 1988), the Service held that a single-beneficiary trust would be a partnership or corporation depending on whether the trust had the requisite number of corporate characteristics; apparently, the Service assumed that there would in the future be more than one beneficiary. See also footnote 10 below (discussing when a contractual arrangement is a state law trust).

8 For further discussion of these factors, see W. Brannan, "Lingering Partnership Classification Issues (Just When You Thought it Was Safe to Go Back into the Water)," *1 Florida Tax Review* 197 (1993).

9 Trusts used in structured finance transactions may be common law trusts or may be organized under a statute, such as the Delaware Business Trust Act (Del. Code Ann., Title 12 Cha 38). The Delaware Business Trust Act was written with the entity classification regulations in mind and is quite flexible.

10 Following the Service's ruling guidelines for partnerships, it is common practice to require any entity that must qualify as a member to own 1% of each class of ownership interests in the entity (and to be prudent, of

(i) ***Continuity of life***. An entity lacks continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a "dissolution" of the organization under local law. [11] Continuity of life is not the same as an indefinite life. It focuses not on how long an organization is expected to last (for example, whether it has a fixed term) but instead on whether its continuing life may be disrupted by changes in the status of any member. Under the regulations, partnerships formed under the Uniform Limited Partnership Act (ULPA) automatically lack continuity of life. There is no per se rule favoring trusts.

Investment trusts typically possess continuity of life because, as a commercial matter, it is undesirable to link the fortunes of an issuer to the status of beneficiaries, particularly if interests in the trusts are freely transferable. Where continuity of life is defeated, it is typically accomplished by having a "bankruptcy-remote" entity hold an interest in the trust and tying dissolution to the bankruptcy or dissolution of that entity. These arrangements raise two issues. Does continuity exist if (1) a dissolution can be triggered by only one of the events listed in the regulations, and (2) the triggering event is unlikely to happen (and even contractually prohibited)? Limiting the triggering event to a bankruptcy of a member should suffice.[12] As to the second point, the relevant standard is whether the member or a third party has the power to cause a triggering event and not whether the event is likely to occur.[13]

---

each class of debt or other nonequity interests that could be recharacterized as ownership interests). See Revenue Procedure 89-12, 1989-1 C.B. 798, §§ 401-03 (general partners of limited partnership, taken together, are required to maintain throughout the life of a partnership at least a 1% interest in the partnership's profits and losses (or, if the total investment in the partnership exceeds $50 million, a smaller percentage interest equal to 1% divided by the ratio of the total investment to $50 million, but in any event not less than a .2% interest), as well as a minimum investment at all times of at least the lesser of 1% of the total partnership capital and $500,000).

11 Treasury Regulation § 30l.7701-2(b).

12 See Larson v. Comm'r, 66 T.C. 159, 174-5 (1976), acq., 1979-1 C.B. 1 (limited partnership lacked continuity of life where only the bankruptcy of its general partner would cause a dissolution of the partnership under local law); P.L.R. 9306008 (November 10, 1992) (limited liability company lacked continuity of life when its dissolution under local law would occur only upon the bankruptcy of a member); P.L.R. 9121025 (February 22, 1991) (foreign joint venture lacked continuity of life where it would be liquidated only on the bankruptcy of a partner); and P.L.R. 9031016 (May 7, 1990) (trust that would terminate only on the bankruptcy of a grantor lacked continuity of life).

13 Treasury Regulation § 301.7701-2(b)(3) includes the following: "If the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life." Cf. Treasury Regulation § 301.7701-2(c)(4) (centralized management does not exist where general partners agree among themselves to vest management authority in a few general partners because ordinarily all partners retain the power to bind the partnership in dealings with third parties who have no notice of the management agreement). Zuckman v. U.S., 524 F.2d 729 (Ct. Cl. 1975), held that a partnership lacked continuity of life where the bankruptcy or dissolution of the corporate general partner triggered a dissolution even though the corporation was contractually bound not to enter into bankruptcy or to dissolve. The court stressed the fact that the corporation had the power, under the relevant partnership law, to act in violation of its contracts to cause a dissolution of the partnership. The court also had held that the partnership automatically lacked continuity of life under the regulations because it was formed under a statute

Continuity of life could also be defeated by giving one or more beneficiaries a right to revoke the trust and trigger a dissolution, perhaps coupled with an agreement (that can be enforced only through a claim for money damages) not to exercise the right.[14]

In a case where an investment trust has some feature that benefits a particular investor and that could cause the trust not to be classified as a trust under the Sears regulations, it is arguable, although by no means certain, that continuity of life can be defeated by eliminating the offending feature upon the occurrence of a bankruptcy or dissolution of that investor. From a tax standpoint at least, the bankruptcy/dissolution would then result in a liquidation of the old entity and its transformation into a trust.[15]

Some investment trusts allow trust beneficiaries to redeem their trust units (in which case the trust generally sells trust assets as necessary and distributes cash equal to the value of the redeemed unit).[16] Although such a right allows individual investors to liquidate their interest in the trust, it does not affect continuity of life, because the withdrawal by one investor does not terminate the trust for the remaining investors. Continuity of life is also not defeated by a right of investors to amend a trust document or to terminate a trust by vote, which would be similar to a right of corporate shareholders to liquidate a corporation or amend its charter.[17]

---

corresponding to the ULPA. Typically, the ability of a bankruptcy-remote corporation to commence a voluntary bankruptcy case is limited by requiring the action to be approved by an independent director, but there is no agreement by the corporation not to take such action because such an agreement would be unenforceable. Such a corporation also could become involved in an involuntary bankruptcy proceeding and trigger a dissolution that way. Even if a corporation is prohibited from incurring debt, it may nonetheless have the power to do so, or may be subject to noncontractual liabilities (e.g., for taxes or securities law claims).

14 See Treasury Regulation § 301.7701-2(b)(3): "[l]f the agreement expressly provides that the organization can be terminated by the will of any member, it is clear that the organization lacks continuity of life."

15 To illustrate, consider the trust described in Part C.l.f.(ii) that holds a corporate bond, allocates rights to interest and principal payments to an interest investor and principal investor, and would clearly be classified as a trust but for the effect of a reallocation of payments from the principal investor to the interest investor in the event of a default on the bond. Suppose that the terms of the trust provide that upon a bankruptcy or dissolution of the interest investor, the trust will be "dissolved" and automatically reconstituted without the offending reallocation feature. It could be argued that if the trust is considered to have a business purpose, and cannot be classified as a trust, solely because of the existence of the reallocation feature, it would lack continuity of life because, for tax purposes, the trust would be liquidated as a business organization, and reconstituted as a trust, upon the bankruptcy of a member. It is not clear, however, whether the change in the tax status of an entity can be considered a "dissolution" within the meaning of the classification regulations, which ordinarily look to local law in applying the classification standards. Further, the enforceability of a term that conditions forfeiture of a valuable right upon a bankruptcy or dissolution of an investor would need to be considered.

16 See footnote 68 above. In the case of a trust characterized as a partnership, a redemption right could affect whether the trust is a publicly traded partnership under section 7704. See Notice 88-75, 1988-2 C.B. 386.

17 See Revenue Ruling 71-277, 1971- C.B. 422; Revenue Ruling 71-434, 1971-2 C.B. 430; G.C.M. 34407 (January 22, 1971); and G.C.M. 34449 (March 8, 1971). In P.L.R. 9002056 (October 18, 1989), a limited liability company was held to lack continuity of life where its articles of association required that all

Once the triggering event has been identified, the trust must then "dissolve". In the context of a state law partnership, this term has a technical meaning (i.e., a termination of the mutual agency which is the partnership). Also, it is fairly easy to know when a dissolution has occurred, because the relevant state law refers to "dissolution" events. For organizations formed solely by contract or under statutes that do not have a dissolution concept, it would seem to be necessary for a "dissolution" to be followed (subject to the discussion of reconstitution below) by a winding up and termination in order to give content to the term. In the case of a passive vehicle such as an investment trust, a dissolution cannot lead to a cessation of business activities, because there are none; but at least the trust can be required to change course by selling and disposing of its assets in a commercially reasonable manner.[18]

A limited partnership will lack continuity of life if an event affecting a general partner causes a dissolution even though there is a power in all remaining general partners, or in a majority in interest of all remaining partners (both limited and general) to continue the partnership.[19] A right to reconstitute a trust that requires the consent of all beneficiaries (other than the one that caused the dissolution) would clearly defeat continuity of life.[20] The same result should hold true if only a majority in interest of the remaining beneficiaries can continue a trust following a dissolution event.[21]

---

shareholders vote to dissolve the company upon the dissolution, bankruptcy or insolvency of a member. Recently, the holding in this ruling has been questioned by IRS officials.

18 Suppose that a trust has pledged all of its assets to secure a borrowing and that the indenture prohibits the sale of assets until the debt is repaid. If the debt is expected to be outstanding over the entire life of the trust, then a dissolution that triggers a requirement to sell assets (subject to the terms of the indenture) may have no practical significance. Query whether a "dissolution" would be considered to occur under these circumstances. If it makes a difference, a technical dissolution can be achieved for a trust organized under the Delaware Business Trust Act by providing that, in a case where a trust is continued following a "dissolution," the old trust is terminated and a new successor trust (that is considered a different trust under the Act) is formed. See Del. Code Ann. Title 12, §§ 3808 (events affecting beneficial owners do not cause a dissolution unless otherwise provided in the governing instrument), and 3806(b)(6) (transfer of trust assets to a new trust).

19 Treasury Regulation § 301.7701-2(b)(l).

20 See Revenue Ruling 88-79, 1988-2 C.B. 361 (Missouri business trust having both managers and passive participants as beneficiaries lacked continuity of life when the trust agreement provided that the trust would dissolve upon the death, insanity, bankruptcy, retirement, or resignation of any manager, unless all remaining managers and a majority of participants agreed to continue the trust, where these trust provisions were effective under local law). A fortiori, a trust reconstitution provision that required the consent of all beneficiaries would defeat continuity of life. See also P.L.R. 9147012 (December 7, 1990) (trust lacked continuity of life where it could be continued with unanimous consent); P.L.R. 9107028 (November 20, 1990) (same; trust was apparently formed under the Delaware Business Trust Act).

21 The rule in Treasury Regulation § 301.7701-2(b)(l) that treats a partnership as lacking continuity of life notwithstanding that it can be continued with partner consent stems from Glensder Textile Co. v. Comm'r, 46 B.T.A. 176 (1942), acq., 1942-1 C.B. 8, which is cited in the regulation. This case held that the need for partner consent made continuation of a partnership following the bankruptcy, withdrawal, etc. of a partner uncertain, which was sufficient to defeat continuity of life. If the need for a majority vote creates sufficient doubt as to the longevity of a partnership, the same should hold true for trusts or other state law entities. The trust in Revenue Ruling 88-79 (see footnote 117 above) cites Glensder Textile as relevant authority. The

(ii) Centralized management. A trust has centralized management if the trustee, or any other person (or group of persons which does not include all of the beneficiaries) has continuing exclusive authority to make the "management decisions necessary to the conduct of the business for which the organization was formed." Centralized management means a concentration of continuing exclusive authority to make "independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is no centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal."[22]

Centralized management would exist in an investment trust that has a business objective if the trustee has the exclusive power to make investment decisions. The trustee would not have such a power if its actions are subject to the direction of, or ratification by, all or a majority in interest of the beneficiaries.[23] In order for a trust to lack centralized management, it is not essential that all beneficiaries participate (or have a right to participate) in management. By analogy to a limited partnership, however, centralized management is likely to exist where the managers own an interest in the trust of 20 percent or less.[24]

An organization with a business objective ordinarily has the power to make business decisions (including, in the case of an investment trust with a power to vary investments, the power to manage investments). However, an investment trust that is entirely passive may be deemed to have a business objective solely by application of the Sears regulations. In that event, there would

---

trust in the ruling could have been continued based on a majority vote if there had been only a single remaining manager. After expressing some reservations on the point, in Revenue Ruling 93-91, I.RB. 1993-41, 21, the Service held that the partnership majority-in-interest standard applies to limited liability companies, and by extension should apply to a trust. For an earlier contrary view, see P.L.R. 9010027 (December 7, 1989) (limited liability company possesses continuity of life when the members could avoid a dissolution under state law by a vote of a majority of its members to continue the company).

22 Treasury Regulation § 301.7701-2(c).

23 See Treasury Regulation § 301.7701-2(c)(4); Revenue Ruling 64-220, 1964-2 C.B. 335; P.L.R. 8510001 (September 28, 1984); P.L.R. 8119056 (February 13, 1981); P.L.R. 8113078 (December 31, 1980); and P.L.R. 8104157 (October 31, 1980). It is not necessary that the beneficiaries actually exercise the power to direct or ratify actions of a trustee, but only that they have the right to do so. Under many state laws, beneficiaries who participate in the management of a trust become liable for obligations of the trust. See G.C.M. 39395 (May 7, 1985), describing New York law. The beneficiaries of a Delaware Business Trust, however, can manage it without being exposed to personal liability for trust debts. See sections 3803 (liability) and 3806 (management).

24 See Treasury Regulation § 301.7701-2(c)(4) (centralized management exists in a limited partner- ship if substantially all of the interests in the partnership are owned by the limited partners; ability of limited partners to remove a general partner will be taken into account); Glensder Textile Co. v. Comm'r, 46 B.T.A. 176 (1942), acq., 1942-1 C.B. 8 (limited partnership lacked centralized management because general partners holding a 42% interest in the partnership "were acting in their own interest . . . and not merely in a representative capacity for a body of persons having a limited investment and a limited liability. . . . Nor were the limited partners here able to remove the general partners and control them as agents, as stockholders may control directors."). The Service generally will not rule that centralized management is lacking in a limited partnership if the general partners have an interest of 20% or less, although factors demonstrating direct or indirect limited partner control over the general partners also will be considered. Revenue Procedure 89-12, 1989-1 C.B. 798, § 4.06. See also G.C.M. 36292 (May 29, 1975) (earlier statement of 20% test).

be no person (including the trustee and the beneficiaries) who has the authority to make nonministerial, management decisions for the trust, so that the trust should be considered to lack centralized management.[25] No authorities have been found specifically addressing this point.

(iii) Limited liability. An 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 (i.e., who may be liable to a creditor to the extent the organization's assets are insufficient to pay claims).[26]

Although general partners are jointly and severally liable for partnership debts, the corporate characteristic of limited liability is defeated if each member is liable for only its proportionate share of the organization's debts.[27] A member who is personally liable for debts of an organization does not lose personal liability be- cause another person agrees to indemnify the member against such liability,[28] and liability of any person can be limited to claims that arise during the period in which that person is a member.[29] Thus, for example, an investment trust that benefits from a guarantee by a federally sponsored agency would lack limited liability if each certificate holder is personally liable for its proportionate share of the claims against the trust

---

25 A trust with no management powers would resemble neither a corporation (which is centrally managed) nor a partnership (which is managed by its members). However, the four-factor test looks to whether an organization resembles a corporation, not whether it is similar to other unincorporated business organizations. The four characteristics are described in Treasury Regulation § 301.7701-2(a)(l) as "major characteristics ordinarily found in a pure corporation". Also, an organization with a business objective that has two, and lacks two, of the four characteristics is classified as a partnership (assuming it has at least two members), even though it may resemble neither a corporation nor a conventional partnership. The view that resemblance to a corporation is the relevant test is borne out by the fact that the corporate characteristic of limited liability does not exist in an organization if its members are severally liable for claims against the organization, even though a partner would have joint and several liability. See footnote 124, below.

26 See Treasury Regulation § 301.7701-2(d).

27 See Bush #1 do Stonestreet Lands Co. v. Comm'r, 48 T.C. 218, 233-4 (1967), acq., 1968-2 C.B. 2; P.L.R. 7951006 (August 21, 1979); P.L.R. 7903084 (October 20, 1978); P.L.R. 7404300620A (April 30, 1974); and G.C.M. 38025 (July 20, 1979).

28 Treasury Regulation § 301.7701-2(d)(l). Similarly, if under local law no member of an organization is personally liable for the debts of the organization, then the organization will possess limited liability, notwithstanding the members' endorsement or guarantee of the organization's liabilities. See Richlands Medical Association v. Comm'r, 60 T.C.M. 1572 (1990). On the other hand, Revenue Ruling 88-79, 1988-2 C.B. 361, confirms that where a trust is formed by contract, unlimited liability may be created contractually under the trust agreement. Cf. Zuckman v. U.S., 524 F.2d 729 (Ct. Cl. 1975) (an organization will lack continuity of life if any member has the power under local law to dissolve the organization, notwithstanding that such member contractually surrenders the right to cause the organization's dissolution); P.L.R. 9002056 (October 18, 1989), described in footnote 114, above.

29 The regulations state that personal liability exists for each general partner in a general partnership subject to a statute corresponding to the Uniform Partnership Act, and under the UPA, a general Partner is liable only for claims that arise while he is a partner. See UPA (1914) § 17 (incoming Partner not personally liable for obligations arising before admission).

arising while it is an owner, even though the agency indemnifies the certificate holders against any such liability.

Limited liability is defeated if members are personally liable for claims against an organization even if it is very unlikely that there will be any such claims.[30]

Further, there is no prohibition against having particular classes of creditors agree contractually to waive claims against members. Partnerships regularly incur nonrecourse debt without losing limited liability.

Limited liability will not exist if some (but not all) of the beneficiaries of a trust are personally liable for trust claims. It would be prudent in such a case to follow the principles that apply in determining whether personal liability exists for general partners of a limited partnership. Thus, the trust beneficiaries that are liable should have substantial assets that can be reached by partnership creditors, or should not be under the control of the other beneficiaries.[31]

(iv) Free transferability of interests. 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 other members, to substitute for themselves in the same organization a person who is not a member.[32] Such a right of substitution exists only if the transferor can confer all of the attributes of his interest in the organization on the transferee. Thus, a power to assign a right to distributions, but not a right to participate in management, is not enough to create free transferability.[33] 130 An organization

30 The regulations do not require that there be actual liabilities. A test based on the existence of actual liabilities would be very difficult to apply.

31 Treasury Regulation § 301.7701-2(d)(2) states that a limited partnership has limited liability if the general partner has no substantial assets (other than his interest in the partnership) which could be reached by a partnership creditor and it is merely a "dummy" acting as the agent of the limited partners. The regulation states that if an organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization. The Service generally will rule that a general partner meets the substantial assets test if its net worth (excluding its partnership interest) is at least 10% of the total contributions to the partner- ship (or in the case of an individual general partner, the lesser of that 10% amount or $1 million). See Revenue Procedure 89-12, 1989-1 C.B. 798, § 4.07; Revenue Procedure 92-88, 1992-2 C.B. 496, § 4.03 (adds rule for individual general partners). If a general partner does not meet the net worth test, then a favorable ruling may still be given if it can be demonstrated that the general partner will act independently of the limited partners. See G.C.M. 39798 (October 24, 1989) for a discussion of the showing that must be made.

32 Treasury Regulation § 301.7701-2(e).

33 An assignment of a right to distributions could nonetheless affect entity classification. For example, where a trust certificate provides the holder with management rights that are necessary to defeat centralized management, the separation of those rights from the right to distributions arguably could cause the certificate holder to not be "acting in [its] own interest" and thus affect whether the entity has centralized management. See footnote 121, above. More generally, consideration should be given to whether an assignment of a right to distributions affects the status of the transferor as a "member". See the text at footnote 107, above.

lacks free transferability if under local law a transfer of a member's interest results in a dissolution of the old organization and the formation of a new one.

A few comments on the free transferability test are in order. Free transferability can be defeated by limiting the transfer of enough interests so that less than "substantially all" of the interests are freely transferable. A Service ruling guideline requires, in order for an entity to lack free transferability, that the transferability of more than 20 percent of the interests be restricted.[34] An interest is not freely transferable if its transfer is conditioned on obtaining the consent of other members. Clearly, the reference to "other members" does not mean that all other members must consent. In the context of a limited partnership, a general partner, who may hold only a small interest in the partnership, is generally given the power to consent to transfers of limited partnership interests. With respect to a trust that does not allocate management rights to fewer than all beneficiaries, requiring the consent of the holders of a majority of the interests in the trust will almost certainly defeat free transferability.[35] Requiring the consent of any member or members owning a smaller, but still significant, interest should also do the job, although the authorities are not as clear on this point.[36] Where consent is required, the party giving it should have the power to withhold it for any reason (i.e., consents should not be subject to a

---

34 See Revenue Procedure 92-33, 1992-1 C.B. 782 (although what constitutes "substantially all" of the interests in an organization generally depends upon the facts and circumstances, the Service generally will rule that a partnership lacks free transferability of interests if, throughout the life of the partnership, the partnership agreement expressly restricts the transferability of partnership interests representing more than 20% of all interests in partnership capital, income and losses). See also Zuckman v. U.S., 524 F.2d 729 (Ct. Cl. 1975) (61% not substantially all); P.L.R. 7830135 (April 28, 1978) (67.76% not substantially all).

35 See Revenue Ruling 88-79, 1988-2 C.B. 361 (trust lacked free transferability where the trust had manager and nonmanager participants, the managers owned an aggregate interest of 10%, a man- ager could not transfer or assign its interest .without the consent of the other managers, and assignees of the participants could become substitute participants only with the consent of a majority of managers). Where a trust has only a single class of interests, consent by a majority of trust interests would seem to be at least as restrictive as consent by a majority of managers. See also Revenue Ruling 93-91, I.RB. 1993-41, 22 (limited liability company lacked free transferability where consent of holders of interests entitled to a majority of non-transferred profits required to effect transfer); P.L.R. 8450082 (September 13, 1984) (trust lacked free transferability of interests where admission of a new settlor or assignment of a trust interest required the consent of not less than 75% of the settlors); and P.L.R. 7830135 (April 28, 1978) (owner trust lacked free transferability of interests where consent of equity owners holding at least 60% of the aggregate interests of all equity owners was required to transfer or assign an interest in the trust).

36 By analogy to a limited partnership, it should be possible to eliminate free transferability by conditioning transfers on obtaining the consent of a designated certificate holder owning at least a 1% interest in the trust. In effect, the designated party would act as the trust manager for purposes of giving such consents. Transfers could also be conditioned on obtaining consent from any other certificate holder or holders who own some minimum interest (e.g., 5%), are not affiliated with the transferor or transferee, and are not a party to the transfer. A consent mechanism of this type would allow a transferor to "shop" to some extent for consents among certificate holders. On the other hand, if the person(s) who can give the required consent must have a meaningful interest in the trust and must be independent of the parties to the transfer, the consent requirement has some teeth. Further, stock in a corporation typically can be transferred without any consents, so that a trust subject to such a mechanism would not resemble a corporation, which should be all that is required. See footnote 122, above.

reasonableness standard).[37] Provisions allowing transfers in certain limited circumstances should be approached with caution. Depending on the circumstances, they could result in at least a modified form of free transferability.[38] The rule that distinguishes transfers of rights to receive distributions from transfers that effect a full substitution of one member for another has been applied to interests in trusts held by passive investors where the other rights of ownership seemed quite limited.[39]

(v) Entities owned by related parties. At one time, the Service took the position that an entity owned by two subsidiaries of a common parent corporation could not lack continuity of life, because the parent would be free to continue the entity following its dissolution without securing the consent of any outside interests. Further, even though each subsidiary's right to transfer its equity interest was conditioned on obtaining consent of the other subsidiary owner, the entity possessed free transferability of interests, because the parent effectively could make all transfer decisions.[40] In a 1993 ruling, the Service reversed itself on the continuity of life point and clarified its views on free transferability.[41] At least in a case where an entity dissolves automatically under local law, without any action being taken by the owners, upon the occurrence of a bankruptcy or

---

37 Cf. Larson v. Comm'r, 66 T.C. 159, 183 (1976) (limited partnership interests that could be transferred with the consent of the general partner which could not be unreasonably withheld were considered to be freely transferable where no grounds for refusing such consent were suggested).

38 For example, a member may wish to be able to transfer an interest to an affiliate without the consent of other owners. Two private letter rulings imply that such a transfer right could create free transferability. See P.L.R. 8117024 (January 27, 1981) (limited liability company lacked free transferability where one of the shareholders had the power to transfer its interest to a wholly owned affiliate without the consent of the other shareholders, because the shareholder with the power did not own substantially all of the interests in the company); P.L.R. 8012080 (December 28, 1979) (same). Where an owner anticipates that it may want to transfer a trust interest to an identified affiliate, one way to do this is to have that affiliate own some interest in the trust from the beginning. The consent requirement applies only to transfers to a nonmember. An owner's power to transfer its interest to an owner's successor in interest may not create free transferability. See P.L.R. 9210019 (December 6, 1991) (limited liability company lacked free transferability although no consent was required for transfers of interests by reason of the death, dissolution, divorce, liquidation, merger, or termination of a transferor member); but see G.C.M. 38012 (July 13, 1979) (trust possessed a modified form of free transferability because a corporate participant could transfer, without the consent of the other participants, its ownership interest in connection with a merger or consolidation with another corporation).

39 See Revenue Ruling 88-79, 1988-2 C.B. 361 (business trust lacked free transferability where all of the rights of a nonmanager participant could be freely transferred except for the right to vote on amendments to the trust agreement and the right to vote on whether to continue the trust upon the death, resignation, etc., of a manager).

40 See Revenue Ruling 77-214, 1977-1 C.B. 408; G.C.M. 37013 (February 25, 1977). See also MCA, Inc. v. U.S., 685 F.2d 1099 (9th Cir. 1982) (holding that foreign entities owned by a controlled foreign corporation (CFC) and an employee trust for the benefit of the CFC's directors lacked free transferability and continuity of life, although the same two individuals controlled the CFC' s board of directors and trust's board of trustees and they were the chief executive officers of the CFC' s two corporate shareholders); P.L.R. 9239014 (June 25, 1992) (limited partnership lacked free transferability where the two 49.5% limited partners, who were husband and wife, could not transfer their interests without the consent of the corporate general partner, all of whose outstanding stock was owned by the husband). For a discussion of entities with a single owner, see footnote 9, above, and accompanying text.

41 Revenue Ruling 93-4, l.R.B. 1993-3, 5

other event relating to an owner, the fact that a common owner can revive the entity without the consent of outside interests will no longer be considered to create continuity of life. The ruling states more broadly that "the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life." Regarding free transferability, the Service reaffirmed its earlier view that requiring consent from an affiliate was not a meaningful transfer restriction, but clarified that an interest in an entity owned by related parties will not be considered freely transferable if the entity's governing documents either prohibit transfer or provide for the dissolution of the entity upon the transfer of an interest, assuming these provisions are effective under local law.

b. Election Out of Partnership Rules. An investment trust that has a business objective, more than one owner and two or fewer corporate characteristics is classified as a partnership. There are a number of potentially significant differences between the tax treatment of trusts beneficiaries and partners. As detailed elsewhere, the holder of an interest in a grantor trust is treated as if it owned directly an interest in trust assets (with the trust being ignored). By contrast, a partnership is recognized to be an entity (and a partnership interest is treated as an interest in an entity) for various tax purposes.[42]

In a case where an investment trust will be (or at least might be) classified as a partnership and not as a trust, the parties may seek to "elect out" of the complex partnership rules of subchapter K of the Code. Section 761(a)(l) authorizes the Service to adopt regulations excluding from all or a part of subchapter K any unincorporated organization that is availed of for investment purposes only, and not for the active conduct of a business. Regulations under this section allow co-owners of investment property to make such an election, but only if, among other requirements, income of the owners may be adequately determined without computing partnership taxable income, and the owners reserve the right separately to take or dispose of their interests in the property.[43] A right to dispose of interests in property separately will not exist if there are substantial restrictions on the transfer of trust interest.[44] Whether the income of the co-owners can be adequately determined without computing partnership income is a less clear cut standard and will depend on

---

42 Some of these differences are outlined in Chapter 7, Part C, which discusses the tax treatment of equity interests in non-REMIC owner trusts.

43 Treasury Regulation § 1.761-2(a).

44 G.C.M. 37016 (February 25, 1977).

the particular terms of the investment.[45] The mechanics for making the election are spelled out in the regulations.[46]

c. Applications of Entity Classification Tests. This section discusses briefly how the entity classification tests are often applied to four types of arrangements: owner trusts that are not subject to the 1MPrules, whole loan participation arrangements, issuers of pass-through debt certificates, and outside reserve funds providing credit support for an investment trust. Combinations of classification factors differing from those described below are, of course, possible.

(i) Owner trusts that are not TMPs. As described in Chapter 2, Parts C and D, a typical owner trust issues pay-through bonds and has equity interests that can be held by a number of different owners. An owner trust that issues debt after December 31, 1991 and qualifies as a 1MP automatically will be classified as a corporation under the 1MP rules (discussed in Part D below). Thus, this discussion is relevant only for owner trusts not affected by the 1MP rules.

To protect bond holders from events affecting the equity owners, owner trusts ordinarily continue in existence notwithstanding the bankruptcy, dissolution, or withdrawal of those owners. Accordingly, owner trusts possess the corporate characteristic of continuity of life.

On the other hand, owner trusts typically lack the three remaining corporate characteristics referred to above. They lack centralized management, because the equity owners have the power

---

45 If an investment trust has a business objective because it has more than one class of ownership interests and the Sears regulations apply, the Service might be expected to argue as a general matter that the income measurement and allocation rules of subchapter K are needed to determine the income of individual investors. The preamble to the final Sears regulations (quoted above in the text following footnote 70) includes the following: "[The existence of multiple classes] introduces the potential for complex allocations of trust income among investors, with correspondingly difficult issues of how such income is to be allocated for tax purposes. These issues are properly foreign to the taxation of trust income, where rules have not developed to accommodate the varied forms of commercial investment, and no comprehensive economic substance requirement governs the allocation of income for tax purposes." An economic substance requirement does apply in making allocations of partnership income under subchapter K (section 704), and those rules would be avoided through a complete election out of subchapter K. On the other hand, at least in some cases, the income allocation issues raised by the existence of multiple classes seem to be fairly straightforward. For example, if the event that may cause a shift in the interests of investors is unlikely to happen (as is true in the example discussed above in Part C.l.f.(ii) involving a reallocation of payments on a bond following a default), the potential shift probably could be ignored unless and until it occurs, at which point income would be based on the allocation of cash. Also, a number of trusts have been formed (particularly in the municipal bond area) that hold a class of fixed rate bonds purchased at par and issue at par two classes of certificates that are entitled to a fixed percentage of the principal payments on the bonds and variable portions of the interest on the bonds, determined under a formula. The trusts are expected to be taxed as partnerships and often provide for an election under section 761. In this setting, a number of tax practitioners have taken the position that the election is available because the interest received by the trust can be allocated based on what each class is entitled to receive.

46 See Treasury Regulation § 1.761-2(b). The election can be made by including a statement in the trust documents expressing the intent not to be subject to subchapter K without making any filing with the Service.

to direct or veto the actions of the owner trustee.[47] In addition, they lack limited liability, because the equity owners are personally liable for claims against the owner trust, other than the obligation to make payments on the pay-through bonds. Finally, interests in the trust are not freely transferable, because the ability of an equity owner to substitute a new owner in its place is subject to the consent of at least one other unrelated equity owner owning a minimum percentage interest in the trust, which may be withheld for any reason.

Under most owner trust agreements, all equity owners are treated the same. However, it would be possible under the regulations to exclude some equity owners from management, to limit the liability of some equity owners, and to permit some equity owners to freely transfer their interests without affecting the classification of the owner trust, provided, in general, that the equity owners that remain liable have at least a 1 percent interest in the trust and that the equity owners who do not participate in management, and those entitled to freely transfer their interests, own less than "substantially all" (generally 80 percent) of the equity interests.

(ii) Whole loan participations. It is not uncommon for the legal owner of mortgages to grant some interest in the mortgages to another person under a participation agreement or some other form of contract that does not create a state law trust. The contract typically lasts over the entire life of the mortgages. The legal owner generally would retain a substantial beneficial interest in the mortgages. Although a participation arrangement would not ordinarily provide any power to vary the investment of the participants, a business objective could be considered to exist under the Sears regulations because of the creation of diverse ownership interests that do not fall within the "incidental" exception.

While the particular terms of a participation arrangement must be examined in each case, a participation arrangement would normally be classified as a partnership if a business objective is present, because it would lack centralized management and limited Either the legal owner would be the principal beneficial owner of the mortgages and would have all rights to manage them (directly or through agents), or all participants would share in management. In addition, if the participation arrangement is not a state law trust, there would be no basis for limiting the liability of the participants (or at least of the legal owner of the mortgages) to third parties for claims arising out of the arrangement. If in a particular case the participants wanted to have additional protection against the possible existence of an association, the participation agreement could be written so that it would terminate upon the bankruptcy of the legal owner, or the assignment of participation interests could be restricted.

(iii) Issuers of pass-through debt certificates. As described in Chapter 2, Part G, issuers of pass-through debt certificates take the position that the certificates are debt for federal income

---

47 Where the assets of the owner trust are all pledged to the indenture trustee for the bonds, certain rights to manage the assets of the owner trust may be exercisable by the indenture trustee or a third party acting on its behalf. It is uncertain whether rights to control assets that are incidental to a pledge of assets would be taken into account in determining whether the owner trust has centralized management. The fact that the indenture trustee is representing the bond holders and not the trust beneficiaries suggests that it should not be treated as a manager of the owner trust. In any event, the powers granted to the indenture trustee would typically be ministerial in the absence of a default. See footnote 122, above and accompanying text. Also, the indenture trustee would not generally have the "exclusive" power to manage the owner trust. For example, it would not have the power to exercise any rights to call bonds.

tax purposes. If the certificates are characterized as debt, they should be treated as limited recourse obligations of the sponsor, and the ng trust should be viewed simply as a device to hold collateral for the debt, not as a separate entity for tax purposes.[48] However, because of the form of the certificates, it may not always be possible to conclude with certainty that the debt characterization of the certificates will be upheld. If the certificates were treated as ownership interests rather than as debt, the trust would be recognized to be an entity for tax purposes and would almost certainly be considered to have a business objective under the Sears regulations. Thus, as a precaution, in transactions where there is uncertainty as to the status of the certificates, the trust would have features ensuring its classification as a partnership if the debt argument were to fail.[49]

If the pass-through debt certificates were treated as ownership interests, the trust would resemble a limited partnership, with the sponsor being the general partner and the certificate holders the limited partners. Centralized management ordinarily does not exist in a limited partnership (and thus by analogy would not exist in the trust for any period in which the sponsor manages the trust) if the general partner (sponsor) has a greater than 20 percent interest in the partnership (trust).[50] On the other hand, centralized management may exist for any period in which a third party who does not own any interest in the trust assumes management responsibilities (such as following a default by the sponsor in carrying out those responsibilities).

The corporate characteristic of free transferability of interests exists only if members owning "substantially all" of the interests in an organization can freely transfer those interests. Thus, the trust would lack this characteristic if the sponsor owns an interest in the trust greater than 20 percent and is prohibited from assigning that interest (whether or not the sponsor is also managing the trust). An organization lacks limited liability if any member has personal liability for claims against the organization. Thus, limited liability would be defeated if the sponsor has such personal liability.[51] Finally, the trust may or may not lack continuity of life. If the trust agreement provides that upon a bankruptcy of the sponsor, there is an "event of acceleration" that does not result in a prompt sale of trust assets but nonetheless shortens the life of the trust, then it may be possible to conclude that the trust lacks continuity of life. Greater certainty would be gained if a bankruptcy of the sponsor triggered an obligation to sell trust assets as soon as is commercially reasonable. If such a term were included in a trust, perhaps the risk of an early

---

48 For authorities treating trusts as mere security devices, see footnote 69, above.

49 In cases where the certificates are divided into classes, concern over possible equity treatment may be confined to certain classes. For example, if there are senior and junior classes of certificates, the risk of equity treatment may exist primarily for the junior classes. In that event, the references to certificate holders below in the text should be read to mean holders of classes of certificates for which equity treatment is considered to be a material risk.

50 The sponsor's interest in the trust would generally be a residual interest, whereas the certificate holders would receive a fixed return or a variable return based on an interest rate index. Under these circumstances, it may not be an easy task to determine whether the sponsor's interest exceeds 20%.

51 The statement in the text assumes that the sponsor has a sufficient interest in the trust to be recognized to be a member and that the sponsor either has substantial assets or is not a "dummy" of the certificate holders. The sponsor would not need to be liable for the claims of other certificate holders against the trust.

collapse would be mitigated by having the sponsor hold its interest through a bankruptcy-remote entity.

(iv) Outside reserve funds. An investment trust may benefit from credit support is in the form of a guarantee payable out of monies in a reserve fund held outside of the trust.[52] The fund may be owned by the trust sponsor, its successor, or a third party. The owner typically has the right to direct the investment of the reserve (which is limited to high-quality debt instruments), receives any monies released unused from the reserve, and is required to pay certain related expenses. Such reserve funds are often found in trusts having senior and subordinated interests, and in that case may be funded through a combination of initial contributions and distributions received on the subordinated interests. The subordinated interests may be transferable together with the rights and obligations of the reserve fund.

An outside reserve fund can be viewed most simply as an asset of the owner that is pledged to secure a nonrecourse guarantee. Under that view, the owner would be treated for tax purposes as earning all income on the fund, and as receiving and paying amounts paid into and out of the fund. The pledge would not create a separate entity for tax purposes, and no classification issues would arise. This analysis is compelling in most cases, particularly where the owner of the reserve owns no interest in the related trust, the reserve is not transferable, and the owner can at its option replace the reserve with other forms of credit support such as a letter of credit. On the other hand, if a reserve fund is to be funded out of distributions on a class of trust interests and must be transferred to any successor holder of that interest, then a question could arise as to whether the fund is truly outside of the trust or alternatively whether the arrangements establishing the reserve could be viewed as a separate investment trust.

Barring unusual circumstances, there is little reason to think that an outside reserve would be folded into the related trust. The rights of the reserve fund owner and of the investors are quite distinct. The fund owner holds liquid assets which are exposed to the risk of credit losses, and the investors hold an interest in the guaranteed assets. Moreover, from a tax policy perspective, as long as the documents are clear in spelling out ownership of the fund and the existence of the guarantee, and the parties report the transaction accordingly, it is difficult to imagine a reason for challenging the arrangement. The treatment of outside reserves in the REMIC regulations supports the view that the taxpayer's form will not be upset.[53]

Where there is a concern that a reserve fund arrangement might be evaluated as a separate entity, classification as an association generally can be avoided by ensuring that the arrangement lacks centralized management and limited liability.

---

52 For a discussion of trust classification issues raised by an inside reserve, see Part C.1.c.(vii) and footnote 84, above. See also Chapter 4, Parts A.2.b.(ii) and C.7.b, discussing inside and outside reserve funds for REMICs.

53 See Chapter 4, Part C.7.b. A recent ruling assumes that a trust with an outside reserve fund can be classified as a trust, but the effect of the reserve is not at issue in the ruling. See P.L.R. 9202011 (October 8, 1991).