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## Associations Classified As Corporations Under the Internal Revenue Code

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THE United States Internal Revenue Code provides that "the term 'corporation' includes associations, joint-stock companies, and insurance companies."<sup>1</sup> By this simple process of extending the definition of "corporation", the Code attaches to unincorporated "associations" the same tax consequences that it attaches to incorporated entities.<sup>2</sup> These consequences are often of vital importance.<sup>3</sup> Many tax saving plans have failed and many unincorporated enterprises have received unexpected tax assessments because the taxpayer and his advisers either overlooked the question, or guessed wrong, in regard to the scope of the word "corporation" as defined in the Internal Revenue Code.

This intention to tax "associations" in the same manner as corporations has been expressed in one form or another in every revenue

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<sup>1</sup> I. R. C. § 3797(a) (3). This subsection was taken from the Revenue Act of 1938, § 901(a) (2), 52 STAT. 447, 583, and it has remained unchanged since the adoption of the Internal Revenue Code, February 10, 1939, 53 STAT. Part I. It is limited by section 169(b) concerning common trust funds maintained by banks. See Dean, *Federal Taxation of Trusts as Associations* (1940) 14 TEMPLE L. Q. 333, 340-1.

Although it is beyond the scope of this article, it should be observed that unincorporated associations have also been classified as corporations for various purposes not related to federal taxation. Some interesting examples are *Liverpool Ins. Co. v. Massachusetts* (1870) 77 U. S. (10 Wall.) 566; *Hemphill v. Orloff* (1928) 277 U. S. 537; *Reilly v. Clyne* (1925) 27 Ariz. 432, 234 Pac. 35; *Lumber Co. v. State Charter Board* (1920) 107 Kan. 153, 190 Pac. 601.

<sup>2</sup> "The definition given to the term 'corporation' . . . applies to the entire Act." *Burk-Waggoner Ass'n v. Hopkins* (1925) 269 U. S. 110, 113; *Tyrrell v. Comm'r* (C. C. A. 5th, 1937) 91 F. (2d) 500, 501, *cert. den.*, (1937) 302 U. S. 747.

<sup>3</sup> See 7A MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1943) § 43.02; Hillix, *Trusts Constituting Associations Taxable as Corporations* (1936) 5 KAN. CITY L. REV. 27, 28; Note (1944) 92 U. OF PA. L. REV. 296.

act since 1913, and in the Corporation Tax Law of 1909, and even in the ill-fated income tax law of 1894.<sup>4</sup> But nowhere in any of the revenue acts has Congress undertaken to define "associations". During all these years Congress has been content to let the courts, the Commissioner of Internal Revenue and the taxpayers try to figure out for themselves just what it is that constitutes an "association" taxable as a corporation.

Since the term "association" is "a word of vague meaning",<sup>5</sup> it is not surprising to find that the courts, the Commissioner and the taxpayers have experienced considerable difficulty in trying to determine precisely what factual ingredients are necessary to make an "association" within the meaning of the revenue acts. Harrassed district courts have referred to the matter as a "troublesome subject"<sup>6</sup> and a "vexed question";<sup>7</sup> and in an article published in October, 1935, one of the lawyers of the Bureau of Internal Revenue expressed the unofficial opinion that the decisions "determining what constitutes an 'association' within the meaning of the statute, bewilder rather than enlighten."<sup>8</sup>

On December 16, 1935, the Supreme Court filed four opinions<sup>9</sup> which undertake a searching analysis of the subject. These four cases have greatly clarified the problem,<sup>10</sup> but we are warned by the Su-

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<sup>4</sup> § 32, 28 STAT. (1894) 556 [held unconstitutional in *Pollock v. Farmers' Loan & Trust Co.* (1895) 158 U.S. 601]; Corporation Tax Law of 1909, § 38, 36 STAT. 112; Income Tax Act of 1913, § II, G(a), 38 STAT. 172; War Tax Law of 1914, schedule A, 38 STAT. 759; Revenue Act of 1916, §§ 10, 407, 39 STAT. 765, 789; Revenue Act of 1917, § 203, 39 STAT. 1000; Revenue Act of 1918, § 1, 40 STAT. (1919) 1057. The language in the latter Act was included in the following revenue acts: 1921 Act § 2(2), 42 STAT. 227; 1924 Act § 2(a)(2), 43 STAT. 253; 1926 Act § 2(a)(2), 44 STAT. 9; 1928 Act § 701(a)(2), 45 STAT. 878; 1932 Act § 1111(a)(2), 47 STAT. 289; 1934 Act § 801(a)(2), 48 STAT. 771; 1935 Act § 501(a)(2), 49 STAT. 1027; 1936 Act § 1001(a)(2), 49 STAT. 1756; 1938 Act § 901(a)(2), 52 STAT. 583.

<sup>5</sup> *People v. Brander* (1910) 244 Ill. 26, 31, 91 N.E. 59, 60; *Van Pelt v. Hilliard* (1918) 75 Fla. 792, 800, 78 So. 693, 695.

<sup>6</sup> *Burk-Waggoner Ass'n v. Hopkins* (N. D. Tex. 1924) 296 Fed. 492, 498, *aff'd*, (1925) 269 U.S. 110.

<sup>7</sup> *Page v. McLaughlin* (E. D. Pa. 1933) 7 F. Supp. 75, 77.

<sup>8</sup> Flagg, *Associations Taxable as Corporations* (1935) 13 TAX MAG. 589. Earlier in 1935 the first circuit court of appeals declared that "the decisions are seemingly in a hopeless state of confusion." *Coleman-Gilbert v. Comm'r* (C. C. A. 1st, 1935) 76 F. (2d) 191, 193, *rev'd*, (1935) 296 U.S. 369.

<sup>9</sup> *Morrissey v. Comm'r* (1935) 296 U.S. 344; *Swanson v. Comm'r* (1935) 296 U.S. 362; *Helvering v. Combs* (1935) 296 U.S. 365; *Helvering v. Coleman-Gilbert* (1935) 296 U.S. 369.

<sup>10</sup> For a review of some of the more important decisions prior to 1935, see Note (1944) 92 U. OF PA. L. REV. 296. The 1935 decisions of the Supreme Court cited *supra*

preme Court in one of them, the leading case of *Morrissey v. Commissioner*,<sup>11</sup> that "it is impossible in the nature of things to translate the statutory concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create."<sup>12</sup> This observation has been echoed and embellished in the circuits, where we are told repeatedly that each case must be decided upon its own particular facts without reference to any fixed formula.<sup>13</sup>

The refusal of the courts to establish a definite formula for an "association" may serve some useful purpose, but neither the taxpayer nor the Commissioner can be entirely happy with a situation where so much seems to depend upon the unpredictable personal reaction of a particular court to a particular set of facts. Judge James M. Morton, Jr., struck a responsive chord in many hearts when he said:

"In matters of this sort the important thing is that the law shall be clear and definite, easy to be understood and applied by business men. Tests involving great subtlety and refinement of analysis are to be avoided if possible."<sup>14</sup>

Ten years have elapsed since the decision of the *Morrissey* case. How does the law stand today? Has the "process of repeated adjudications"<sup>15</sup> drawn the line more clearly? Is it now possible "to trans-

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note 9 are of such basic importance that prior cases on this subject are of limited value today. No reliance should be placed upon earlier authorities unless they are found to be wholly consistent with the letter and spirit of the 1935 decisions of the Court. But *cf.* Dean, *op. cit. supra* note 1, at 348: "The decisions of the United States Supreme Court in *Morrissey v. Commissioner* and its three companion cases are probably greatly overrated from the standpoint of the new law which they are generally considered to have made."

<sup>11</sup> *Supra* note 9.

<sup>12</sup> 296 U. S. at 356.

<sup>13</sup> *Myers v. Comm'r* (C. C. A. 7th, 1937) 89 F. (2d) 86, 90; *Thrash Lease Trust v. Comm'r* (C. C. A. 9th, 1938) 99 F. (2d) 925, 928, *cert. den.*, (1939) 306 U. S. 654; *Comm'r v. Horseshoe L. Syndicate* (C. C. A. 5th, 1940) 110 F. (2d) 748, 749, *cert. den.*, (1940) 311 U. S. 666; *Comm'r v. Gibbs-Preyer Trusts* (C. C. A. 6th, 1941) 117 F. (2d) 619, 623; *Keating-Snyder Trust v. Comm'r* (C. C. A. 5th, 1942) 126 F. (2d) 860, 862.

<sup>14</sup> *Gardiner v. United States* (D. C. Mass. 1930) 43 F. (2d) 450, 451, *rev'd*, (C. C. A. 1st, 1931) 49 F. (2d) 992, 994. *Cf.* *Huron River Syndicate v. Comm'r* (1941) 44 B. T. A. 859, 863, where the Board found it necessary to make a rather subtle distinction between equitable title to property as compared with a mere right to income from property, in order to reconcile prior decisions concerning associations.

<sup>15</sup> This phrase is borrowed from Mr. Justice Reed who said in respect to another branch of the law of federal taxation: "In the absence of a legislative rule, we have left to the process of repeated adjudications" the drawing of a distinguishing line marking off the different classes of factual situations. *Helvering v. Stuart* (1942) 317 U. S. 154, 167.

late the statutory concept of 'association' into a particularity of detail" which is sufficient for the legitimate needs of both the Commissioner and the taxpayer? Are our remaining difficulties inherent "in the nature of things", or are they attributable to more accessible causes? These are the questions that have stimulated the preparation of this article.

#### PRELIMINARY OBSERVATIONS

Under the statutes of 1909 and 1916,<sup>16</sup> corporation excise taxes were imposed upon both corporations and unincorporated associations, but the only associations subject to these taxes were those that enjoyed some special statutory privilege.<sup>17</sup> But the corporation income taxes of both 1913 and 1916, the stamp tax of 1914, and all internal revenue taxes on corporations since 1918<sup>18</sup> were extended to include "associations as they may exist at common law."<sup>19</sup>

*Crocker v. Malley*,<sup>20</sup> decided by the Supreme Court in 1919, was generally assumed to establish the principle that a trust could not be classed as an "association" unless the beneficiaries had some degree of control over the management of the enterprise. The Court implied that such a rule would be consistent with the leading case on the nature of "Massachusetts trusts".<sup>21</sup> However, it was soon discovered that the matter was not as simple as that, and in *Hecht v. Malley*,<sup>22</sup> decided five years later, the Court explained the *Crocker* case at great length and declared:

"We do not believe that it was intended that organizations of this character . . . should be exempt from the excise tax . . . merely because such a slight measure of control may be vested in the bene-

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<sup>16</sup> *Supra* note 4.

<sup>17</sup> *Eliot v. Freeman* (1911) 220 U.S. 178; *Hecht v. Malley* (1924) 265 U.S. 144. In *Roberts v. Anderson* (C. C. A. 2d, 1915) 226 Fed. 7, it was held that the statutory-privilege test under the Corporation Tax Law of 1909 was satisfied by a statute which permitted an association to sue and be sued in the name of a designated officer of the organization.

<sup>18</sup> *Supra* note 4.

<sup>19</sup> *Hecht v. Malley*, *supra* note 17; *Morrissey v. Comm'r*, *supra* note 9; *Malley v. Bowditch* (C. C. A. 1st, 1919) 259 Fed. 809.

<sup>20</sup> (1919) 249 U.S. 223.

<sup>21</sup> *Williams v. Milton* (1913) 215 Mass. 1, 102 N.E. 355. In the *Crocker* case the Supreme Court made no mention of the fact that in the *Williams* case the court was distinguishing between a trust and a partnership—not a trust and an association or a corporation. See *infra* note 88.

<sup>22</sup> *Supra* note 17.

ficiaries that they might be deemed strict trusts within the rule established by the Massachusetts courts."<sup>23</sup>

This conclusion was reaffirmed by the Court in the *Morrissey* case. Although the facts in this respect are frequently recited, the appellate court decisions subsequent to *Hecht v. Malley* do not appear to give any controlling weight to the question of whether or not the beneficial owners of the enterprise have any degree of control over its management or any right to select or remove the managers.<sup>24</sup>

In *Burk-Waggoner Oil Association v. Hopkins*<sup>25</sup> the taxpayer argued that it was a violation of the Constitution to tax a Texas unincorporated joint-stock company as if it were a corporation. The Court brushed aside all constitutional objections in the following far-reaching language:

"It is true that Congress cannot convert into a corporation an organization which by the law of its State is deemed to be a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated. The power of Congress so to tax associations is not affected by the fact that, under the law of a particular State, the association cannot hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed."<sup>26</sup>

Thus, in determining the scope of the word "association", no question of congressional power is involved. The problem is "simply one

<sup>23</sup> 265 U.S. at 161. In *E. A. Landreth Co. v. Comm'r* (1928) 11 B. T. A. 1, 22, this rule is said to be justified by the fact that "stockholders can by contract deprive themselves of the right to vote the stock and thereby remove from themselves the right to control a corporation."

<sup>24</sup> See, e.g., *White v. Hornblower* (C. C. A. 1st, 1928) 27 F. (2d) 777, 778; *Little Four Oil & Gas Co. v. Lewellyn* (C. C. A. 3d, 1929) 35 F. (2d) 149, 150, *cert. den.*, (1930) 280 U.S. 613; *Willis v. Comm'r* (C. C. A. 9th, 1932) 58 F. (2d) 121, 122; *Comm'r v. Vandegrift R. & Inv. Co.* (C. C. A. 9th, 1936) 82 F. (2d) 387, 390; *Bert v. Helvering* (App. D. C. 1937) 92 F. (2d) 491, 494; *Marshall's Heirs v. Comm'r* (C. C. A. 3d, 1940) 111 F. (2d) 935, 938, *cert. den.*, (1940) 311 U.S. 658; *Fidelity-Bankers Trust Co. v. Helvering* (App. D. C. 1940) 113 F. (2d) 14, 17, *cert. den.*, (1940) 310 U.S. 649. But *cf.* *Comm'r v. Kelley* (C. C. A. 1st, 1934) 74 F. (2d) 71, 74; *N. B. Whitcomb Coca-Cola Syndicate v. Comm'r* (1937) 35 B. T. A. 1031, 1035, *aff'd*, (C. C. A. 5th, 1938) 95 F. (2d) 596; *Comm'r v. United States & Foreign S. Corp.* (C. C. A. 3d, 1945) 148 F. (2d) 743, 745.

<sup>25</sup> (1925) 269 U.S. 110.

<sup>26</sup> *Ibid.* at 114.

of statutory construction."<sup>27</sup> What has Congress meant during all these years when it has repeatedly used the word "association" in the various revenue acts?

The delicacy of this job of statutory construction is at once apparent from a mere examination of the Internal Revenue Code itself. The Code defines "corporation" to include not only "associations" but also "joint-stock companies",<sup>28</sup> thereby implying that an "association" is something other than a joint-stock company.<sup>29</sup> The Code treats trusts<sup>30</sup> and partnerships<sup>31</sup> differently from the way it treats corporations,<sup>32</sup> thereby implying that an "association" is something different from a trust and a partnership within the meaning of the Code.<sup>33</sup> Further, although the Code does not define either "association" or "trust", it does define "partnership"—and it declares that "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, . . . which is not, within the meaning of this title, a trust or estate or a corporation . . ."<sup>34</sup>

Therefore, as a matter of rational statutory construction the concept of "association" must be broad enough to include more than a joint-stock company, but on the other hand it must be sufficiently limited to leave room for certain kinds of trusts, partnerships, syndicates, groups, pools, joint ventures and other unincorporated organizations which must be classified as trusts or partnerships under the pertinent provisions of the Code. The distinguishing lines have been (and are being) worked out very largely by the "process of repeated adjudications"; and even at the present time it is no great overstatement to say that almost any sort of arrangement may be

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<sup>27</sup> *Morrissey v. Comm'r*, *supra* note 9, at 356.

<sup>28</sup> *Supra* note 1. The Corporation Tax Law of 1909, the Income Tax Act of 1913 and the Revenue Acts of 1916 and 1917 (with minor variations) all referred to "every corporation, joint-stock company or association, and every insurance company", as if "association" and "joint-stock company" might possibly be two different names for the same thing. [See argument for petitioner in *Crocker v. Malley* (1919) 249 U.S. 223, 227.] But ever since the Revenue Act of 1918 the statutory definition has been: "The term 'corporation' includes associations, joint-stock companies, and insurance companies."

<sup>29</sup> *Morrissey v. Comm'r*, *supra* note 9, at 358.

<sup>30</sup> I. R. C. §§ 161, 162.

<sup>31</sup> *Ibid.* § 181.

<sup>32</sup> *Ibid.* § 13.

<sup>33</sup> *Cf.* *Comm'r v. Brouillard* (C. C. A. 10th, 1934) 70 F. (2d) 154, 158-9, *cert. den.*, (1934) 293 U.S. 574; *Cleveland Trust Co. v. Comm'r* (C. C. A. 6th, 1940) 115 F. (2d) 481, 483, *cert. den.*, (1941) 312 U.S. 704; *Comm'r v. Gibbs-Preyer Trusts*, *supra* note 13, at 623.

<sup>34</sup> I. R. C. § 3797(a)(2).

classified under the federal tax laws as either a corporation, a trust or a partnership, depending upon the judgment of the particular court as to which type of organization it resembles most in terms of operating effectiveness, without giving much weight to formal technicalities.<sup>35</sup>

There is one primary consideration that we must keep in view throughout this discussion. It is clear that Congress has had one basic reason for classifying "associations" as corporations. It has been the purpose of Congress to tax as a corporation all associations which are organized in a form which provides substantially the same business effectiveness as the corporate form of organization. A business organization which achieves most of the typical advantages of incorporation should be taxed as a corporation, regardless of technical names and formal distinctions. Enterprises of the same essential character should be placed in the same category under the tax laws, without regard to the formal technicality of incorporation.<sup>36</sup>

#### IMPORTANCE OF UNUSED POWERS PROVIDED FOR IN GOVERNING INSTRUMENT

Before undertaking a detailed discussion of associations it is necessary to direct attention to the question of the relative importance of the provisions in the written instrument governing the enterprise, as compared with what the parties have actually done.

Prior to the *Morrissey* case it was generally held that what the parties actually did was controlling, regardless of provisions in the governing instrument which were either never fulfilled or had been long unused.<sup>37</sup> But in the *Morrissey* case the Supreme Court declared that the character of the trust under consideration "was determined by the terms of the trust instrument."<sup>38</sup> In *Helvering v. Coleman-Gilbert Associates*<sup>39</sup> the Court enlarged upon this point by saying,

<sup>35</sup> Cf. U. S. Treas. Reg. 111, § 29.3797-1.

<sup>36</sup> *Burk-Waggoner Ass'n v. Hopkins*, *supra* note 2, at 114: "Because of this resemblance in form and effectiveness, these business organizations are subjected by the Act to these taxes as corporations." Cf. *Helvering v. Combs* (1935) 296 U.S. 365, 368-9; *Helvering v. Coleman-Gilbert*, *supra* note 9, at 373; *Solomon v. Comm'r* (C. C. A. 5th, 1937) 89 F. (2d) 569, 571, *cert. den.*, (1937) 302 U.S. 692; *Fidelity-Bankers Trust Co. v. Helvering*, *supra* note 24; *Malley v. Howard* (C. C. A. 1st, 1922) 281 Fed. 363, 372-3, *aff'd and rev'd*, *Hecht v. Malley*, *supra* note 17.

<sup>37</sup> *Lucas v. Extension Oil Co.* (C. C. A. 5th, 1931) 47 F. (2d) 65; *Tyson v. Comm'r* (C. C. A. 7th, 1931) 54 F. (2d) 29; *Dunbar v. Comm'r* (C. C. A. 1st, 1933) 65 F. (2d) 447; *Comm'r v. Brouillard*, *supra* note 33.

<sup>38</sup> 296 U.S. at 361.

<sup>39</sup> *Supra* note 9, at 374.

"The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted."

In the light of this clear pronouncement by the Supreme Court in 1935 it is rather alarming to find that in 1941 the circuit court of appeals in the sixth circuit reaffirmed its allegiance to the discredited point of view that "The crucial test in determining whether a trust is an association, taxable as a corporation, must be found in what the trustees actually do and not in the existence of long unused powers."<sup>40</sup> Which is the better rule—the one formerly followed in the circuits that what the parties actually do is controlling, or the declaration in the *Morrissey* case that the character of the organization is determined by the terms of the governing instrument?

Appealing reasons were presented in support of the earlier rule. In *Tyson v. Commissioner*<sup>41</sup> the court observed that "the articles of agreement which brought the Zenith Real Estate Trust into existence suggest that the counsel drawing the articles entertained for it somewhat pretentious hopes for its future enlargement"; and the court refused to give any weight to the broad business powers expressed in the instrument, which it attributed to "the caution of counsel to take care of the unforeseen and unforeseeable", as against the testimony of the parties that they had no actual intention to create a business trust or ever to embark the trust on a business career. In *Lucas v. Extension Oil Co.*<sup>42</sup> the court believed that to give full weight to expressed powers and purposes that were never fulfilled "would be a surrender to formalism" and would make "fiction" controlling.

It cannot be denied that these decisions tend to invoke an initial sympathy in the mind of the lawyer who wants his law to be realistic. But on further consideration it is seen that—in respect to this particular subject—form is reality. The tax on corporations is a tax on a particular type of organization, not a tax on certain actual activities.<sup>43</sup> Thus it is that the substantial and effective form of the organization is the real substance of the matter, and the conclusion reached on this point in the *Morrissey* case is perfectly sound.

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<sup>40</sup> *Comm'r v. Gibbs-Preyer Trusts*, *supra* note 13, at 622-3.

<sup>41</sup> *Supra* note 37, at 31.

<sup>42</sup> *Supra* note 37, at 66.

<sup>43</sup> Some excises imposed on corporations are a tax on a particular type of organization conducting certain actual activities, but the type of organization is not determined by the activity.



If the parties select a form of organization which makes available most of the typical advantages of a corporation, they should expect to find that form burdened with the tax consequences of a corporation—whether or not they ever have occasion to use all the conveniences provided by their chosen instrumentality. The matter is made perfectly plain if, for illustration, we apply the rule to the attribute of limitation of personal liability. If it is ascertained that a trust or a limited partnership effectively limits the liability of the participants in the venture, obviously that fixes the character of the organization so far as this particular item is concerned. No one would think of pursuing the inquiry further to see whether or not the enterprise had ever fallen into financial difficulties so that the parties had the occasion to reap the benefit of this attribute of their chosen form of organization.

The treasury department has construed the Supreme Court's decisions to mean that "The purpose will not be considered narrower than that which is formally set forth in the instrument under which the activities of the trust are conducted",<sup>44</sup> thus leaving the Commissioner and the courts free to test, interpret and expand, the purposes stated in the instrument by reference to the actual conduct of the parties; and this is the rule that has been generally followed since the decision in the *Morrissey* case.<sup>45</sup> The application and effect of this principle will be considered at appropriate points throughout this article.<sup>46</sup>

#### TESTS ESTABLISHED BY MORRISSEY V. COMMISSIONER

*Morrissey v. Commissioner*<sup>47</sup> establishes three basic tests for determining whether or not any unincorporated organization should be classified as an association taxable as a corporation. For convenience, these basic ingredients of an association may be designated as follows:

- I. Associates in a joint enterprise.
- II. Business purpose.
- III. Substantial resemblance to a corporation.

The *Morrissey* case also gives us five subsidiary tests for determining whether or not a particular enterprise complies with the third

<sup>44</sup> U. S. Treas. Reg. 111, § 29.3797-3.

<sup>45</sup> See Note (1943) 144 A. L. R. 1050, 1057.

<sup>46</sup> E.g., *infra* pp. 494-496.

<sup>47</sup> *Supra* note 9.

basic test of substantial resemblance to a corporation.<sup>48</sup> These subsidiary tests may be designated as follows:

- (a) Title vested in a single entity.
- (b) Centralized management.
- (c) Continuity.
- (d) Transferability of beneficial interests.
- (e) Limitation of personal liability.

These three basic tests and five subsidiary tests have generally fixed the pattern of discussion in all the opinions on this subject since 1935. The principal difficulty has been that under varying factual situations there are many different degrees of compliance or non-compliance with each of these tests. Also, there has been some uncertainty as to how many of these various elements are required in any particular case to constitute an association taxable as a corporation.

In the attempt to analyze these separate tests in separate detail it is soon discovered that some of them are so closely related to others that the courts frequently merge one test imperceptibly into another in the discussion of either abstract principles or particular facts. There are good and understandable reasons for this practice, but it tends to frustrate the exact analysis of the characteristics of an association. The only feasible way "to translate the statutory concept of 'association' into a particularity of detail" is first, to learn to define and recognize the various relevant ingredients, and only then to approach the problem of the combination and relationship of ingredients that are necessary to constitute an association.

Therefore, we shall first examine each of the *Morrissey* case tests in detail. After this is completed it will be in order to explore the various combinations of factual ingredients which cause an unincorporated organization to be classified as a corporation under the federal tax laws.

#### THE FIRST BASIC TEST:

##### ASSOCIATES IN A JOINT ENTERPRISE

The principal parts of the discussion of "associates" in the *Morrissey* case are quoted below:

" 'Association' implies associates. It implies the entering into a joint enterprise . . . . Undoubtedly the terms of an association may make the taking or acquiring of shares or interests sufficient to constitute

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<sup>48</sup> In its description of the salient features of a corporation the *Morrissey* case builds squarely on the foundation laid in *Flint v. Stone Tracy Co.* (1911) 220 U. S. 107, 162, which was decided under the Corporation Tax Law of 1909.

participation, and may leave the management, or even control of the enterprise, to designated persons . . . . Thus a trust may be created as a convenient method by which persons become associated for . . . commerce, or other sorts of business; where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.<sup>49</sup>

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"Applying these principles to the instant case, we are of the opinion that the trust constituted an association . . . . Thus those who took beneficial interests became shareholders in the common undertaking . . . ."<sup>50</sup>

*Associates are persons who have a beneficial interest in the profits of a joint enterprise.*

It is at once apparent from the foregoing quotation that the corporate analogy of "associates" has reference to the stockholders of a corporation. "Associates" are persons who are beneficially interested in a joint enterprise.<sup>51</sup> One beneficiary and several trustees, or one principal and several agents, cannot be "associates" within the meaning of the *Morrissey* case. The enterprise must have (or contemplate) more than one person beneficially interested in the distributable profits, or it cannot be an "association".

This principal is inherent in the language of the *Morrissey* case. It is also established by the opinion of the Supreme Court in *Lewis & Co. v. Commissioner*<sup>52</sup> which involved three separate parties: one beneficial owner of a tract of land, one trustee, and one exclusive selling agent. All three were interested (in their separate capacities) in the single enterprise of subdividing and selling a tract of land, but there was only one beneficial owner of the enterprise.<sup>53</sup> Upon this

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<sup>49</sup> 296 U.S. at 356.

<sup>50</sup> 296 U.S. at 360.

<sup>51</sup> In the earlier case of *Hecht v. Malley*, *supra* note 17, at 161, it was implied that the several trustees of a single trust might constitute the associates in an association. Cf. *Brooklyn Trust Co. v. Comm'r* (C. C.A. 2d, 1936) 80 F. (2d) 865, 868, *cert. den.*, (1936) 298 U.S. 659, where the court said: "The fact that there is but one trustee does not preclude the finding that an association exists between the investors and their trustee or among the investors alone."

<sup>52</sup> (1937) 301 U.S. 385. See also *Pacific Nat. Co. v. Welch* (C. C.A. 9th, 1937) 91 F. (2d) 590, *aff'd* on other issues (1938) 304 U.S. 191.

<sup>53</sup> It may be said that the exclusive selling agent was the beneficial owner of a separate enterprise of his own, *i.e.*, the operation of a real estate sales agency business. But his mere percentage interest in the gross sales prices, by way of commission for his services, did not give him a beneficial interest as an "associate" with the owner of the land that was put up for sale.

state of facts the Supreme Court concluded that "there are no associates",<sup>54</sup> and judgment was rendered for the taxpayer.

Nevertheless, in *Lombard Trustees v. Commissioner*<sup>55</sup> a trust was held to be taxable as a corporation during the whole year of 1937 although there was only one beneficiary of the trust during the first two and one-half months of that year. It is unfortunate that the opinion in the *Lombard* case makes no reference whatever to the *Lewis* case. The court merely bases its decision upon the observation that a corporation is none the less a corporation although it has only one stockholder, and therefore no significance should be attached to the fact that the trust had only one beneficiary for a part of the year in question.<sup>56</sup>

Although the Court makes no particular mention of the point, it may be said that in the *Lewis* case there was apparently no actual plan or purpose ever to associate any additional beneficial owners. On the other hand, in the *Lombard* case several beneficial owners actually were associated in the enterprise both before and after the short period when there was only one beneficiary, and this circumstance demonstrated a genuine and continuing purpose in this respect. This seems to supply a factual distinction which may be considered adequate to reconcile the two decisions, but it does not solve all our problems.

In the *Lewis* case the governing instruments provided a framework and a method for injecting additional participants as shareholders in the enterprise. This element is supplied by the provision

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<sup>54</sup> 301 U. S. at 389. This was an alternative ground of decision. The Court was also of the opinion that the arrangement did not meet the corporate-resemblance test. See comment on the *Lewis* case in *Comm'r v. Fortney Oil Co.* (C. C. A. 6th, 1942) 125 F. (2d) 995, 997; *Comm'r v. North American B. Trust* (C. C. A. 2d, 1941) 122 F. (2d) 545, 546, *cert. den.*, (1942) 314 U. S. 701; *Kilgallon v. Comm'r* (C. C. A. 7th, 1938) 96 F. (2d) 337, 340, *cert. den.*, (1938) 305 U. S. 622.

<sup>55</sup> (C. C. A. 9th, 1943) 136 F. (2d) 22. Both the facts and the holding in the *Lombard* case are anticipated in Dean, *op. cit. supra* note 1, at 347, n. 72.

<sup>56</sup> *Cf. Ittleson v. Anderson* (C. C. A. 2d, 1933) 67 F. (2d) 323, decided before the *Morrissey* case. There a trust was held to be an association although at all times it had only one beneficiary. The court emphasized the fact that the trust instrument authorized, and the trustee actually issued to the sole beneficiary, "negotiable shares of beneficial interest, which may be transferred at any time", thereby providing an express instrument for associating others in the enterprise. In *Titus v. United States* (C. C. A. 10th, 1945) 150 F. (2d) 508, 511, *cert. den.*, (1945) ..... U. S. ...., 66 S. Ct. 230, a trust was classified as a corporation although a single person apparently owned 2998/3000 of the beneficial interest and, in the words of the court, "For all practical purposes, Titus was the sole owner of this business."

in the trust instrument that transferable certificates of beneficial interest could be issued by the trustee; but none were ever actually issued.<sup>57</sup> By reason of this provision it may be said that the organization involved in the *Lewis* case was expressly designed for assembling associates to share in the profits, although no use was ever made of this attribute of the trust.<sup>58</sup> Why is this different from the case of a corporation which has only one stockholder but is nevertheless still taxed as a corporation?<sup>59</sup> In the *Morrissey* case we are told that the organization's "character was determined by the terms of the trust instrument."<sup>60</sup> Where the governing instrument supplies the express means for associating numerous beneficial owners of the enterprise, why should not that fact fix the character of the enterprise in that respect, regardless of whether or not the full potentiality of the specified organizational framework has actually been employed by the parties? Neither the regulations nor the adjudicated cases supply clear answers to these questions.

It is perfectly proper to tax a corporation as a corporation even if it has only one stockholder, and at the same time to refuse to tax a trust as a corporation whenever the trust has only one beneficiary, if that be considered an expedient rule to follow. The basis for the distinction is simply that, after all, the corporation is a corporation,<sup>61</sup> and the trust is a trust. There is nothing necessarily illogical about refusing to treat a trust as an "association" whenever the trust does not actually accomplish the association of two or more beneficiaries

<sup>57</sup> *Supra* note 52, at 387.

<sup>58</sup> However, the original beneficiary in the *Lewis* case actually did assign all of her interest in the trust, and thereafter the assignee died. The Court mentions this fact but does not discuss it. (301 U. S. at 387.) If the deceased assignee had more than one heir, there would be more than one beneficiary of the *Lewis* trust as soon as the assignee's estate was distributed. In that event good use might be made of the convenient instrumentality provided for associating several beneficiaries in the enterprise.

<sup>59</sup> The taxpayer generally cannot reduce taxes by arbitrarily disregarding the corporate fiction upon the ground that the corporation is the mere *alter ego* of its sole stockholder. *Moline Properties v. Comm'r* (1943) 319 U. S. 436; *Burnet v. Commonwealth Imp. Co.* (1932) 287 U. S. 415. But in a proper case the Government can consolidate the income of a corporation with that of its sole stockholder in order to increase the tax. *Higgins v. Smith* (1940) 308 U. S. 473; *Comm'r v. Smith* (C. C. A. 2d, 1943) 136 F. (2d) 556. See Finkelstein, *The Corporate Entity and the Income Tax* (1935) 44 *YALE L. J.* 436.

<sup>60</sup> 296 U. S. 344, 361.

<sup>61</sup> In *United States v. Morris & Essex R. Co.* (C. C. A. 2d, 1943) 135 F. (2d) 711, 713, *cert den.*, (1943) 320 U. S. 754, Judge Learned Hand said: "It is true that the Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat his corporation as a different person from himself . . ."

as shareholders in a joint enterprise. On the other hand, if it is sound and expedient policy to give full weight to those provisions of the trust instrument that vest in the trustee unused power to engage in business,<sup>62</sup> why is it not equally sound and expedient to give full weight to the unused power to associate numerous beneficiaries in the enterprise? If an enterprise is conducted in a form which makes available the substantial advantages of a corporation, should not that fact be sufficient to place the enterprise in the corporate category for taxation?<sup>63</sup>

If the foregoing argument is accepted, how far does it carry us? Transferable certificates of beneficial interest—like certificates representing shares of corporate stock—provide one of the most convenient methods for associating numerous beneficial owners in a single enterprise.<sup>64</sup> But any beneficial interest in any trust is generally transferable unless transferability is expressly limited.<sup>65</sup> Thus, any trust which has no "spendthrift clause" will usually provide a reasonably satisfactory framework for acquiring at least a small number of associates by the simple means of an ordinary assignment.<sup>66</sup> This discussion suggests that, as an original proposition, a court might choose any one of the following alternative factual ingredients as being necessary or sufficient to meet the test of "associates":

1. Two or more beneficial owners actually present during all of the period in question.

2. Two or more beneficial owners during part of the period, thereby demonstrating a purpose to associate several persons in a joint enterprise.

3. Provision for the issuance of transferable certificates representing units of undivided beneficial interest in the enterprise, thereby providing a most convenient method for acquiring associates whether or not this convenience is ever used.

4. Failure to make the beneficial interest nontransferable.

Probably everyone will agree that it would be going too far to

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<sup>62</sup> See *infra* pp. 494-496.

<sup>63</sup> See *supra* p. 469.

<sup>64</sup> In the *Morrissey* case it is pointed out that "the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests . . . and also the introduction of large numbers of participants." (296 U. S. at 359.)

<sup>65</sup> See 1 SCOTT, TRUSTS (1939) § 132.

<sup>66</sup> In the *Morrissey* case we are told that "the test of an association is not to be found in the mere formal evidence of interests or in a particular method of transfer." (296 U. S. at 358.)

hold that the test of "associates" is met by the mere failure to include an express provision in the governing instrument making the beneficial interest nontransferable. But where the trust instrument supplies the convenience of transferable certificates representing units of beneficial interest—thus supplying a device which is inconsistent with a purpose of not associating more than one beneficial owner of the enterprise—it is difficult to see why the inquiry should be carried further so far as the test of "associates" is concerned.

In respect to the effect to be given to the unused devices provided in the governing instrument, it seems unwise to rely upon the *Lewis* case as an authority beyond its own particular facts. It is quite possible that the courts may hold under various circumstances that the requirement of "associates" is satisfied where the written instrument governing the enterprise expressly provides the means and indicates the purpose of associating several beneficial owners in a joint enterprise, even when the available means have not been used and the indicated purpose has not been accomplished. We may certainly expect that the *Lombard* case will be followed in all factual situations where there actually were several beneficial owners of the enterprise, with transferable certificates, during a large portion of the period in question. How much further the principle of the *Lombard* case may be extended must depend upon judgments yet to be rendered in future cases.

On the other hand, it seems certain that an organization cannot be an "association" within the meaning of the Code unless it includes (or contemplates in some degree) two or more persons beneficially interested in the distributable profits of the enterprise; but this beneficial interest need not involve participation in all the net profits of the whole enterprise,<sup>67</sup> and the taxpayer's case is not benefited by putting a definite ceiling on the aggregate amount of profits to be distributed to the associates.<sup>68</sup>

Suppose a trust instrument names only a single beneficiary, but the single beneficiary actually holds his interest as trustee for other parties who have contributed money to the enterprise. To fail to

<sup>67</sup> *Adkins Properties v. Comm'r* (C. C. A. 5th, 1944) 143 F. (2d) 380; *Nashville Trust Co. v. Cotros* (C. C. A. 6th, 1941) 120 F. (2d) 157, 122 F. (2d) 326, *cert. den.*, (1941) 314 U.S. 680. In each case the association owned only a one-third interest in the whole enterprise, but that did not prevent it from being classified as a corporation in respect to the one-third interest.

<sup>68</sup> *Comm'r v. Highlands E.-L. Subd.* (C. C. A. 7th, 1937) 88 F. (2d) 355, *cert. den.*, (1937) 302 U.S. 691; *Fidelity-Bankers Trust Co. v. Helvering*, *supra* note 24.

recognize these undisclosed contributors as associates in the joint enterprise may often put a premium on subterfuge. It seems to be perfectly proper to look through the single beneficiary and to find the multiple ultimate beneficiaries who constitute the real associates, as was done by the Board of Tax Appeals (now the Tax Court) in *Central Republic Bank & Trust Co. v. Commissioner*.<sup>69</sup>

*Associates need not be actual contributors to the enterprise, and associations are not restricted to organizations for raising new capital.*

Prior to the *Morrissey* case, it was held that there was a "controlling distinction" between "a voluntary association of individuals for convenience and profit" as contrasted with a mere "method of equitably distributing a legacy or donation", and the latter arrangement was held not to be an association taxable as a corporation.<sup>70</sup> This is no longer the law.

Let us look at the corporate analogy. A corporation is an excellent device for bringing together several independent contributors to the capital of a single enterprise, and this is generally understood to be one of the principal objectives and advantages of the corporate form of organization. On the other hand, the familiar "family corporation" is an excellent device for the purposes of a parent who wishes to keep the family fortune intact but also desires to donate undivided interests therein to his wife and children. A corporation is taxed as a corporation whether it be availed of for raising and combining capital or for giving away undivided interests in a family fortune.<sup>71</sup>

In a trust, or any other convenient type of unincorporated organization—just as well as in a corporation—the parties may enjoy the advantage of pooling their resources in a joint enterprise; and the characteristic advantages of pooling resources in a joint enterprise are no different whether the associates voluntarily enter into the combination or have the combination thrust upon them by a generous donor. Our problem is not to classify the originating act that gives birth to an organization; rather, the problem is to classify the organization according to its effective attributes. The formal method used to bring the organization into being is not an effective attribute of the organization in action after its creation.

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<sup>69</sup> (1936) 34 B. T. A. 391. Cf. *Kilgallon v. Comm'r*, *supra* note 54, at 339.

<sup>70</sup> *Blair v. Wilson Syndicate Trust* (C. C. A. 5th, 1930) 39 F. (2d) 43, 46, followed in *Comm'r v. Guitar Trust Estate* (C. C. A. 5th, 1934) 72 F. (2d) 544.

<sup>71</sup> *Comm'r v. Montgomery* (C. C. A. 5th, 1944) 144 F. (2d) 313; *Jacks v. Comm'r* (1930) 19 B. T. A. 559.



The fact that all the associates are mere donees, rather than voluntary contributors to a joint enterprise, may be relevant in construing the purposes of the parties in close cases, but it is now settled that such a circumstance is not controlling in respect to whether or not the several beneficial owners of an enterprise are "associates" within the meaning of the *Morrissey* case.

In the *Morrissey* case itself Mr. Chief Justice Hughes said, "Undoubtedly the terms of an association may make the taking or acquiring of shares or interests sufficient to constitute participation . . . ." <sup>72</sup> Shortly after the *Morrissey* decision there arose in the ninth circuit a case where virtually all the property of a trust was contributed by a father, beneficial interests were donated to his children, and it was found by the Board of Tax Appeals that the father's principal purpose was "to provide an assured income for his children . . . and to place the property beyond their control." <sup>73</sup> The court rightly refused to follow the earlier cases <sup>74</sup> on this subject and held the trust to be taxable as a corporation. This decision was followed by the same court in the subsequent case of *Porter v. Commissioner* <sup>75</sup> where the court said it was immaterial whether or not the alleged association was created as a gift in trust from parents to their children. This principle is also now recognized in the fifth circuit where the court has said, "The grantor contributed all the property, but her sons undertook the management of the enterprise and received for themselves and others shares in it. Each person on accepting shares in a business enterprise thus organized becomes an associate." <sup>76</sup> The present treasury department regulations provide that "the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association." <sup>77</sup>

The contrary opinion <sup>78</sup> that has been expressed on this point in the sixth circuit must be deemed to be against the weight of authority and unsound in principle. Of course, if a would-be donor offers

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<sup>72</sup> 296 U. S. at 357.

<sup>73</sup> *Comm'r v. Vandegrift R. & Inv. Co.*, *supra* note 24, at 389.

<sup>74</sup> *Supra* note 70.

<sup>75</sup> (C. C. A. 9th, 1942) 130 F. (2d) 276.

<sup>76</sup> *Solomon v. Comm'r*, *supra* note 36, at 571. *Cf.* earlier cases *contra* in the same circuit, *supra* note 70.

<sup>77</sup> U. S. Treas. Reg. 111, § 29.3797-3.

<sup>78</sup> *United States v. Davidson* (C. C. A. 6th, 1940) 115 F. (2d) 799. The decision in this case was also based on the opinion that there was no business purpose within the meaning of the *Morrissey* case.

beneficial interests in an enterprise to the objects of his intended bounty, and if those proposed donees refuse to accept the gift so that the intended donation is frustrated before its completion, it is clear that the intended donees do not become "associates". But on the other hand, no affirmative "voluntary act of the beneficiaries"<sup>79</sup> should be required. Their passive acquiescence is sufficient.

Therefore, it must be concluded that a parent may create an association by establishing a trust and by making an *inter vivos* gift of beneficial interests therein to his children. Is the result the same if he accomplishes this same purpose by a testamentary disposition? The regulations say, "It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise."<sup>80</sup>

The mere fact that a trust is originated by a will or by a probate decree does not appear to be relevant in the application of any of the *Morrissey* case tests. If there is any pertinent distinction between a testamentary and an *inter vivos* trust it may be based upon the nature and effect of the probate court's continuing supervision over the trustee's administration.<sup>81</sup> But under the common practice of drafting a will in such a manner as to reduce the probate court's supervisory power to a minimum, it is not at all clear that the court's technical and somewhat illusory jurisdiction over the administration of a modern testamentary trust would necessarily keep it from being an association in all cases.

*Estate of Becker v. Commissioner*<sup>82</sup> appears to be the only case on record where the Commissioner has sought to classify a testamentary trust as a corporation. The Tax Court held that the trust was not an association, but this result was accomplished by a rather strained application of the business-purpose test. The court did not indicate

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<sup>79</sup> *Ibid.* at 801.

<sup>80</sup> U. S. Treas. Reg. 111, § 29.3797-2. (Italics added.)

<sup>81</sup> *Cf.* *United States v. Whitridge* (1913) 231 U.S. 144, 149, where the Government petitioned the court for an order to compel the receivers of certain street railway companies to file a return of net income under the Corporation Tax Law of 1909. In affirming the denial of the Government's petition the Court said that, although the receivers were operating the railroads, "they did this as officers of the court, and subject to the orders of the court; not as officers of the respective corporations, nor with the advantages that inhere in corporate organization as such." But *cf.* *United States v. Metcalf* (C. C. A. 9th, 1942) 131 F. (2d) 677, *cert. den.*, (1943) 318 U.S. 769, where a trustee in bankruptcy operating the business of a bankrupt corporation was held liable for corporation income taxes.

<sup>82</sup> T. C. Memo Op., Dkt. 110,598, CCH Dec. 13,332(M).

that a testamentary trust could never be taxed as a corporation. Either the element of business purpose or the attribute of corporate resemblance should be reduced to the vanishing point in a testamentary trust, as well as in an *inter vivos* trust, if it is the wish of the parties to make sure that the trust will not be classified as a corporation under the federal tax laws.

Many of the cases cited above carry the clear implication that the number of associates is immaterial (so long as there are at least two), and that it is not necessary that the association be used to accomplish some new aggregation of capital in a new enterprise. This principle is well illustrated by *Swanson v. Commissioner*<sup>83</sup> where it was held that a trust was an association taxable as a corporation although there were only two beneficiaries, who received their interests from their respective husbands, and where the only enterprise involved had previously been carried on by the husbands as tenants in common prior to the creation of the trust. To the same effect is *Helvering v. Coleman-Gilbert Associates*<sup>84</sup> where for a substantial period of time five persons had been associated in the business of owning and operating apartment houses as tenants in common. Without bringing in any new participants, these five persons put their apartment houses into a trust which had many of the substantial attributes of a corporation. In holding that the trust was an association the Court said, "They had been co-owners but they preferred to become 'associates,' and also not to become partners."<sup>85</sup> This principle is also illustrated by subsequent cases decided in the circuits.<sup>86</sup>

*There must be a joint enterprise.*

The concept of "associates" has reference primarily to "a union of . . . interests in the common enterprise"<sup>87</sup> analogous to the pooling of the resources of stockholders in a corporation. A union of personal services or a sharing of the power and responsibility of management as in the case of the typical partnership is not an essential element of an "association".<sup>88</sup> Nevertheless, there seems to be no reason why

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<sup>83</sup> *Supra* note 9.

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.* at 374.

<sup>86</sup> *Marshall's Heirs v. Comm'r*, *supra* note 24; *Sears v. Hassett* (C. C. A. 1st, 1940) 111 F. (2d) 961; *United States v. Hill* (C. C. A. 10th, 1944) 142 F. (2d) 622.

<sup>87</sup> *Supra* note 49.

<sup>88</sup> See *supra* p. 465. Cf. *Williams v. Milton*, *supra* note 21, at 10, 102 N. E. at 358, where in considering the distinction between a trust and a partnership the court said that when the beneficiaries of a trust have no control over its management they "are in

people may not become "associates" merely by pooling their personal services under some convenient form of unincorporated organization where the parties share the profits of the joint enterprise as co-owners of the project.<sup>89</sup> Two cases involving personal service operations by alleged associates have been adjudicated, and these two cases aptly illustrate a typical problem in regard to "joint enterprise".

In *Pelton v. Commissioner*<sup>90</sup> three doctors of medicine transferred to themselves, as trustees, office and medical equipment valued at \$14,000. Under the trust indenture the trustees were authorized to "operate clinics and any business or professional pursuit allied therewith . . . and invest and reinvest in securities." The three trustees were also the beneficiaries of the trust, and their respective beneficial interests were allotted to them according to their agreed earning capacity rather than upon the basis of the value of property contributed. Over 99 per cent of the income of the trust in the tax years in question was derived from fees for professional services rendered by the trustee-beneficiaries; and most of the people who paid these fees were not the patients of the "Pelton Clinic" but were "the patients of and called for some one of the doctors."<sup>91</sup> In holding that the trust was taxable as a corporation, the Board of Tax Appeals said that the three doctors "became voluntarily associated for the purpose of carrying on the practice of medicine and surgery."<sup>92</sup> The circuit court of appeals affirmed on the authority of the *Morrissey* case, notwithstanding the fact that under the applicable state law a corporation was not permitted to practice medicine.

In *Mobile Bar Pilots Association v. Commissioner*<sup>93</sup> the petitioner was an association of about twenty licensed steamship pilots. The members of the association owned as tenants in common certain boats which they had purchased for \$15,000 and which were necessary for

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no way associated together" although they do have "a common interest". This may be a fair statement when comparing a trust with a partnership, but when comparing a trust with a corporation such a statement has no meaning. See *Crocker v. Malley* (C. C. A. 1st, 1918) 250 Fed. 817, 824, *rev'd*, (1919) 249 U.S. 223.

<sup>89</sup> However, the type of organization selected for such a project would normally have the substantial attributes of an ordinary partnership and would fail to pass the corporate-resemblance test of the *Morrissey* case.

<sup>90</sup> (C. C. A. 7th, 1936) 82 F. (2d) 473. For a fuller statement of the facts see (1935) 32 B. T. A. 198.

<sup>91</sup> (1935) 32 B. T. A. 198, 202.

<sup>92</sup> *Ibid.* at 207.

<sup>93</sup> (C. C. A. 5th, 1938) 97 F. (2d) 695. For a fuller statement of the facts see (1936) 35 B. T. A. 12.

carrying on their profession as pilots in Mobile harbor. Piloting fees were collected by the association, placed in its bank account, and after deducting certain expenses and an amount for a reserve fund the balance was distributed to the members apparently on a *per capita* basis. The Board of Tax Appeals held that the association was engaged in the piloting business and that it was taxable as a corporation. In reversing the judgment the circuit court of appeals said: "Piloting is the performance of personal services requiring the pilot to have the highest degree of skill as a seaman and is controlled by law . . . . It would be impossible for petitioner to engage in the business of piloting as an independent contractor. Petitioner does no business except as an agent of its individual members."<sup>94</sup>

In the *Pelton* case it was held that the parties were engaged in a joint enterprise for the practice of medicine. But in the *Mobile* case it was held that each member of the association was practicing his profession as an independent individual enterprise, and that the association merely handled certain business details as the agent of the several pilots. In each case virtually all the income was derived from the practice of a skilled profession regulated by law, a profession which could not lawfully be practiced by a corporation. In each case the earnings of the alleged associates were pooled in a common fund, expenses of the enterprise were paid out of the common fund, and each member drew his agreed share of the net balance of the fund without reference to how much thereof was directly attributable to his own personal services. Formal differences between the two cases are readily apparent, but it is difficult to find any realistic and substantial distinction between them.

We may venture the opinion that the practical reason the doctors were held to be an "association" in the *Pelton* case, while the pilots were held not to be an "association" in the *Mobile* case, is simply this. The idea of a joint enterprise by physicians and surgeons is not questioned in the law of partnerships.<sup>95</sup> But the peculiar status of pilots has created a serious doubt as to whether or not it is legally possible for pilots to carry on their profession with such a community of interest as is required to constitute a partnership.<sup>96</sup> The law of pilotage

<sup>94</sup> *Ibid.* at 696.

<sup>95</sup> See, e.g., *Hess v. Lowrey* (1890) 122 Ind. 225, 23 N. E. 156; *Haase v. Morton & Morton* (1908) 138 Iowa 205, 115 N. W. 921.

<sup>96</sup> See, e.g., *Guy v. Donald* (1906) 203 U. S. 399, which is cited in the *Mobile* case; *The Joseph Vaccaro* (E. D. La. 1910) 180 Fed. 272; *Dampskibsselskabet Atlanta A/S v. United States* (C. C. A. 5th, 1929) 31 F. (2d) 961. Cf. *Fleming v. Lay* (C. C. A. 6th,

is outside the scope of this article; but regardless of whether or not the *Mobile* case was correctly decided, it seems clear that no great reliance should be placed upon it as an authority except in respect to associations of licensed pilots.

A study of the *Pelton* and *Mobile* cases suggests that there is a close analogy between the concept of "joint enterprise" under the *Morrissey* case and the familiar concept of community of interest in the law of partnerships.<sup>97</sup> It seems perfectly clear that wherever there is a sufficient community of interest to satisfy the partnership test, there is certainly enough community of interest to constitute a "joint enterprise";<sup>98</sup> and in that event, whether the organization is to be taxed as a partnership or as a corporation will depend upon whether or not the particular arrangement satisfies the third basic test of the *Morrissey* case, namely, substantial resemblance to a corporation.

When earnings from personal services rendered by several persons are pooled in a common fund, and when the expenses incurred in rendering such services are paid out of the common fund, and the net balance of the common fund is distributed among the participants in accordance with their prior agreement so that the share of each is not computed upon the basis of his own net earnings solely from his own personal services, it is difficult to escape the conclusion that the parties "share the advantage of a union of their interests in the common enterprise" within the meaning of the *Morrissey* case. The parties, as proprietors, share in the net balance of the common fund, and under most circumstances this should be sufficient to characterize the arrangement as a joint enterprise.<sup>99</sup>

*Unified management, an important element of joint enterprise.*

When a lawyer designs an arrangement for the pooling of capital

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1901) 109 Fed. 952, 955, where an association of tug boat owners, operating in much the same manner as the typical pilots' association, was held to be a partnership because each participant was "interested in all the sums earned in the operations of each, and correspondingly the operations of each were in the general business of all."

<sup>97</sup> See MECHEM, *ELEMENTS OF THE LAW OF PARTNERSHIP* (2d ed. 1920) § 75: "An agreement between two or more persons to unite their property, labor, skill, or capital to establish and carry on a business, in which business they are to have a community of interest—which they are to *own* in common, in which each is to be a principal owner or proprietor as distinguished from a mere agent, clerk or creditor—and the profits and losses of which they are to share because they *are* such owners, principals or proprietors, is the typical form of partnership."

<sup>98</sup> In *Levine v. Michel* (1883) 35 La. Ann. 1121, 1126, the court made the pertinent observation that "Whilst every association of persons does not imply a partnership, it is certain that every partnership implies an association."

<sup>99</sup> Cf. BURDICK, *THE LAW OF PARTNERSHIP* (3d ed. 1917) 35-36.

contributions in a joint enterprise it is often easy to draft the governing instruments and to set up the necessary records in such a manner that, as a matter of form, each contributor seems to receive merely the net return of the business conducted by his own separate agent employing his own separate capital fund in his own individual enterprise.

Thus, undivided interests in property are sold in separate independent transactions to separate and independent purchasers, but each sale is made subject to a separate exclusive management contract or power of attorney so that the separate undivided property interests remain pooled under unified management;<sup>100</sup> or several owners each execute separate and independent trust deeds to the same trustees;<sup>101</sup> or the governing instrument carefully provides that the manager of the enterprise shall buy and sell securities for the separate account of each member of the group.<sup>102</sup> In each case cited in the three preceding notes it was held that no association existed, and these cases are sometimes thought to be authority for the view that the parties were not associated in a joint enterprise merely because they did not act jointly (as a matter of form) in setting up the arrangement or in conducting the contemplated operations. However, sound analysis demonstrates that in these cases the parties were associated in a joint enterprise,<sup>103</sup> and (if these cases were correctly decided) the failure of the parties to create an "association" is explained by the lack of compliance with some other test postulated in the *Morrissey* case.

In determining whether or not persons are associated together in a joint enterprise the taxpayer cannot expect the courts to accommodate him by "giving substance to pure fiction."<sup>104</sup> No purely technical separation of transactions or relationships will overcome the substantive fact of the pooling of individual interests to form the common capital of a joint enterprise. But there has been some difficulty

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<sup>100</sup> *Comm'r v. Rector & Davidson* (C. C. A. 5th, 1940) 111 F. (2d) 332, *cert. den.*, (1940) 311 U. S. 672; *Comm'r v. Horseshoe L. Syndicate*, *supra* note 13. See *infra* note 300, and accompanying text.

<sup>101</sup> *McKean v. Scofield* (C. C. A. 5th, 1940) 108 F. (2d) 764. See *infra* notes 212, 241 and 301, and accompanying text.

<sup>102</sup> *Comm'r v. N. B. Whitcomb Coca-Cola Syndicate*, *supra* note 24. See *infra* notes 114 and 302, and accompanying text.

<sup>103</sup> Compare cases *supra* notes 100, 101 and 102, with cases *infra* notes 109 and 110.

<sup>104</sup> *Second Carey Trust v. Helvering* (App. D. C. 1942) 126 F. (2d) 526, 528, *cert. den.*, (1942) 317 U. S. 642.

in drawing the correct distinguishing line between fictional and substantial separation of interests.

The typical cases call for a distinction between associates in a joint enterprise as compared with either several independent customers who trade with the same merchant, or several principals who happen to employ the same agent or trustee in the conduct of individual enterprises of their own. The presence or absence of the factual ingredient of unified management usually provides the key to the problem. This may be conveniently illustrated by an analysis of two of the so-called investment trust cases.

Suppose each individual in a group of one hundred persons reaches the independent decision to buy varying amounts of the stock of Income Foundation Fund, Inc., a Maryland corporation. They discover that the sale of this stock is controlled by an exclusive sales agent, and the only convenient way to invest in the stock is to pay the money to the Equitable Trust Company, as trustee. Pursuant to a written agreement among the interested parties, the trustee puts all the money contributed by these hundred people into a single fund and buys a single block of the stock of Income Foundation Fund, Inc., in its own name as trustee; and the Equitable Trust Company then issues trust certificates to the various investors to represent their respective proportional interests. The purpose of this arrangement is to facilitate sales on the installment plan and the application of dividends toward the purchase of more stock. These are substantially the facts of *Equitable Trust Co. v. Magruder*<sup>105</sup> where it was correctly held that the trust administered by the Equitable Trust Company was not an "association". The beneficiaries of the trust were not associates in a joint enterprise. They were nothing more than independent customers purchasing beneficial interests in the stock of Income Foundation Fund, Inc., from a single dealer, which is no different in principle from the hundred independent customers of a single apple merchant.

Of course, in the *Equitable Trust Co.* case the respective customers became associated as shareholders in the joint enterprise conducted by Income Foundation Fund, Inc., which presumably paid all the regular corporation taxes without protest. The sole question at issue was whether or not the intervening trust administered by the Equitable Trust Company was an association taxable as a corporation; and clearly it was not, because there was no joint enterprise.

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<sup>105</sup> (D. Md. 1941) 37 F. Supp. 711.



Next, assume the same facts as those in the *Equitable Trust Co.* case with this significant difference. Under the governing agreement any money deposited with the trustee could be used for the purchase of any bonds (meeting certain general standards) selected by the sales agent from time to time. With this variation in our facts we have substantially the case of *Commissioner v. North American Bond Trust*<sup>106</sup> where it was held that the trust was an association taxable as a corporation.

The manifest distinction between the two cases is this. In the *Equitable Trust Co.* case each beneficiary was engaged in an independent enterprise of his own because each one made his own independent decision as to what to buy, when to buy and what price to pay. In sharp contrast, under the arrangement in the *North American Bond Trust* case the respective individual investors paid their money into a single investment fund, and thereupon they immediately relinquished their independent status. The sales agent decided what to buy, when to buy and what price to pay. The individual investors thereby pooled their separate contributions to form the capital of a joint investment enterprise under the centralized management of the sales agent and the trustee.<sup>107</sup>

The crucial factual element in this important distinction is simply the fact of unified management.<sup>108</sup> Unified clerical administration is relatively immaterial. But when the separate investments of the several contributors are subjected to unified management in respect to important business decisions, the separate contributions of the several investors become merged in a single joint enterprise. As a matter of practical fact, unified management is wholly inconsistent with the concept of several individual enterprises conducted independently by the several participants in the arrangement. Regardless of the formal language of the governing instruments, the several nature of the individual interests is necessarily destroyed by a single unified management.

Going beyond the investment trust cases, we find that a "venture

<sup>106</sup> *Supra* note 54.

<sup>107</sup> There is a very realistic business distinction between the independent management of a large number of small investment funds as compared with the unified management of a single large investment fund. See *Brooklyn Trust Co. v. Comm'r*, *supra* note 51, at 866.

<sup>108</sup> This element of "unified management" is closely related to "business purpose" (*infra* p. 487) and "centralized management" (*infra* p. 513) but the factual ingredients of these three items are not always the same.

by tenants in common" was held to be taxable as a corporation where the organization was created by the execution of separate powers of attorney by each cotenant;<sup>109</sup> and a like result was reached where the association was created by separate assignments of undivided interests in the proceeds from an oil well.<sup>110</sup> In each of these cases the formal arrangement might make it appear that no joint enterprise existed. But the facts clearly showed the pooling of individual resources under unified management, and this substantive fact easily overcame the formalities of the governing instruments.

Suppose several persons, each acting independently of the others, lend money to a corporation to finance a business carried on by the corporation. These individuals do not become associates in the corporation's enterprise, because they are mere creditors of the corporation rather than beneficial owners.<sup>111</sup> They are not associates in the enterprise of lending money, because each one has acted independently and has made his own business decisions. But suppose they act in concert pursuant to a mutual agreement among them, so that the substantial effect of the transaction is that instead of making separate loans to the corporation they contribute to a common fund which serves as the capital of a money-lending business operated under unified management. When they do that, they embark in a joint money-lending enterprise, and they thereby become associates even if the enterprise is restricted to lending money to a single corporation.<sup>112</sup>

In *Pennsylvania Co. Etc. v. United States*<sup>113</sup> two separate trusts were involved and each was held to be taxable as a corporation. Under one of the trust agreements all of the net capital deposited with the trustee was to be used solely for the purchase of the stock of Wellington Fund, Inc., a corporation. But under certain circumstances either the trustee or the sales agent could give the beneficiaries thirty days' notice of their intention to substitute other securities. During the thirty-day notice period each beneficiary had the option either to consent to the purchase of the proposed substituted securities or to

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<sup>109</sup> *Comm'r v. Fortney Oil Co.*, *supra* note 54.

<sup>110</sup> *Monrovia Oil Co. v. Comm'r* (C. C. A. 9th, 1936) 83 F. (2d) 417.

<sup>111</sup> *Thomas v. Perkins* (C. C. A. 5th, 1939) 108 F. (2d) 87. *Cf. Wellston Hills Syndicate Fund v. Comm'r* (C. C. A. 8th, 1939) 101 F. (2d) 924, 927, where under the particular facts the court rejected the taxpayer's argument that a mere debtor-creditor relationship was established.

<sup>112</sup> *Fidelity-Bankers Trust Co. v. Helvering*, *supra* note 24.

<sup>113</sup> (C. C. A. 3d, 1943) 138 F. (2d) 869, *cert. den.*, (1944) 321 U. S. 788.

object and withdraw his money; but any beneficiary who failed to present an express objection within the thirty-day period was conclusively presumed to have authorized the proposed substitution. Upon these facts it is difficult to find any joint enterprise. Any beneficiary who received notice of the proposed substitution of securities had a very real and substantial opportunity to maintain the independence of his own separate enterprise by making his own independent decision as to what securities to buy. It seems that the decision to tax this trust as a corporation can be justified only upon the rather questionable theory that the supposed lack of unified management was largely illusory because the governing instrument supplied a conclusive presumption that all beneficiaries who neglected to make an express objection were deemed to have authorized the proposed substitution of securities.

In *Commissioner v. N. B. Whitcomb Coca-Cola Syndicate*<sup>114</sup> a stock syndicate was held not to be an "association". The syndicate manager was authorized to buy and sell the stock of either or both of two separate Coca-Cola corporations. But the syndicate manager had almost unlimited discretion as to which of the two securities to buy, when to buy, when to sell, and what prices to pay or demand. The language of the opinion seems to indicate that the court thought there was no joint enterprise, but rather that each syndicate member was merely employing the same agent in the conduct of his own separate business. However, the conclusion seems inescapable that the unified management, vested in the syndicate manager in respect to the important business decisions described above, was more than sufficient to destroy the several character of the separate interests of the respective members of the syndicate. If the decision in favor of the taxpayer in the *Coca-Cola* case is correct it is apparent that it must be justified on some ground other than the supposed absence of a joint enterprise.

#### THE SECOND BASIC TEST: BUSINESS PURPOSE

The principal parts of the discussion of "business purpose" in the *Morrissey* case are quoted below:

"'Association' . . . implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust—whether created by will, deed, or declaration—by which particular

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<sup>114</sup> *Supra* note 24.

property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons . . . . In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management and sale of properties; or for dealings in securities or other personal property; or for the production, or manufacture, and sale of commodities; or for commerce, or other sorts of business; where those who become beneficially interested . . . seek to share the advantages of a union of their interests in the common enterprise."<sup>115</sup>

*Justification and origin of the business-purpose test.*

Of course, the business-purpose test is entirely different from the familiar distinction between business corporations and nonprofit organizations. The business purpose that is required to make an "association" is not a prerequisite for the taxation of corporations.<sup>116</sup> What is the justification for this rule that an unincorporated organization cannot be an association taxable as a corporation unless it was established (or used) for the purpose of carrying on a business? Why should such a business purpose be a prerequisite for placing an association in the corporate category for taxation when this element is not an essential attribute of a corporation?

The Internal Revenue Code itself suggests and justifies the business-purpose test. We have already seen that, as a matter of rational statutory construction, the concept of "association" must be sufficiently limited to leave room for certain kinds of trusts which are to be classified merely as trusts under the pertinent provisions of the

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<sup>115</sup> 296 U. S. at 356.

<sup>116</sup> Where the dominant purpose of an unincorporated organization is the mere orderly liquidation of assets, it does not satisfy the business-purpose test (*infra* p. 496). But a "dissolved corporation in process of liquidation", which has no authority under applicable state law to do anything except what is necessary to wind up its affairs, is nevertheless still taxable as a corporation. *O'Sullivan Rubber Co. v. Comm'r* (C. C. A. 2d, 1941) 120 F. (2d) 845. *Cf. Burnet v. Lexington Ice & Coal Co.* (C. C. A. 4th, 1933) 62 F. (2d) 906; *Taylor Oil & Gas Co. v. Comm'r* (C. C. A. 5th, 1931) 47 F. (2d) 108. A liquidating corporation may even be subjected to an excise tax on corporations "with respect to carrying on or doing business." *Magruder v. Realty Corp.* (1942) 316 U. S. 69. On the other hand, many cases might be cited where a corporation was not doing enough business to incur an excise tax "with respect to carrying on or doing business", but the corporation nevertheless paid the regular corporation income tax without question or protest. See, e.g., *Goodyear Inv. Corp. v. Campbell* (C. C. A. 6th, 1943) 139 F. (2d) 188.

Code.<sup>117</sup> Under the Code the income tax is levied generally upon the net income of individuals<sup>118</sup> and corporations.<sup>119</sup> But in marked contrast, the tax in respect to trusts is levied upon "the income of . . . any kind of property held in trust."<sup>120</sup> The Code thus implies that the kind of trust which is to be classified as a trust for purposes of taxation is one that merely receives income from property.

If the income of any particular taxpayer includes nothing more than "the income of . . . any kind of property held in trust", then the taxpayer fits perfectly the formula for the taxation of trusts. But if the taxpayer's income includes the profits of a business, then the trust-taxing section of the Code cannot be applied without doing violence to its express language. Therefore, under the system of classification adopted by the Internal Revenue Code, any unincorporated organization that is empowered merely to hold and conserve property in trust and to collect and distribute income therefrom has a controlling resemblance to a trust; but any organization that contemplates the receipt of profits from the conduct of a business has a preponderant resemblance in this respect to either a corporation or a partnership.

This seems to be an entirely satisfactory justification for the business-purpose test as applied to trusts; but the courts have neither developed nor defended the test upon the basis of any such statutory analysis. Indeed, the business-purpose test was developed in a much more haphazard manner.

It has been said that *Crocker v. Malley*<sup>121</sup> first laid down the business-purpose test.<sup>122</sup> This may be true,<sup>123</sup> but few people realized it<sup>124</sup>

<sup>117</sup> *Supra* p. 466.

<sup>118</sup> I. R. C. § 11.

<sup>119</sup> *Ibid.* §§ 13, 14.

<sup>120</sup> *Ibid.* § 161(a). The phrase "income of . . . any kind of property held in trust" originated in the Revenue Act of 1916 § 2(b), 39 STAT. 756, 757, prior to the decision in *Crocker v. Malley*, *infra* note 121. Cf. 1 SCOTT, TRUSTS (1939) § 2.6: "In the case of a trust, however, there is always some property which is the subject matter of the trust, and which is held by the trustee for the benefit of the *cestui que trust*."

<sup>121</sup> *Supra* note 20.

<sup>122</sup> See Dean, *op. cit. supra* note 1, at 335.

<sup>123</sup> In the *Crocker* case the Court rather casually mentioned the fact that "The function of the trustees is not to manage the mills but simply to collect the rents and income of such property as may be in their hands" (249 U. S. at 232), and this is suggested as a ground of distinction in *Malley v. Bowditch*, *supra* note 19, at 812. But in the *Crocker* case the overwhelming emphasis is placed upon the fact that the beneficiaries had no control over the trustees. See *supra* note 20, and accompanying text.

<sup>124</sup> *E.g.*, the treasury department rulings issued in the period between the *Crocker* and *Hecht* cases, reported in *Woodrow Lee Trust v. Comm'r* (1929) 17 B. T. A. 109, 111.

until after the idea was stated more forcibly in *Hecht v. Malley*<sup>125</sup> five years later.

The only taxes involved in *Hecht v. Malley* were excise taxes imposed on corporations (including "associations") "with respect to the carrying on or doing business." Even a technical corporation was not subject to these taxes unless it was engaged in "business". The Court does not emphasize the clear distinction between "business purpose" as a possible factual ingredient of an "association", and the actual business activity that was the subject of the particular excise taxes involved in the dispute under consideration.<sup>126</sup> Nevertheless, the language of the opinion requires the conclusion that the Court considered business purpose to be an important element in determining whether or not the petitioning trusts were "associations", although the carrying on of business was also an essential fact to show that the trusts had engaged in the particular activity that was burdened by the excise.

Undoubtedly *Hecht v. Malley* is the first decision of the Supreme Court that unmistakably postulates the business-purpose test. But nowhere in that opinion does the Court expressly say why, or to what extent, it considers business purpose to be important. The Court declares that "The word 'association' appears to be used in the Act in its ordinary meaning", and thereupon the opinion quotes three dictionary definitions which state (among other things) that the objective of an association is "the prosecution of some common enterprise"<sup>127</sup> or "the prosecution of some purpose"—but none of the quoted definitions say anything to suggest that business purpose is an indicium of an association. Having quoted these definitions, the Court concludes:

"We think that the word 'association' as used in the Act clearly includes 'Massachusetts Trusts' such as those herein involved, having quasi-corporate organizations under which they are engaged in carrying on business enterprises. What other form of 'associations', if any, it includes, we need not, and do not, determine."<sup>128</sup>

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"We conclude, therefore, that when the nature of the three trusts

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<sup>125</sup> *Supra* note 17.

<sup>126</sup> See Flagg, *op. cit. supra* note 8, at 592. In *Tyson v. Comm'r*, *supra* note 37, at 30, the court said that in the *Hecht* case "'Doing business' was the test for the imposition of the excise tax, not the character of the instrumentality that transacted the business."

<sup>127</sup> The dictionary definition of "enterprise" does not suggest that the word refers exclusively, or even primarily, to *business* enterprise.

<sup>128</sup> 265 U. S. at 157.

here involved is considered, as the petitioners are not merely trustees for collecting funds and paying them over, but are associated together in much the same manner as the directors in a corporation for the purpose of carrying on business enterprises, the trusts are to be deemed associations within the meaning of the Act . . . ."<sup>129</sup>

Why did the Court consider business purpose to be an important element of an "association"? The opinion in the *Hecht* case does not directly and unequivocally say so, but the context makes it clear that the Court thought Congress intended to include "business trusts" within the corporate category simply because business trusts had long been used as a substitute for (and as a practical equivalent of) corporations.<sup>130</sup> The Court seemed to think that "business trusts" were so like corporations in purpose and effectiveness that Congress must have intended to include them in the term "association". In any event, in the *Hecht* case the Court firmly laid the foundation for the distinction between "ordinary trusts" and "business trusts".

The next association case to reach the Supreme Court was *Burk-Waggoner Oil Association v. Hopkins*<sup>131</sup> where the taxpayer apparently relied solely upon certain issues which it sought to raise under the Constitution. In the course of its opinion the Court wrote two sentences which reinforce the idea that the business-purpose test was conceived of primarily as merely one element of resemblance to a corporation. The Court said:

"Because of this resemblance in form and effectiveness, these business organizations are subjected by the Act to these taxes as corporations. . . . But nothing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated."<sup>132</sup>

Next comes the *Morrissey* case. Although the opinion in this case undertakes a rather elaborate "further examination of the congressional intent",<sup>133</sup> the Court refrains from tabulating any explicit reasons why "business purpose" should be an essential attribute of

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<sup>129</sup> *Ibid.* at 161.

<sup>130</sup> In a footnote the Court quotes without comment a statement by the circuit court of appeals that "It is a matter of common knowledge that, for most business and financial purposes, all the larger organizations of this sort [*i.e.*, "Massachusetts trusts"] have for years been indistinguishable from corporations." (265 U. S. at 157, n. 8.)

<sup>131</sup> *Supra* note 2.

<sup>132</sup> *Ibid.* at 114.

<sup>133</sup> 296 U. S. at 356.

an association. In his discussion of the business-purpose test,<sup>134</sup> the Chief Justice does not attempt to justify the doctrine.

If the *Morrissey* case adds any new thought in justification of the business-purpose test, it appears to be this. The Court recognized<sup>135</sup> that even the most "ordinary" and the most "traditional" of trusts will usually satisfy the corporate-resemblance test which is fully expounded in the opinion. Title vested in a single entity, centralized management, continuity, transferability, and limitation of personal liability,<sup>136</sup> are inherent in the very nature of even an "ordinary" trust. Therefore, some further test, in addition to these five "salient features" of the corporate-resemblance test, is required to mark off those trusts which are to be classified as corporations under the federal tax laws. The business-purpose test expediently fills this pressing requirement.

*General scope of the business-purpose test.*

The foregoing discussion shows that the function of the business-purpose test is to draw a distinguishing line between an "ordinary" or "traditional" trust and a "business trust". Anything which is an "ordinary" or "traditional" trust is not a "business trust", and *vice versa*. Presumably, all trusts may be expected to fit into one or the other of these two classifications.

What does the Court mean by an "ordinary" or "traditional" trust? In the *Crocker* case, which involved only an "ordinary" trust, it is explained that the function of the trustees was "simply to collect the rents and income of such property as may be in their hands."<sup>137</sup> In the *Hecht* case, which involved "business trusts", the Court noted that "the petitioners are not merely trustees for collecting funds and paying them over."<sup>138</sup> In the *Morrissey* case we are told that in the "traditional" trust the object is "to hold and conserve particular property, with incidental powers."<sup>139</sup> Also in the *Morrissey* case it is said that "the question has arisen because of the use and adaptation of the trust mechanism."<sup>140</sup>

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<sup>134</sup> *Supra* note 115.

<sup>135</sup> 296 U. S. at 359.

<sup>136</sup> *Cf. supra* p. 470.

<sup>137</sup> *Supra* note 123.

<sup>138</sup> *Supra* note 129.

<sup>139</sup> *Supra* note 115.

<sup>140</sup> 296 U. S. at 359.



It is manifest that the Court did not intend, in the few words quoted in the preceding paragraph, to define all the permissible powers and objectives of an "ordinary" trust. The Court was merely attempting to *identify* an "ordinary" trust, not to give a full description of all its legitimate attributes. It seems unmistakably clear that the Court intended to identify an ordinary trust in which the business powers of the trustee do not substantially exceed the ordinary powers given to a trustee by law, as contrasted with an "adaptation of the trust mechanism" wherein the governing instrument gives the trustee extensive business powers beyond those that would be vested in him by law in the absence of any express provision in the trust instrument.

This analysis is expressly adopted by the treasury department in its current regulations, as follows:

"The term 'trust', as used in the Internal Revenue Code, refers to an ordinary trust, namely, one . . . the trustees of which take title to the property for the purpose of protecting or conserving it *as customarily required under the ordinary rules applied in chancery and probate courts.*"<sup>141</sup>

Under this analysis, the proper way to decide whether or not a trust is "ordinary" is to determine whether or not the business powers of the trustee substantially exceed those that he would have "under the ordinary rules applied in chancery and probate courts." These ordinary chancery powers<sup>142</sup> may be considerably different from "simply to collect the rents and income", or "collecting funds and paying them over", or "to hold and conserve particular property", as stated in the *Crocker*, *Hecht* and *Morrissey* cases, because these brief statements by the Court are mere identifications of an "ordinary" trust rather than a comprehensive definition.

This principle is recognized in varying degree in some of the decisions.<sup>143</sup> But very often, when a court is called upon to interpret and apply the business-purpose test, the judges seek guidance from prior decisions determining what constitutes "doing business" under some excise tax statute, or they consult cases where the question at issue is whether or not the taxpayer was engaged in business so as to

<sup>141</sup> U. S. Treas. Reg. 111, § 29.3797-3. (Italics added.)

<sup>142</sup> 2 SCOTT, TRUSTS (1939) §§ 181, 189, 227, 231.

<sup>143</sup> *Lansdown Realty Trust v. Comm'r* (C. C. A. 1st, 1931) 50 F. (2d) 56, 58; *Ittle-son v. Anderson*, *supra* note 56, at 326; *Myers v. Comm'r*, *supra* note 13, at 89; *Hill v. United States* (D. Kan. 1943) 49 F. Supp. 158, 162, *rev'd*, (C. C. A. 10th, 1944) 142 F. (2d) 622.

be entitled to deduct certain items as "business expense" under an appropriate statutory provision.

If the foregoing analysis is correct, precedents concerning the meaning of the word "business", as used in various tax statutes, are not directly relevant to the business-purpose test described in the *Morrissey* case.<sup>144</sup> If such precedents are relevant at all in this connection, it is only by way of a rather tenuous analogy. The supposed analogy can be supported only if it is concluded that the trustee of an ordinary trust, vested only with ordinary powers provided by law, has no authority to engage in "business" within the technical meaning of the tax statutes; but the courts have generally hurdled this obstacle without comment or discussion.

As a matter of fact, more often than not the courts appear to reach a sound result in the interpretation and application of the business-purpose test when they rely upon the supposed analogy referred to in the preceding paragraph. But this happy result must be deemed to be an unreliable fortuitous circumstance rather than the inevitable product of logical reasoning.

The application of the business-purpose test to specific factual situations will be examined in subsequent pages, but before we undertake the project it is desirable to consider once again the relative importance of the provisions of the governing instrument as compared with the actual activities of the parties.

*Primary importance of provisions in the governing instrument, as compared with the actual activities of the parties.*

We have already observed that in the *Morrissey* case the Supreme Court decided that the character of the trust under consideration "was determined by the terms of the trust instrument,"<sup>145</sup> and that in the *Coleman-Gilbert* case the Court said, "The parties are not at liberty to say that their purpose was other or narrower than that

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<sup>144</sup> But see *City Bank Co. v. Helvering* (1941) 313 U. S. 121, 125, n. 4, which was a case involving the deductibility of "business expense", wherein the Court cites the *Morrissey* case together with two excise tax cases in support of the proposition that the trust in the case at bar was not a "business trust". See also dissenting opinion of Judge Leech in *Marshall's Heirs v. Comm'r* (1939) 39 B. T. A. 101, 113, *aff'd*, (C. C. A. 3d, 1940) 111 F. (2d) 935, *cert. den.*, (1940) 311 U. S. 658. Judge Leech said the business-purpose test should be identical with the rule concerning the deduction of expenses incurred in a "business", and on that ground he thought the petitioner was not an "association"; but the majority of the board, and the circuit court of appeals, held that the petitioning trust satisfied the business-purpose test and was taxable as a corporation.

<sup>145</sup> *Supra* note 38.

which they formally set forth in the instrument under which their activities were conducted.”<sup>146</sup> In each case these remarks were made with specific reference to the business-purpose test, and it is in respect to the business-purpose test that this principle has been most frequently applied in subsequent cases. Most of the cases concerning this test are decided upon the basis of the powers provided in the governing instrument, and the only weight generally given to the actual activities of the parties is to test, interpret and sometimes to expand the purposes expressed in the written instrument wherever that seems to be necessary.

A striking example of the application of the rule is provided by the case of *Sears v. Hassett*<sup>147</sup> where the Commissioner assessed both the corporation income tax and the capital stock tax against a real estate trust. The capital stock tax was an excise on doing business. The court held that the trust was an association taxable as a corporation because the trustees were “empowered to engage in extensive real estate operations and in the business of investing and reinvesting in securities.”<sup>148</sup> But at the same time the court held that the capital stock tax had been unlawfully assessed because the trust had not actually done any “business” during the years in question. The interested parties immediately amended the declaration of trust so as to eliminate all the unused business powers that had been needlessly vested in the trustee; and when the Commissioner tried to collect ordinary corporate income taxes for the following year the taxpayer won on a motion for summary judgment.<sup>149</sup>

The lesson of *Sears v. Hassett* is plain. Taxes may frequently be saved if the lawyer drafting a declaration of trust succeeds in resisting the otherwise laudable inclination to supply the trustee with broad business powers which might possibly be useful under future contingencies but which are not actually within the contemplation of the parties. Sound judgment must be exercised in reaching a proper balance between supplying powers reasonably required for the successful operation of the project, and keeping the powers to such a minimum as to avoid the possibility of incurring corporation taxes. Sometimes the easiest way out of this dilemma may be merely to reduce the features of “corporate resemblance” to a safe level; it is not

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<sup>146</sup> *Supra* note 39.

<sup>147</sup> *Supra* note 86.

<sup>148</sup> *Ibid.* at 964.

<sup>149</sup> *Sears v. Hassett* (D. Mass. 1942) 45 F. Supp. 772.

enough that persons are associated in a joint enterprise for carrying on a business for profit—it is also necessary for the organization to have substantial resemblance to a corporation before it can be classified as a corporation under the Internal Revenue Code.<sup>150</sup>

*Business-purpose test applied to liquidating trusts.*

About four years after the business-purpose test had been established in *Hecht v. Malley*, the circuit court of appeals decided that liquidation was not "business" within the meaning of this test.<sup>151</sup> In all the subsequent cases it has been held that when both the authority and the activities of a trustee are limited to the liquidation of property and the distribution of its proceeds, and the holding of such property until an advantageous sale can be made, together with such incidental business activity as is wholly consistent with the dominant purpose of liquidation, the trust is not taxable as a corporation.<sup>152</sup> In the *Morrissey* case the Supreme Court gave passive recognition to this rule when it made the following observation concerning the trust there under consideration: "It was not a liquidating trust; it was still an organization for profit, and the profits were still coming in."<sup>153</sup>

This rule appears to be justified by the proper distinction between an ordinary trust and a business trust. The orderly liquidation of all kinds of property, together with the minimum of business activity that is necessary to avoid loss in the course of such liquidation, is well established as a proper function to be carried out by a trustee under the ordinary powers vested in him by law.<sup>154</sup>

Under the decision in the *Morrissey* case concerning the importance of the purposes expressed in the governing instrument, a taxpayer cannot hope to be classed as a liquidating trust unless the dominant purpose of liquidation is clearly and consistently expressed in

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<sup>150</sup> See *infra* p. 527 *et seq.*

<sup>151</sup> *White v. Hornblower*, *supra* note 24. The decision was partially based upon an opinion of the Supreme Court concerning the meaning of the word "business" in the Corporation Tax Law of 1909, *supra* note 4.

<sup>152</sup> The decisions prior to the *Morrissey* case frequently emphasized the activities of the trustee to the virtual exclusion of the provisions of the governing instrument. These cases are: *Blair v. Wilson Syndicate Trust*, *supra* note 70; *Busch v. Comm'r* (C. C. A. 5th, 1931) 50 F. (2d) 800; *Fisk v. United States* (D. Mass. 1932) 60 F. (2d) 665. *Cf. Willis v. Comm'r*, *supra* note 24. For decisions subsequent to the *Morrissey* case, see *infra* notes 155-157.

<sup>153</sup> 296 U. S. at 361.

<sup>154</sup> 2 SCOTT, TRUSTS (1939) § 230.4.

the declaration of trust.<sup>155</sup> On the other hand, the courts have been diligent in checking up on the actual activities of the trustee to determine whether or not the formal declaration of strict liquidating powers and purposes was sincere and genuine, or whether the original purpose to liquidate the property has been abandoned in subsequent years. In this connection the courts generally want to know whether or not reasonable and continuous efforts have been made to sell the property,<sup>156</sup> and whether or not reinvestment of income or principal has been either authorized or undertaken.<sup>157</sup> In one case the court took particular notice of the fact that, although the contemplated liquidation was long delayed, and in the meantime numerous leases of the property were made, nevertheless all the leases made by the trustee contained a provision permitting cancellation when the property was sold.<sup>158</sup>

A study of the cases cited in the preceding paragraph indicates that if the court is thoroughly convinced that liquidation is the dominant, sincere and consistent purpose of a trust it will not be taxed as a corporation even though a very considerable amount of business activity is conducted pending the completion of the liquidation. The apparent aspiration of the courts in this respect has been well stated by the Board of Tax Appeals, as follows:

"The law does not require that in liquidating a property the owner must abandon all ordinary business judgment and sacrifice the property immediately without regard for condition of the market or amount of loss. The liquidation is to be accomplished with reasonable regard for all surrounding circumstances. These circumstances may vary with the type of property and the state of the market. If the activity of the trust or property owner in the interim is only such as a reasonably prudent man would undertake in the preservation of the property or the minimizing of his loss, and is consistent with the

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<sup>155</sup> In *Sears v. Hassett*, *supra* note 86, the taxpayer introduced evidence that liquidation was the dominant purpose of the parties, but the court held that the provision of broad business powers in the declaration of trust was controlling. See also *Jackson v. United States* (C. C. A. 9th, 1940) 110 F. (2d) 574, 575, where the court noted that the governing agreement failed to state that liquidation was the primary purpose of the bondholders protective committee, and it held it taxable as a corporation. *Cf. United States v. Rayburn* (C. C. A. 8th, 1937) 91 F. (2d) 162, 167.

<sup>156</sup> *Helvering v. Washburn* (C. C. A. 8th, 1938) 99 F. (2d) 478; *Jackson v. United States*, *supra* note 155; *Paine v. United States* (D. Mass. 1940) 32 F. Supp. 672. *Cf. United States v. Davidson*, *supra* note 78.

<sup>157</sup> *United States v. Hill*, *supra* note 86; *Helvering v. Washburn*; *Paine v. United States*, both *supra* note 156.

<sup>158</sup> *Helvering v. Washburn*, *supra* note 156.

primary purpose of liquidation, the owner is not to be penalized for such activity. If, on the other hand, the purpose of liquidation be so obscured by the manifold business activities of the trust that the declared purpose can be said to be lost or abandoned, a very different case is presented."<sup>159</sup>

*Business-purpose test applied to oil producing enterprises.*

After it had become well established that a bona fide liquidating trust could not be an "association", an unsuccessful attempt was made to bring oil production enterprises within the protection of this doctrine.<sup>160</sup> Oil land had been conveyed to a trustee with authority to lease the land for oil production, to receive and sell its royalty share of the products, to sell the trust property and to make any agreements deemed for the best interests of the beneficiaries. The taxpayer argued that the trust was "merely liquidating its capital investment", since its sole business was the reduction of its oil to possession and selling it with a minimum of incidental activity. The court did not undertake to discuss or distinguish the liquidation cases, but abruptly rejected the taxpayer's argument with the declaration that, "To state the proposition is to refute it." The court held that the trust was engaged in business and that it was taxable as a corporation.<sup>161</sup>

In *Kettleman Hills Royalty Syndicate No. 1 v. Commissioner*<sup>162</sup> the only assets of the trust were certain "royalty rights contracts" under which the trust was entitled to receive royalty upon the production of oil from certain lands. Under these contracts the trustees had an option, to be exercised annually, to receive the royalty either in cash or in kind; but they had always elected to take the royalty in cash. Under the declaration of trust the trustees were authorized to drill wells and to buy and sell oil and gas, but they had never engaged in such activities. In holding the trust to be taxable as a corporation the court said, "It is our opinion that in making these successive decisions whether it will require the delivery of the royalty product in kind or in cash, the taxpayer is making a succession of business judg-

<sup>159</sup> *Broadway-Brompton Buildings Liquidation Trust v. Comm'r* (1936) 34 B. T. A. 1089, 1093.

<sup>160</sup> *United States v. Trust No. B. I. 35, Etc.* (C. C. A. 9th, 1939) 107 F. (2d) 22.

<sup>161</sup> The court might have pointed out that the most expeditious way to liquidate oil-bearing land is to sell the land with the oil in place rather than to arrange for the production and sale of the oil apart from the land. But *cf.* *Hugh MacRae Land Trust v. Comm'r* (1943) 1 T. C. 899, 903, where the court concluded that "The purpose of the owners was to dispose of the underlying coal through the instrumentality of a lease", and held the trust not to be taxable as a corporation.

<sup>162</sup> (C. C. A. 9th, 1940) 116 F. (2d) 382, *cert. den.*, (1941) 313 U.S. 582.

ments and 'is doing business' within the decision of *Morrissey v. Commissioner*, . . . though through the tax years in question it thought it better business to accept cash rather than the oil products."<sup>163</sup>

In *Helm & Smith Syndicate v. Commissioner*<sup>164</sup> a trust was held taxable as a corporation where the sole property of the trust was "an interest . . . in certain real properties having petroleum producing prospects", and the authority of the managing committee included "exclusive power to manage and control the property, . . . and to lease, including for oil and gas development purposes", and to sell or otherwise dispose of or encumber the property. The statement of facts set forth in the opinion does not indicate that the trustee was authorized to buy or lease any other oil land or to buy or sell petroleum products or to drill or operate wells. The court said that the trust's function "was not one of mere conservation of assets but of the usual leasing, selling and managing of petroleum properties of any of the oil owning and leasing corporations."<sup>165</sup>

Of course, whenever an unincorporated organization is authorized (or has actually undertaken) to drill or operate wells, either directly or through an agent or contractor, the courts have no difficulty in finding that the business-purpose test is satisfied.<sup>166</sup>

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<sup>163</sup> *Ibid.* at 383. *Cf.* *Comm'r v. Security-First Nat. Bank* (C. C. A. 9th, 1945) 148 F. (2d) 937. A distinction should be made between rights reserved in a lease and powers granted by a trust instrument. For example, a trustee might acquire an oil and gas lease (as lessor) reserving the right to take the royalty share of the product in kind, but the declaration of trust under which he operated might deny him the power or authority to take oil or gas in kind or to engage in the business of buying or selling petroleum products. The declaration of trust, rather than the lease, should be the measure of the trust's "business purpose".

<sup>164</sup> (C. C. A. 9th, 1943) 136 F. (2d) 440. *Cf.* *United States v. Rayburn*, *supra* note 155.

<sup>165</sup> *Ibid.* at 441. It seems the court might have concluded that the trust's function was even more closely related to the traditional activity of an ordinary testamentary trust which acquired oil land from the testator. See *infra* note 169, and accompanying text.

<sup>166</sup> *Helvering v. Combs*, *supra* note 36; *Little Four Oil & Gas Co. v. Lewellyn*, *supra* note 24; *Monrovia Oil Co. v. Comm'r*, *supra* note 110; *Thrash Lease Trust v. Comm'r*, *supra* note 13; *Nashville Trust Co. v. Cotros*, *supra* note 67; *Comm'r v. Fortney Oil Co.*, *supra* note 54; *Comm'r v. Nebo Oil Co. Trust* (C. C. A. 10th, 1942) 126 F. (2d) 148, *cert. den.*, (1942) 317 U.S. 636; *Second Carey Trust v. Helvering*, *supra* note 104; *Keating-Snyder Trust v. Comm'r*, *supra* note 13; *Adkins Properties v. Comm'r*, *supra* note 67. But *cf.* *Lucas v. Extension Oil Co.*, *supra* note 37, decided prior to the *Morrissey* case.

In the following oil production cases the courts held for the taxpayer on various grounds, but the courts did not deny that the business-purpose test was satisfied: *McKean*

In none of these oil production cases did any of the courts make any serious inquiry as to the authority or lack of authority that might be vested in an ordinary trustee in the absence of any express provision on the subject in the governing instrument.<sup>167</sup> What is the position of such a trustee when he is faced with the prospect of drilling for oil, or leasing land for oil production, or holding leased land and taking royalty either in cash or in kind?

It is clear that an ordinary trustee cannot properly engage in the business of drilling wells, nor can he purchase prospective oil land with the intention of developing production either directly or through a contractor or a lessee. Such activities or investments would undoubtedly be held improper in the absence of special authorization.<sup>168</sup> But it seems to be equally clear that there are many factual situations where a trustee may properly execute an oil lease, or hold land subject to such a lease, without special authority in the governing instrument.<sup>169</sup>

If the question is to be decided on the basis of the ordinary powers vested in a trustee by law, the cases applying the business-purpose test to oil production enterprises appear to be correctly decided (with one possible exception), although it may be concluded that some of the language in the opinions does not form a very satisfactory guide for the decision of future cases involving slightly different facts.

The possible exception is the *Helm & Smith Syndicate* case. On the basis of the facts stated in the opinion it is difficult to find anything in either the authority or activity of the trustee that transcends the authority that would be possessed by an ordinary trustee of a traditional testamentary trust. The opinion appears to be based upon an unreasonably narrow conception of the scope of an ordinary trust.

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v. Scofield, *supra* note 101; Comm'r v. Horseshoe L. Syndicate, *supra* note 13; Comm'r v. Rector & Davidson, *supra* note 100.

<sup>167</sup> Cf. *supra* pp. 492-494.

<sup>168</sup> See 2 SCOTT, TRUSTS (1939) §§ 227.3, 227.6.

<sup>169</sup> *Ibid.* § 189.7. In the following cases it was held that a trustee of a testamentary trust had authority to execute an oil lease: Layman v. Hodnett (1943) 205 Ark. 367, 168 S. W. (2d) 819; Heffelfinger v. Scott (1935) 142 Kan. 395, 47 P. (2d) 66; Franklin v. Margay Oil Corp. (1944) 194 Okl. 519, 153 P. (2d) 486. The only special authority vested in these trustees by the respective wills, and relied upon by the courts, was authority to sell or otherwise dispose of the testator's real estate, which certainly is not an unusual authority for an ordinary trustee to possess. 2 SCOTT, TRUSTS (1939) § 190. Undoubtedly none of the courts in these three cases had any idea that they were sanctioning an "adaptation of the trust mechanism" beyond the traditional function of an ordinary testamentary trust. Cf. *supra* note 140.



*Application of business-purpose test to real estate subdivision enterprises.*

In several of the real estate subdivision cases the argument has been advanced that the dominant purpose of the enterprise was liquidation and that it was therefore improper to classify it as a corporation. This argument has rarely been successful.

Four years before the *Morrissey* decision, a case arose which involved a typical subdivision trust, and where virtually the sole activity of the trust during the tax year in question was the collection of deferred installments on the purchase price of lots already sold and the promotion of sales of the remaining lots in the tract.<sup>170</sup> The taxpayer argued that during the year involved the trust was a mere liquidating organization. In rejecting this argument the court pointed out that the trust had been "organized for the purchase and sale of a tract of land which was to be improved for the purpose of rendering the land salable and augmenting the profits to be derived therefrom."<sup>171</sup> The court thought that this purpose went far beyond the legitimate scope of a mere liquidating trust and held the trust to be taxable as a corporation.

Likewise, subsequent to the *Morrissey* case it has been consistently held that an unincorporated organization satisfies the business-purpose test when it was organized to acquire, improve, subdivide and sell a tract of land.<sup>172</sup> In these cases the courts are not concerned with any attempt to differentiate the changing operations of the organization over a period of years. The organization's authority to acquire and improve land may be exhausted in the first year or two of its existence, and its remaining life may be devoted exclusively to the liquidation of the subdivided land, but it is nevertheless classified as a corporation throughout the whole term of its existence. Of course, this result is even clearer when the organization is not restricted in its powers to the acquisition of a single tract of land, but is authorized generally to acquire and develop any land selected by the managers of the enterprise at any time during the existence of the organization.<sup>173</sup>

<sup>170</sup> Trust No. 5833, *Security-First Nat. Bank v. Welch* (C. C. A. 9th, 1931) 54 F. (2d) 323, *cert. den.*, (1932) 286 U. S. 544.

<sup>171</sup> *Ibid.* at 329.

<sup>172</sup> *Comm'r v. Highlands E.-L. Subd.*, *supra* note 68; *Wellston Hills Syndicate Fund v. Comm'r*, *supra* note 111; *Del Mar Addition v. Comm'r* (C. C. A. 5th, 1940) 113 F. (2d) 410.

<sup>173</sup> *Morrissey v. Comm'r*, *supra* note 9; *Kilgallon v. Comm'r*, *supra* note 54. *Cf. infra* note 185, and accompanying text.

Two subdivision trusts have been held not to be "associations" upon the ground that there were no "associates" under the particular facts involved,<sup>174</sup> but in neither of these cases did the court deny that the business-purpose test was satisfied.

In *Girard Trust Co. v. Commissioner*<sup>175</sup> nine people inherited a tract of land from their parents. They wanted to sell the land but were advised that the only advantageous way to liquidate the property was to subdivide it. In accordance with this advice the interested parties conveyed the land to a trustee who was authorized "to manage, develop, improve . . . and convey" the land. Under this trust arrangement roads were completed, curbs, sewers and wiring installed, and a campaign was conducted to sell the subdivided lots. The board found that the business transacted was merely "an incident of the paramount process of liquidation",<sup>176</sup> and held that the trust was not taxable as a corporation.

In the liquidation cases the parties are the passive recipients of the property to be liquidated, or there is a very distinct hiatus between the enterprise of acquiring the property and the project of disposing of it, and any business activity to maintain or improve the property pending liquidation is entirely subservient to the dominant purpose of getting rid of the property;<sup>177</sup> but in the subdivision cases the purpose of the enterprise includes the acquisition of the property for the express purpose of improving it and selling it at a profit.<sup>178</sup>

*Business-purpose test applied to other real estate enterprises.*

Historically the most traditional and the most ordinary of trusts is a trust to hold real estate. In an ordinary real estate trust it is usually the duty of the trustee to make the land productive by leasing it even if the trust instrument contains no express provision on this subject.<sup>179</sup> Likewise, it is the duty of such a trustee to keep in repair

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<sup>174</sup> *Supra* note 52.

<sup>175</sup> (1936) 34 B. T. A. 1066. *Cf.* *Comm'r v. Morriss R. Co. Trust No. 2* (C. C. A. 7th, 1934) 68 F. (2d) 648.

<sup>176</sup> *Ibid.* at 1070.

<sup>177</sup> The passive acquisition of property for liquidation is closely analogous to the situation of the typical testamentary trustee who receives property from his testator to be converted into cash. See *supra* note 154.

<sup>178</sup> *Cf.* *Central Republic Bank & T. Co. v. Comm'r* (1936) 34 B. T. A. 391, where the real estate was bought and paid for several years before the subdivision trust was formally created, but the trust was held to be taxable as a corporation. Apparently the acquisition and subdivision were planned together as a single project notwithstanding the lapse of time between the two transactions.

<sup>179</sup> 2 SCOTT, TRUSTS (1939) § 189.

any buildings on the land held by the trust, to pay taxes, to prevent the foreclosure of a mortgage on the trust property, and to maintain reasonable insurance.<sup>180</sup> On the other hand, it is ordinarily improper for a trustee to buy real estate as a speculative investment or for resale, or to operate the land by farming it or by conducting a business on the premises without special authority in the governing instrument.<sup>181</sup> If the trust estate includes unimproved land which cannot be made productive except by the construction of a building, it is ordinarily the duty of the trustee to sell the land and invest the proceeds.<sup>182</sup> In the absence of special authority in the trust instrument, it may be improper for a trustee to construct a building on the land held by the trust.<sup>183</sup>

If our analysis of the proper nature of the business-purpose test is correct,<sup>184</sup> the general principles stated in the preceding paragraph should govern the application of the test to real estate trusts. The question in each case of this kind should be whether or not the special powers vested in the trustee are of such a nature that it can be said that the trust mechanism has been adapted to a business purpose beyond the traditional scope of an ordinary trust for the holding of real estate.

It has been held in many cases that where a trustee is authorized generally to deal in land or to improve or operate real estate, the trust satisfies the business-purpose test whether or not these powers are fully exercised by the trustee.<sup>185</sup>

In the business world there is a well-recognized distinction between leasing a business or apartment building to a single tenant, as compared with operating the building directly by handling all the details of the leasing of stalls, offices or apartments to the individual occupants and supplying the diverse services generally required by such

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<sup>180</sup> *Ibid.* § 176.

<sup>181</sup> *Ibid.* § 227.6.

<sup>182</sup> *Ibid.* § 181.

<sup>183</sup> *Ibid.* § 188.2.

<sup>184</sup> *Supra* pp. 492-494.

<sup>185</sup> *Morrissey v. Comm'r*; *Swanson v. Comm'r*; *Helvering v. Coleman-Gilbert*, all *supra* note 9; *Comm'r v. Vandegriff R. & Inv. Co.*, *supra* note 24; *United States v. Rayburn*, *supra* note 155; *Ross Lewis Trust v. Comm'r* (C. C. A. 10th, 1940) 110 F. (2d) 937; *Marshall's Heirs v. Comm'r*, *supra* note 24; *Sears v. Hassett*, *supra* note 86; *Porter v. Comm'r* (C. C. A. 9th, 1942) 130 F. (2d) 276; *Lombard Trustees v. Comm'r* (C. C. A. 9th, 1943) 136 F. (2d) 22. *Cf.* *Comm'r v. Gerstle* (C. C. A. 9th, 1938) 95 F. (2d) 587, where a real estate syndicate was held not to be an "association" because of lack of "corporate resemblance", but the court did not deny that the business-purpose test was satisfied.

tenants. The first type of transaction is a mere investment operation, while the second may often reach such proportions as to constitute an operating business. Therefore, it is not surprising to find that where a trustee is authorized to operate one or more business or apartment buildings it has been held that the trust satisfies the business-purpose test.<sup>186</sup>

In *Myers v. Commissioner*<sup>187</sup> the sole asset of the trust was a piece of real estate improved with an office building which was operated by the trustee. The court observed that the "only business transacted by the trust was the keeping of the building in a tenantable condition and the collection of rents for the use of the owners of the beneficial interests." On this basis the court concluded: "We think it reasonably clear on the facts stated that the purpose of this trust was not the operation of a business enterprise."<sup>188</sup> The foregoing language quoted from the opinion seems entirely consistent with the correct analysis of the business-purpose test, but it also seems to involve an unusually narrow interpretation of the facts recited in the opinion. Not only was the trustee actually operating an office building, but the trust instrument authorized him to "manage, improve . . . and dispose of said property", and provided that "In the control, management and disposition of said trust estate, the Trustees shall not be limited to the usual powers of trustees, but said Trustees shall have the same and as absolute powers as if they were the absolute owners of said trust estate . . . ."<sup>189</sup>

In *Cleveland Trust Co. v. Commissioner*<sup>190</sup> improved real estate subject to a ninety-nine year lease was conveyed to a trustee under a declaration of trust which authorized the trustee "to sell, lease,

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<sup>186</sup> In *Helvering v. Coleman-Gilbert*, *supra* note 9, although the trustees were authorized to do other things, their actual activity had been restricted to the owning and operating of apartment houses. The Court said that the trustees were "actually engaged . . . in carrying on an extensive business for profit." (296 U.S. at 373.) See also *Swanson v. Comm'r*, *supra* note 9.

In *Solomon v. Comm'r*, *supra* note 36, the trustee owned and rented five multiple-storied "mercantile buildings". In holding the trust taxable as a corporation the court said: "It does not appear how many tenants there are, but the facts found indicate that an extensive and profitable business is conducted which requires constant attention." (*Ibid.* at 571.) To the same effect is *Jackson v. United States*, *supra* note 155, where the trustee operated a central wholesale market which involved renting more than one hundred stalls, over half of which were occupied by tenants on a day-to-day basis.

<sup>187</sup> *Supra* note 13.

<sup>188</sup> *Ibid.* at 89.

<sup>189</sup> *Ibid.* at 88.

<sup>190</sup> *Supra* note 33.

manage, operate or dispose of the premises, as it judged to be to the best interests of" the beneficiaries. In the event of the sale of the property the trustee had no authority to reinvest, but was to distribute the proceeds of the sale to the beneficiaries. After a few years the lessee became insolvent. The trustee negotiated a new lease under which the old building was demolished, a new building was constructed, and the trustee paid \$25,000 of the cost of the new building. The court observed that "The mere receipt of income from leased property and its distribution to cestuis que trustent amounts to no more than receiving the ordinary fruits that arise from the ownership of property and does not constitute doing business." The court concluded that "The trust here in question was not carrying on a business, but was conceived for investment purposes", and held that it was not taxable as a corporation. Here again, although no fault can be found with the court's statement of the law, it seems that the court was unusually generous with the taxpayer in the interpretation of the facts. Undoubtedly some courts would have held that the authority to operate the property and the actual activity of investing \$25,000 in the construction of a new building was sufficient to satisfy the business-purpose test.<sup>191</sup>

The taxpayer was not as fortunate in the case of *Title Insurance & Trust Co. v. Commissioner*.<sup>192</sup> There the sole asset of the trust was real estate improved with a twelve-story office and store building which was subject to a ninety-eight and one-half year lease which had already been negotiated before the declaration of trust was signed. The lease was executed by the trustee at or about the same time as the execution of the declaration of trust. The trust agreement provided that if the contemplated lease should expire or be terminated "the trustee may take such steps as in its opinion may be necessary and proper for the best interest of certificate holders with respect to leasing, operating, selling, conveying or otherwise disposing of the trust property." In the event of a sale of the property it was apparently the duty of the trustee to distribute the money to the beneficiaries and not to reinvest the funds. The court said: "As disclosed by the trust agreement, its purpose was to carry on the business of owning, managing, leasing and selling real property . . . Hence, this was not, as in *Crocker v. Malley*, a mere trust for the receipt and distribution of income, but was, we think, a business trust and properly classifi-

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<sup>191</sup> Cf. *Sherman v. Comm'r* (C. C. A. 6th, 1944) 146 F. (2d) 219.

<sup>192</sup> (C. C. A. 9th, 1938) 100 F. (2d) 482. Cf. *Sherman v. Comm'r*, *supra* note 191;

able as an association.”<sup>193</sup> It would seem that the decision should have gone the other way if the trust instrument had not given the trustee such broad authority to operate the property in the event of the termination of the lease.

In the second *Sears v. Hassett*<sup>194</sup> case the sole asset of the trust was improved real estate which was subject to a lease which, in the words of the court, required the lessee “to pay taxes and assume all burdens, obligations and risks which the law casts on owners of real estate.” The trust was to terminate when the lease terminated. The trustee had no specific authority to rebuild damaged structures, to make leases, to acquire property or make investments or transact any other business. The court said, “In my opinion the case for the taxpayers is so plain that discussion is unnecessary and would be ostentatious.”<sup>195</sup>

To create a real estate trust which will not satisfy the business-purpose test, the task of the draftsman of the declaration of trust appears to be to steer a sound course between the second *Sears v. Hassett* case and the case of *Title Insurance & Trust Co. v. Commissioner*.

*Business-purpose test applied to stock and bond enterprises.*

Although the trust mechanism was originally developed primarily in respect to land, we are told that “The typical trust to-day is a trust of which the subject matter is income-producing securities.”<sup>196</sup> Therefore, a properly designed stock and bond trust should be just as “traditional” and “ordinary” as any other. In the ordinary trust the general investment policy which governs the trustee may be briefly tabulated as follows:<sup>197</sup>

- (1) A trustee must exercise care, skill and caution.
- (2) The primary purpose must be to preserve the trust estate while receiving a reasonable income, rather than to take risks to increase principal or income.
- (3) A trustee cannot properly purchase securities on margin.
- (4) A trustee cannot properly purchase securities of a speculative nature or securities in a new or untried enterprise.

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Codman v. United States (D. Mass. 1939) 30 F. Supp. 732.

<sup>193</sup> *Ibid.* at 485.

<sup>194</sup> (D. Mass. 1942) 45 F. Supp. 772. *Cf.* *Sears v. Hassett*, *supra* note 86. See *supra* p. 495.

<sup>195</sup> *Ibid.* at 773.

<sup>196</sup> 1 SCOTT, TRUSTS (1939) § 1.7.

<sup>197</sup> See 2 *ibid.* §§ 227, 227.3, 227.6, 231.

(5) It is the duty of a trustee to dispose of investments which become improper, and he should sell securities which have risen in value to a point where it is likely that a fall in value will occur.

Since these are the rules that govern an ordinary trust, it is proper to conclude that when the trust instrument authorizes the trustee to speculate in securities without regard to any of the usual restrictions on trust investments, the trust mechanism has thereby been adapted to a business purpose.<sup>198</sup>

Although the provisions of the governing instrument are usually of primary importance in these cases, the courts sometimes interpret the trustee's powers by reference to his actual activities. In this connection the courts are principally interested in whether or not the volume and frequency of purchases and sales of securities indicate that the trustee has been trying to make a profit from short-term market rises instead of contenting himself with the collection of dividends or interest on long-term conservative investments.

In *Commissioner v. Chase National Bank*<sup>199</sup> the trustee was absolutely restricted in his investments to the common stocks of a list of thirty specified American corporations. The only way in which the trustee could make any change in the investment portfolio was, in the words of the court, "... by weeding out whatever became unsound for investment and retaining the remainder."<sup>200</sup> Although no mention of the point is made, it seems quite certain that the original portfolio of thirty common stocks contained securities which would not be legal investments for trustees in many states. However, except for this one feature, the terms of the trust instrument effectively restrained the trustee within the limits of the investment policy prescribed for trustees of an "ordinary" trust. With one judge dissent-

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<sup>198</sup> *Brooklyn Trust Co. v. Comm'r*, *supra* note 51; *Bert v. Helvering*, *supra* note 24; *United States v. Hill*, *supra* note 86. *Cf.* *Comm'r v. N. B. Whitcomb Coca-Cola Syndicate*, *supra* note 24, where a stock syndicate was held not to be an "association" because of lack of "corporate resemblance", but the court apparently believed that the business-purpose test was satisfied.

In some of these cases there may be room for doubt as to whether or not the court correctly interpreted the authority of the trustee under the governing instrument. See 2 SCOTT, TRUSTS (1939) § 227.14.

<sup>199</sup> (C. C. A. 2d, 1941) 122 F. (2d) 540. Closely similar cases are: *Pennsylvania Co. Etc. v. United States* (C. C. A. 3d, 1944) 146 F. (2d) 392; *Comm'r v. Buckley* (C. C. A. 9th, 1942) 128 F. (2d) 124.

<sup>200</sup> *Ibid.* at 543. *Cf.* *Equitable Trust Co. v. Magruder*, *supra* note 105, where the trustee had no discretionary powers whatever, and it was held that there was no joint enterprise.

ing, it was held that the trust did not satisfy the business-purpose test and was not taxable as a corporation.

The opposite result was reached on closely similar facts in *Commissioner v. City National Bank & Trust Company*.<sup>201</sup> In this case the trustee had a somewhat wider discretion as to when to eliminate a security from the portfolio, but the trustee's discretion was still strictly limited to the weeding out of whatever became unsound for investment and retaining and reinvesting in the remaining issues on the original approved list of securities.

In *Commissioner v. North American Bond Trust*<sup>202</sup> the trustee had discretion to vary the securities in the portfolio, but the only securities which the trustee might purchase were obligations of (or guaranteed by) the United States, obligations of Canada or a province thereof, obligations of corporations which have earnings bearing a specified relation to fixed charges, or railroad equipment trust certificates.<sup>203</sup> Without making any serious attempt to compare this trustee's "business powers" with the authority vested in an ordinary trustee by law, the court held (with one judge dissenting) that the trust satisfied the business-purpose test and was taxable as a corporation.<sup>204</sup>

The foregoing cases go a long way toward establishing a rule that whenever a trustee has authority to vary his investment portfolio the trust satisfies the business-purpose test.<sup>205</sup> The opinions in these cases exhibit no substantial interest in the question of whether or not the powers of the trustee exceed those enjoyed by an ordinary trustee as a matter of law in the absence of any special authority under the declaration of trust. In the investment trust cases the courts seem to have been so impressed with the size of the enterprise and the number of participants, that they have completely lost sight of

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<sup>201</sup> (C. C. A. 10th, 1944) 142 F. (2d) 771, *cert. den.*, (1944) 323 U.S. 764. *Cf.* *Hamilton Depositors Corp. v. Nicholas* (C. C. A. 10th, 1940) 111 F. (2d) 385.

<sup>202</sup> *Supra* note 54.

<sup>203</sup> See dissenting opinion, 122 F. (2d) at 548.

<sup>204</sup> *Cf.* *Pennsylvania Co. Etc. v. United States* (C. C. A. 3d, 1943) 138 F. (2d) 869, *cert. den.*, (1944) 321 U.S. 788; *Continental Bank & Trust Co. v. United States* (S. D. N. Y. 1937) 19 F. Supp. 15.

<sup>205</sup> See T. D. 5468, 1945-16 C. B. 15, amending U. S. Treas. Reg. 111, § 29.3797-2. The court in the third circuit seems to have deduced a corollary to the effect that so long as a syndicate portfolio is restricted to the stock of a single company it cannot satisfy the business-purpose test, no matter how speculative its operations may be. See *Comm'r v. United States & Foreign S. Corp.*, *supra* note 24. But *cf.* *Bert v. Helvering*, *supra* note 24.



the fact that the most ordinary and traditional trusts contemplate, and even require, something less than complete rigidity in the investment portfolio.

Under these decisions it seems that there is only one thing that saves hundreds of the strictest and purest of trusts from taxation as corporations. That one thing is the good judgment of the Commissioner of Internal Revenue in exercising a healthy self-restraint when selecting his victims. If the Commissioner should go too far afield in this connection, it may be expected that the courts will find some way to stop him; but no logical restraint can be offered by the courts without disregarding a number of prior decisions.

What should the rule be in respect to stock and bond enterprises? What special business powers must be vested in the trustee before the courts are justified in holding that the trust has been adapted to a business purpose?

In many of our states the law limits trustees, in the selection of investments, to a very narrow class of securities in the absence of contrary provisions in the governing instrument. In carefully drawn trust instruments it may now be the rule, rather than the exception, to provide that the trustee shall have somewhat more latitude in the selection of investments than is ordinarily permitted by the applicable state law. A reasonable expansion of the trustee's discretion in the selection of investments should not be sufficient to transform the arrangement into a "business trust". But in order to avoid the possibility of classification as a corporation, the trust instrument should make it indisputably clear that it is the duty of the trustee to seek a reasonable income from dividends and interest, and not to try to make a business profit by his skill in buying and selling speculative stocks and bonds.

*Miscellaneous decisions concerning the business-purpose test.*

In the foregoing pages attention has been directed to the decisions which have been instrumental in making the business-purpose test what it is today. The principal problems have arisen where the taxpayer has advanced the claim that his unincorporated organization was limited to the liquidation of property, or to holding land or securities and collecting the usual income to be derived from such property. In other cases, where the organization has been engaged in an obvious business operation, there has been no problem concerning the business-purpose test.<sup>206</sup>

<sup>206</sup> Pelton v. Comm'r (C. C. A. 7th, 1936) 82 F. (2d) 473 (medical clinic); Whole-

## THE THIRD BASIC TEST: SUBSTANTIAL RESEMBLANCE TO A CORPORATION

The principal parts of the discussion of the corporate-resemblance test in the *Morrissey* case are quoted below:

"The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts. . . . While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive . . . ."<sup>207</sup>

"What, then, are the salient features of a trust—when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains—which may be regarded as making it analogous to a corporate organization? A corporation, as an entity, holds the title to the property embarked in the corporate undertaking. Trustees, as a continuing body with provision for succession, may afford a corresponding advantage during the existence of the trust. Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation. The designation of trustees, who are charged with the conduct of an enterprise,—who act 'in much the same manner as directors'—may provide a similar scheme, with corresponding effectiveness . . . . An enterprise carried on by means of a trust may be secure from termination or interruption by the death of owners of beneficial interests and in this respect their interests are distinguished from those of partners and are akin to the interests of members of a corporation. And the trust type of organization facilitates, as does corporation organization, the transfer of beneficial interests without affecting the continuity of the enterprise, and also the introduction of large numbers of participants. The trust method also permits the limitation of the personal liability of participants to the property embarked in the undertaking."<sup>208</sup>

In dealing with the corporate-resemblance test the courts have generally taken full advantage of the admonition in the *Morrissey* case that "it is impossible in the nature of things to translate the statutory

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salers Adjustment Co. v. Comm'r (C. C. A. 8th, 1937) 88 F. (2d) 156 (collection agency); Fidelity-Bankers Trust Co. v. Helvering, *supra* note 24 (lending money); Nat'l Met. Bank v. Comm'r (C. C. A. 4th, 1944) 145 F. (2d) 649 (candy business, but after a specified period the trust was to be devoted to charity); Poplar Bluff Printing Co. v. Comm'r (C. C. A. 8th, 1945) 149 F. (2d) 1016 (printing and publishing); Fletcher v. Clark (C. C. A. 10th, 1945) 150 F. (2d) 239, *cert. den.*, (1945) ..... U.S. ...., 66 S. Ct. 144 (managing mining claims); Titus v. United States, *supra* note 56 (broad business power).

<sup>207</sup> 296 U.S. at 357.

<sup>208</sup> *Ibid.* at 359.

concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create."<sup>209</sup> The courts have studiously avoided any tendency to reduce the corporate-resemblance test to an exact formula either in respect to the precise ingredients of the five "salient features" of corporate resemblance, or in respect to the combination of these salient features which may be sufficient to require that the organization be classified as either a corporation, trust or partnership. Nevertheless, it is both possible and instructive to analyze each of the five salient features of corporate resemblance as they have been developed in the decisions subsequent to the *Morrissey* case.

*Title vested in a single entity.*

Mr. Flagg, in an article written a short time prior to the decision of the *Morrissey* case, has forcefully declared that the status of an "association" is not at all dependent upon "the existence of a recognized separate personality", and that it does not matter whether or not "such organizations are technically distinct persons or entities."<sup>210</sup> Taxpayers who seek a method of doing business in some kind of organized capacity do not seek to establish a separate legal personality as an end in itself. They are interested in the functional attributes which may accompany the establishment of a technical legal entity, but if they can obtain the benefit of most of those attributes while falling short of the creation of a new legal person, they are usually well satisfied with the arrangement.

In the great majority of the association cases which have reached the appellate courts the legal title to the property embarked in the enterprise has been vested in one or more trustees of a single trust. This is the typical case of full compliance with the attribute of title vested in a single entity. With very few exceptions, the courts have paid no attention whatever to highly technical distinctions concerning the nature of the equitable property rights of the beneficiaries of the enterprise.<sup>211</sup>

In *McKean v. Scofield*<sup>212</sup> five persons owned certain property as tenants in common. Each tenant in common decided to create a trust for the benefit of himself and his descendants, and for that purpose

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<sup>209</sup> *Supra* note 12.

<sup>210</sup> Flagg, *op. cit. supra* note 8, at 590.

<sup>211</sup> *Cf. supra* note 14.

<sup>212</sup> *Supra* note 101.

each tenant in common conveyed his undivided interest in the property to trustees, thereby creating five separate trusts, each for the benefit of five different groups of beneficiaries. But all five of the tenants in common happened to select the same persons as trustees, with the result that a single group of three persons, acting as trustees of the five separate trusts, was in control of all the undivided interests in the property in question. In holding that there was no "association", a majority of the court said, "But we think that so long as each owner kept his interest separate, and for the use of his own chosen beneficiaries, *with no compulsory cooperation with the others*, there arose among the several trusts nothing so like a corporation that it could be held an association taxable as a corporation."<sup>213</sup>

A strong dissent was filed in the *McKean* case by Circuit Judge Holmes in which he said, "Unity of a fee-simple title in the trustees is not indispensable where there is unity of use, control, possession, management, and operation for a definite time, with consequent unity of income and expenses for the taxable year."<sup>214</sup> Judge Holmes' dissent serves to emphasize the fact that the majority opinion was not based solely upon the technical arrangement of the legal title to the property. The decision by the majority was based primarily upon its conclusion that there was "no compulsory cooperation" among the several trusts.

In *Commissioner v. Gerstle*<sup>215</sup> the managers of a real estate syndicate were authorized to hold the title to the syndicate's property in any way they thought best. What they actually did was to take title to the real estate in the name of one or the other of two title companies, primarily to conceal the identity of the real purchasers of the property. The court held that the syndicate was not taxable as a corporation, but the opinion makes it clear that this rather unconventional method of holding title to the property had little influence on the decision of the case.

In the fifth circuit there are several cases where the court was of the opinion that the property embarked in the enterprise was vested in the alleged associates as tenants in common, and on a consideration of all the facts the court held that no "association" had been cre-

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<sup>213</sup> *Ibid.* at 766. (Italics added.)

<sup>214</sup> *Ibid.* at 767.

<sup>215</sup> *Supra* note 185.

ated.<sup>216</sup> On the other hand, in *Commissioner v. Fortney Oil Co.*,<sup>217</sup> in the sixth circuit, the associates were tenants in common of real estate, and the enterprise was held to be taxable as a corporation. No legal or equitable title was centralized in any single entity, but certain management contracts executed by all the tenants in common supplied all the other four salient attributes of corporate resemblance, and on this ground the court held that an "association" had been created.

If the *Fortney* case was correctly decided, it must be concluded that the mere absence of title vested in a single entity is not in itself a controlling factor, but it is important only in relation to the facts concerning the other attributes of corporate resemblance.

#### *Centralized management.*

In a corporation centralized management is exercised by a board of directors elected by the stockholders at specified intervals of time. But since *Hecht v. Malley* there have been many cases where an unincorporated organization has been classified as a corporation although the beneficial owners had no right to select or remove the managers.<sup>218</sup>

The board of directors is a fundamental and essential part of all business corporations. None of our larger corporations could function properly without at least some equivalent technique for separating the detailed management of the corporation from the beneficial ownership of the enterprise. Even in closely held corporations with few stockholders, the separation of the power and responsibility of management from the beneficial ownership has many obvious advantages.

The fundamental characteristic of a board of directors is that it has a status and identity separate from that of the beneficial owners of the corporation, and it controls the enterprise in a representative capacity. This representative capacity of a board of directors—as contrasted with the direct action of stockholders in their capacity as the actual beneficial owners of the enterprise—has been well recognized as an important element in the concept of "centralized management".

In the *Morrissey* case the Supreme Court said: "Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation. The desig-

<sup>216</sup> *Comm'r v. N. B. Whitcomb Coca-Cola Syndicate*, *supra* note 24; *Mobile Bar Pilots Ass'n v. Comm'r* (C. C. A. 5th, 1938) 97 F. (2d) 695; *Comm'r v. Horseshoe L. Syndicate*, *supra* note 13; *Comm'r v. Rector & Davidson*, *supra* note 100.

<sup>217</sup> *Supra* note 54.

<sup>218</sup> *Supra* note 24.

nation of trustees, who are charged with the conduct of an enterprise,—who act ‘in much the same manner as directors’—may provide a similar scheme, with corresponding effectiveness.”<sup>219</sup> In the *Coleman-Gilbert* case the Court said further: “The significant resemblance to the action of directors does not lie in the formalities of meetings or records but in the fact that, by virtue of the agreement for the conduct of the business of a joint enterprise, the parties have secured the centralized management of their undertaking through designated representatives.”<sup>220</sup> This concept of centralized management *through representatives* is also emphasized by the present regulations of the treasury department which tell us that the affairs of an association, “like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity.”<sup>221</sup>

Typical compliance with the attribute of “centralized management” is achieved where one or more persons acting in a representative capacity, rather than directly as beneficial owners, have authority to exercise a reasonably wide discretion in the management and control of the joint enterprise. However, the adjudicated cases present many factual variations.

The typical business corporation is generally required by state law to provide for a board of not less than three directors. But in many cases an unincorporated organization has been classified as a corporation where centralized management of its affairs was exercised by a single trustee or managing agent.<sup>222</sup>

A typical arrangement in the investment trust cases divides the managerial authority between a trustee and a sales agent, but this has never been held to be incompatible with a finding of “centralized management”. Thus, in *Hamilton Depositors Corporation v. Nicholas*,<sup>223</sup> where a trust was held taxable as a corporation, the court said: “The fact that management is shared between the trustee and the corporation does not destroy continuity or centralization of management.”

Centralized management may exist although the association owns

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<sup>219</sup> 296 U. S. at 359.

<sup>220</sup> *Ibid.* at 373.

<sup>221</sup> U. S. Treas. Reg. 111, § 29.3797-2. *Cf. ibid.* §§ 29.3797-4, 29.3797-5.

<sup>222</sup> See, e.g., *Brooklyn Trust Co. v. Comm'r*, *supra* note 51; *Title Ins. & Trust Co. v. Comm'r* (C. C. A. 9th, 1938) 100 F. (2d) 482; *Marshall's Heirs v. Comm'r*, *supra* note 24; *Comm'r v. Nebo Oil Co. Trust*, *supra* note 166; *Keating-Snyder Trust v. Comm'r*, *supra* note 13.

<sup>223</sup> *Supra* note 201, at 387. *Cf. Comm'r v. North American Bond Trust*, *supra* note 54; *Pennsylvania Co. Etc. v. United States*, *supra* note 204.

only an undivided one-third interest in an oil lease.<sup>224</sup> In such a case the unified management of the whole enterprise conducted under the lease may depend on direct participation and voluntary cooperation of the other part-owners who are not members of the association. Nevertheless, centralized management may exist in respect to the one-third interest owned by the association.

It seems to be possible for the governing instrument to restrict the authority and discretion of the manager within such narrow limits as to leave no room for "management" of any kind. The authority of the organization may be limited to mere clerical administration and there can scarcely be said to be any business management at all within the proper meaning of the word. The decisions have not clearly analyzed "centralized management" in those terms, but there is at least a hint of the idea in some of the cases.<sup>225</sup> On the other hand, centralized management has been found to exist in several cases where substantial restraint was placed upon the discretion of the management in the conduct of the enterprise.<sup>226</sup>

A trust has been classified as a corporation when all the beneficiaries were also trustees.<sup>227</sup> But in this case the parties retained their two separate capacities, as trustees and beneficiaries, and the unity might have been destroyed at any time by transfers of beneficial interests.

It is not unusual for a trust agreement to contain a provision that the beneficiaries may advise the trustee in regard to the management of the enterprise, but that such advice shall not be binding. Such arrangements seem to be immaterial so far as the attribute of centralized management is concerned.<sup>228</sup> However, the situation may be entirely different when the beneficiaries have authority to control the action of the trustees.

<sup>224</sup> See cases cited *supra* note 67.

<sup>225</sup> Facts of this nature are frequently discussed by the courts with reference to the business-purpose test. *Cf. Lewis & Co. v. Comm'r* (1937) 301 U.S. 385, 388-9, where the Court observed that the managing agent's powers were "definitely fixed in advance of their exercise", and the Court concluded on all the facts that there was "no essential characteristic of corporate control." See comment on the Lewis case in *Fletcher v. Clark*, *supra* note 206.

<sup>226</sup> See cases cited *supra* notes 201, 202 and 204, and *infra* notes 233 and 235.

<sup>227</sup> *Helvering v. Coleman-Gilbert*, *supra* note 9.

<sup>228</sup> See, e.g., *Morrissey v. Comm'r*, *supra* note 9; *Title Ins. & T. Co. v. Comm'r*, *supra* note 222; *Porter v. Comm'r*, *supra* note 185, at 278; *Adkins Properties v. Comm'r*, *supra* note 67. *Cf. Comm'r v. Gerstle*, *supra* note 185; *Comm'r v. Nebo Oil Co. Trust*, *supra* note 166.

In *Commissioner v. Gerstle*<sup>229</sup> the governing agreements provided for centralized management by three syndicate managers. Because of an unanticipated drop in land values, the original plan of the enterprise had to be abandoned, and thenceforth by common consent all the syndicate members participated directly in the decision of all business questions of importance. The court held that the syndicates could not be classified as a corporation, but the majority opinion seems to indicate the view that centralized management existed on the theory that the terms of the written agreement controlled. But Judge Denman concurred specially upon the ground that "whatever may be the form of the syndicate agreements, they did not control after the frustration of the plan for immediate resale and the transactions under which the losses were sustained were conducted in a manner of direct participancy of the taxpayers." In a subsequent opinion the same court explained the *Gerstle* decision upon the ground that the syndicates lacked "a governing directorate with the usual managerial functions."<sup>230</sup>

In *Commissioner v. Gibbs-Preyer Trusts*<sup>231</sup> the owners of two-thirds of the beneficial interest could control the trustee in all matters, and this seems to have influenced the court substantially in reaching the conclusion that there was no centralized management and that the trust was not taxable as a corporation; but the court was also of the opinion that the trustee's managerial powers were largely suspended by a contemporaneous oral agreement among the parties.

Under varying facts, the Board of Tax Appeals has held that substantial, direct control of detailed business affairs by the beneficial owners of the enterprise was sufficient to defeat the attribute of centralized management.<sup>232</sup>

A syndicate was held to be taxable as a corporation notwithstanding the fact that the trustee was bound to follow any written direc-

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<sup>229</sup> *Supra* note 185, at 590.

<sup>230</sup> *Helm & Smith Syndicate v. Comm'r* (C. C. A. 9th, 1943) 136 F. (2d) 440, 441.

<sup>231</sup> *Supra* note 13. *Cf. Fidelity-Bankers Trust Co. v. Helvering*, *supra* note 24 (particularly at 20, n. 21), where under the syndicate agreement the trustee had broad powers "acting with approval of a majority of syndicate owners"; but the owners elected an executive committee of five which exercised their managerial powers in a representative capacity for all the owners. The court found that centralized management had been achieved.

<sup>232</sup> *George Bros. & Co. v. Comm'r* (1940) 41 B. T. A. 287; *Cooperative Power Plant v. Comm'r* (1940) 41 B. T. A. 1143; *P-H Group v. Comm'r* (1941) 43 B. T. A. 1041. But *cf. Royal Palm Cemetery Syndicate v. Comm'r* (1941) 45 B. T. A. 138.



tions signed by a majority of the beneficial owners of the syndicate.<sup>233</sup> If the beneficiaries gave no such directions, the trustee had a broad discretion to manage the enterprise in accordance with his own judgment. The court said, "There was absent in their scheme the mutual agency of a partnership, and they enjoyed the advantages of centralized control . . . ."<sup>234</sup>

A different type of limited control by the beneficiaries was provided for in *Sherman v. Commissioner*.<sup>235</sup> The consent of the owners of three-fourths of the beneficial interest was required before the trustee could execute a lease for a term in excess of ten years, or modify any existing lease or erect any new buildings; but in other matters the trustee was empowered to manage the trust estate without any control by the beneficiaries. The court did not seem to think that this arrangement detracted materially from the attribute of centralized management, and it held that the trust was properly classified as a corporation.

In *Glensder Textile Co. v. Commissioner*<sup>236</sup> the Board of Tax Appeals was called upon to classify a limited partnership organized under the Uniform Limited Partnership Act of New York. The general partners had made a substantial investment in the enterprise, and to that extent they were part-owners; and there were several limited partners who had invested money but had no control over the business. The general partners operated the business under the mutual agency rule of partnerships, rather than in the manner of a board of directors. The Board of Tax Appeals made the following comment:

"There was centralized control by the general partners, but this fact did not make them analogous to directors of a corporation. They were acting in their own interest as hitherto, which constituted five-twelfths of the partnership, and not merely in a representative capacity for a body of persons having a limited investment and a limited liability."<sup>237</sup>

The foregoing quotation seems to confine the idea of representative management within unreasonably narrow limits. It is difficult to see why any significance should be attached to the fact that the

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<sup>233</sup> *Bert v. Helvering*, *supra* note 24. *Cf. Comm'r v. Highlands E.-L. Subd.*, *supra* note 68, at 356, where the "trustee was to deal with the property only on written direction of the Realty Company or of the beneficiaries."

<sup>234</sup> 92 F. (2d) at 495.

<sup>235</sup> *Supra* note 191. *Cf. Marshall's Heirs v. Comm'r*, *supra* note 24, at 937.

<sup>236</sup> (1942) 46 B. T. A. 176.

<sup>237</sup> *Ibid.* at 185.

managers of the enterprise owned an interest in the business. In many cases either the local law or the articles of incorporation require directors to own stock in the corporation. They still operate in a manner distinctly different from democratic management by all the owners, and they act largely in a representative capacity. Many trusts have been classified as corporations although the trustees owned a substantial beneficial interest in the enterprise, and in these cases the courts had no doubt that the attribute of centralized management was present.<sup>238</sup>

The mutual agency of all the beneficial owners, as in the case of an ordinary common-law partnership, is manifestly incompatible with the concept of centralized management.<sup>239</sup> Undoubtedly it is to avoid just that kind of arrangement that many corporations are created. Likewise, direct control of any considerable part of the details of management by the majority vote of all the beneficial owners is substantially and realistically different from the "centralized management" described in the *Morrissey* and *Coleman-Gilbert* cases.

### *Continuity.*

The opinion in the *Morrissey* case refers to "trustees, as a continuing body with provision for succession", and it also observes that "an enterprise carried on by means of a trust may be secure from termination or interruption by the death of owners of beneficial interests and in this respect their interests are distinguished from those of partners and are akin to the interests of members of a corporation."<sup>240</sup>

An unconstrained continuity, which is wholly dependent on the habitual voluntary cooperation of the associates, is not very significant. The organized continuity which people seek to establish for the conduct of a business involves a reasonable certainty of duration supported by enforceable rights and obligations.

Reference has already been made to *McKean v. Scofield* where five tenants in common created five separate trusts, naming the same

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<sup>238</sup> *Helvering v. Coleman-Gilbert*, *supra* note 9; *Pelton v. Comm'r*, *supra* note 206; *Comm'r v. Nebo Oil Co. Trust*, *supra* note 166; *Keating-Synder Trust v. Comm'r*, *supra* note 13.

<sup>239</sup> See *Poplar Bluff Printing Co. v. Comm'r*, *supra* note 206, at 1019.

<sup>240</sup> *Supra* note 208. Of course, the typical provision that a trust shall terminate upon the death of the last survivor, often inserted with an eye on the rule against perpetuities, is not the kind of "interruption by death" referred to in the *Morrissey* case. The reference is to the interruption by the death of any participant, as in the case of the common-law partnership.

three persons as trustees of each of the five trusts, and thereupon the three trustees proceeded to manage the property as a single unit just as if there had been only one trust. The court said:

"If five individuals owning each an undivided interest in property cooperate voluntarily in its management, no taxable association results. If they each employ the same agent to manage it the same thing is true. If each conveys his interest in trust for himself and his children only, and not for the other owners, the case is not altered . . . . They may have thought and purposed that a harmonious cooperation would be achieved by selecting the same trustees and giving them the same powers. But we think that so long as each owner kept his interest separate, and for the use of his own chosen beneficiaries, with no compulsory cooperation with the others, there arose among the several trusts nothing so like a corporation that it could be held an association taxable as a corporation."<sup>241</sup>

When the existence of the organization depends upon the maintenance of a simple agency relationship, there may be room for doubt as to whether or not adequate compulsory continuity can be provided in view of the well-known rules concerning the terminability of agencies.<sup>242</sup>

In the great majority of the decided cases the courts inquire as to what arrangements have been made to replace the managers of the enterprise if the original incumbents should die, become incapacitated, or resign; and in most cases they find that the governing instrument has supplied a convenient method for the selection of successors. The most troublesome arrangement for taking care of such a contingency seems to be that set forth in *Helvering v. Washburn*<sup>243</sup> where it was provided that the owners of three-fourths of the beneficial interest should petition the county court for the appointment of a successor trustee. This kind of procedure for the appointment of a successor trustee would seem to be available, without any special agreement, in all jurisdictions which follow the familiar rule that a trust will not be allowed to fail for lack of a competent trustee. In the *Washburn* case the court did not seem to think that this cumbersome procedure detracted from the continuity of the enterprise, but it was held not to be taxable as a corporation because the court concluded that the organization did not satisfy the business-purpose test.

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<sup>241</sup> (C. C. A. 5th, 1940) 108 F. (2d) 764, 766.

<sup>242</sup> Cf. cases cited *supra* notes 100, 101 and 102.

<sup>243</sup> *Supra* note 156.

The usual business corporation can be dissolved by the vote of a majority of its stockholders. A similar provision in respect to an unincorporated association is not repugnant to the idea of continuity.<sup>244</sup> There are several cases where the organization could be dissolved at any time by the trustees (but not by any beneficiary), and the court seemed to think that such an arrangement had no great significance in determining whether or not the organization should be classified as a corporation.<sup>245</sup>

There are two cases where the sole asset of the trust was a single parcel of real estate subject to a lease which gave the lessee an option to purchase for a stated price at any time, and apparently the trust was to be terminated if the lessee exercised the purchase-option. Thus a third party, not a member of the association, had power to terminate the organization by purchasing the property. In each case the court seemed to think there was adequate continuity.<sup>246</sup>

In some of the investment trust cases any beneficial owner had the right to withdraw his money at any time, without affecting the continuity of the arrangement in regard to the other members of the enterprise; but the courts did not seem to think that this fact had any significance.<sup>247</sup> In these investment trust cases the assets of the enterprise consisted entirely of marketable securities, and the partition and liquidation of the interest of a few members of the organization was no threat to the enterprise as a whole.<sup>248</sup> But if the sole asset of the

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<sup>244</sup> Marshall's Heirs v. Comm'r, *supra* note 24; Second Carey Trust v. Helvering, *supra* note 104; Helm & Smith Syndicate v. Comm'r, *supra* note 230.

<sup>245</sup> Wholesalers Adjustment Co. v. Comm'r, *supra* note 206; Solomon v. Comm'r, *supra* note 36. Cf. the following cases where the court held the trust was not taxable as a corporation, but the decision apparently was not influenced by the power of the trustee to terminate the trust: Myers v. Comm'r, *supra* note 13; United States v. Davidson, *supra* note 78. But cf. Comm'r v. United States & Foreign S. Corp., *supra* note 24.

In the following cases the trustees had power to sell the trust property, and in event of sale the trust was to be terminated, but in each case the trust was classified as a corporation: Swanson v. Comm'r; Helvering v. Coleman-Gilbert, both *supra* note 9; Title Ins. & T. Co. v. Comm'r, *supra* note 222; Keating-Synder Trust v. Comm'r, *supra* note 13. Cf. Cleveland Trust Co. v. Comm'r, *supra* note 33, where the trust was held not taxable as a corporation.

<sup>246</sup> Cleveland Trust Co. v. Comm'r, *supra* note 33 (trust held not taxable as a corporation); Title Ins. & T. Co. v. Comm'r, *supra* note 222 (trust held taxable as a corporation).

<sup>247</sup> Brooklyn Trust Co. v. Comm'r, *supra* note 51; Comm'r v. North American Bond Trust, *supra* note 54; Pennsylvania Co. Etc. v. United States, *supra* note 204; Continental Bank & T. Co. v. United States, *supra* note 204.

<sup>248</sup> If as much as fifty per cent of the capital fund should be withdrawn, the remaining investment fund might be so small as to lack many of the advantages of the

trust is a parcel of real estate of such a nature that the interest of one beneficiary cannot be liquidated without selling the whole parcel of land, an entirely different situation may be presented.<sup>249</sup> It seems unwise to suppose that these investment trust cases establish a general rule that the right of a beneficiary to withdraw his interest will never be considered inconsistent with the concept of continuity.

In *Thrash Lease Trust v. Commissioner*<sup>250</sup> there were two different classes of alleged associates. One group appeared to be tenants in common owning undivided interests in an oil and gas leasehold, while the other group was composed of assignees of undivided interests in the oil and gas to be produced under the lease. The court said that there was no definite trust agreement or any writing expressing the purposes and limitations of the enterprise, but that the two promoters of the arrangement "acted as managers by common consent." The court also said that the two promoters "were impliedly given extensive powers of management and control", but the basis for the implication is not explained. From what appears in the opinion, it is difficult to see anything more than a group of tenants in common engaged in purely voluntary cooperation from day to day, subject to having the enterprise liquidated at any time whenever any one of the parties should demand a partition. The opinion contains no discussion of this aspect of the case. The court said that "This is a borderline case",<sup>251</sup> but held it taxable as a corporation.

Suppose the governing instrument provides that the organization shall exist for a term of only three months, or thirty days, or one day. Is there a point at which mere shortness of duration becomes repugnant to the idea that an "association" has been created? In *Commissioner v. N. B. Whitcomb Coca-Cola Syndicate*<sup>252</sup> the agreement provided that the syndicate was to have a life of ninety days, but the

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original enterprise. (See *supra* note 107.) But fifty per cent of the beneficial ownership can usually dissolve a business corporation completely.

<sup>249</sup> Cf. *McKean v. Scofield*, *supra* note 101. In *Glensder Textile Co. v. Comm'r*, *supra* note 236, at 185, the decision in favor of the taxpayer was influenced by the fact that upon the death of a general partner the value of his interest was to be paid to his estate, although the limited partnership was to remain in operation under the management of the surviving general partners.

<sup>250</sup> *Supra* note 13.

<sup>251</sup> *Ibid.* at 928.

<sup>252</sup> *Supra* note 24. Cf. *Comm'r v. United States & Foreign S. Corp.*, *supra* note 24, at 745; *Darol Trading Account v. Comm'r* (1936) 34 B.T.A. 837, 839; *Raskob v. Comm'r* (1938) 37 B.T.A. 1283, 1288, *aff'd* on other issues *sub. nom.* *Du Pont v. Comm'r* (C. C. A. 3d, 1941) 118 F. (2d) 544.

manager could extend it for another ninety days and a majority of the syndicate members could extend it for a total period of not more than one year. It actually remained in existence for less than five months. The court declared that "an association which can be taxed as a corporation is organized with more permanency",<sup>253</sup> and on a consideration of all the facts it was held not taxable as a corporation.

The foregoing decisions suggest the conclusion that the attribute of continuity is reasonably well provided for if the interests of the various beneficial owners are bound together in a joint enterprise for a substantial period of time by enforceable rights and obligations, and if the continuity is not broken by the death or incapacity of any of the parties or by the transfer of beneficial interests. No significance should be attached to the fact that a majority of the beneficiaries can dissolve the organization, or that the enterprise can be wound up by the managers without consulting the beneficial owners. But if the only thing that holds the joint enterprise together is the voluntary cooperation of each one of the parties, it cannot be said that any adequate continuity has been provided for.

*Transferability of beneficial interests.*

In the *Morrissey* case the Court observed that "the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests without affecting the continuity of the enterprise, and also the introduction of large numbers of participants."<sup>254</sup> But in the same opinion the Court said: "While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive. . . . Again, while the faculty of transferring the interests of members without affecting the continuity of the enterprise may be deemed to be characteristic, the test of an association is not to be found in the mere formal evidence of interests or in a particular method of transfer."<sup>255</sup>

The clearest case of transferability exists when the unincorporated organization issues certificates of beneficial interest which are negotiable by delivery. At the other extreme, in a "spendthrift trust" the

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<sup>253</sup> 95 F. (2d) at 598. But *cf.* *Bert v. Helvering*, *supra* note 24, where the term of the syndicate was originally fixed at three years, but it was terminated after only eight months of operation and was held to be taxable as a corporation.

<sup>254</sup> 296 U. S. at 359.

<sup>255</sup> *Ibid.* at 358.

beneficiary has no power to transfer his interest by any means whatever. Between these two extremes there are many variations.

Any beneficial interest in any trust is generally transferable unless transferability is expressly limited.<sup>256</sup> Even if the transfer must be made by a formal deed or bill of sale, it is much easier to transfer a beneficial interest in a trust than it is to make a proper deed and bill of sale covering an undivided interest in each separate asset held by the trust. To this extent, the mere existence of the trust facilitates the transfer of undivided interests in the enterprise and its property, even if no special aids are provided such as transferable certificates analogous to certificates of stock in a corporation.

In *Helvering v. Coleman-Gilbert Associates*<sup>257</sup> there was no provision for certificates of beneficial interest or any other special facility for making transfers, but neither was there any special impediment to the transfer of beneficial interests. The Court held the trust taxable as a corporation with no discussion of the attribute of transferability.

Likewise there are many cases in the circuits where there was neither any special facility nor impediment in respect to transfers of beneficial interests, and the organization was held to be taxable as a corporation.<sup>258</sup> In some of these opinions it is difficult to ascertain whether the court thought the attribute of transferability was adequately provided for, or merely that the attribute was of no controlling importance.

On the other hand, there are several cases where the court relied upon the absence of transferable certificates, together with other shortcomings in respect to corporate resemblance, in reaching a decision in favor of the taxpayer, although there was no special impediment to transfers of beneficial interests.<sup>259</sup> But in *Commissioner v. Horseshoe Lease Syndicate*,<sup>260</sup> while deciding in favor of the taxpayer

<sup>256</sup> See *supra* note 65.

<sup>257</sup> *Supra* note 9.

<sup>258</sup> *United States v. Rayburn*, *supra* note 155; *Kilgallon v. Comm'r*, *supra* note 54; *Marshall's Heirs v. Comm'r*, *supra* note 24; *Del Mar Addition v. Comm'r*, *supra* note 172; *Nashville Trust Co. v. Cotros*, *supra* note 67; *Comm'r v. Fortney Oil Co.*, *supra* note 54; *Comm'r v. Nebo Oil Co. Trust*, *supra* note 166; *Keating-Snyder Trust v. Comm'r*, *supra* note 13; *Porter v. Comm'r*, *supra* note 185.

<sup>259</sup> *Lewis & Co. v. Comm'r*, *supra* note 225 (certificates were provided for but not actually issued); *Myers v. Comm'r*, *supra* note 13; *Comm'r v. Gerstle*, *supra* note 185; *Comm'r v. N. B. Whitcomb Coca-Cola Syndicate*, *supra* note 24; *Comm'r v. Rector & Davidson*, *supra* note 100.

<sup>260</sup> *Supra* note 13.

on consideration of all the facts of the case, the court was of the opinion that there was adequate transferability of beneficial interests although no certificates or other devices were provided to facilitate such transfers.

In some of the investment trust cases there were restrictions on the transfer of beneficial interests, but any beneficiary had the right to surrender his interest to the trustee and collect its current value in cash. The trusts were held to be taxable as corporations and the courts seemed to think there was adequate compliance with the attribute of transferability.<sup>261</sup>

In *Fidelity-Bankers Trust Co. v. Helvering*<sup>262</sup> provision was made for certificates which could be freely transferred to any other member of the syndicate, but it was also provided that no additional parties could become interested in the syndicate except by consent of a majority of the syndicate owners.<sup>263</sup> Undoubtedly this was a restriction on transferability, and particularly a restriction on the introduction of new participants; but in holding the syndicate taxable as a corporation the court said that the syndicate agreement disclosed "all of the corporate attributes which business trusts commonly simulate, including provisions for . . . transferability of shares."<sup>264</sup>

An unincorporated organization was held taxable as a corporation where the beneficial interests could not be transferred unless the managing partner consented.<sup>265</sup> The opinion in this case does not contain any discussion of the attribute of transferability.

The particular formalities that may be required to effect a valid transfer do not seem to be very important. In one case the governing instrument provided that beneficial interests could be transferred only by a separate instrument of conveyance executed and delivered with the formality of a deed.<sup>266</sup> The court was apparently of the opinion that this was not a material impediment to transferability, but on a consideration of all the facts it was held that the trust was not an association.

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<sup>261</sup> See cases cited *supra* note 247.

<sup>262</sup> *Supra* note 24.

<sup>263</sup> 113 F. (2d) at 15, n. 3.

<sup>264</sup> *Ibid.* at 20. *Cf.* *Swanson v. Comm'r*, *supra* note 9, at 365, where the Court seemed to think it was immaterial that interests must first be offered to the other beneficiaries before they could be sold to outsiders. See also *Poplar Bluff Printing Co. v. Comm'r*, *supra* note 206.

<sup>265</sup> *Wholesalers Adjustment Co. v. Comm'r*, *supra* note 206. But *cf.* *Comm'r v. United States & Foreign S. Corp.*, *supra* note 24, at 745.

<sup>266</sup> *Comm'r v. Gibbs-Preyer Trusts*, *supra* note 13.



In *McKean v. Scofield*<sup>267</sup> each beneficiary was prohibited from selling or encumbering any part of the trust estate or its income. The court may have given some weight to this circumstance in reaching its decision in favor of the taxpayer, although other grounds are emphasized much more strongly.

It may be concluded from the foregoing decisions that the attribute of transferability of beneficial interests is reasonably well provided for by the mere creation of a trust which imposes no restrictions on transferability, but that a greater or lesser degree of transferability may be relied upon by the courts, in conjunction with other facts, in deciding an evenly balanced issue in regard to the corporate-resemblance test.

#### *Limitation of personal liability.*

In several of the association cases the courts have noted that the governing instrument provided limited liability for the trustees but apparently the agreement was silent concerning the liability of the beneficiaries. In some of these cases the courts have said that the arrangement provided limited liability.<sup>268</sup> In other cases the courts have merely recited the nature of the arrangement without making any definite statement as to whether or not there was compliance with the attribute of limited liability.<sup>269</sup> In one such case, the court avoided the issue by saying that the possible absence of limited liability was not important since all the other "salient features" of corporate resemblance were present.<sup>270</sup>

The taxpayer also lost on converse facts. In this case a substantial part of the business of the enterprise was conducted on the personal credit of the trustee and no effort was made to protect him against personal responsibility; but the governing agreement did contain a provision limiting the liability of the beneficiaries. In holding the trust taxable as a corporation the court observed that the agreement "purports to limit the respective liabilities of the parties."<sup>271</sup>

Even where there was a total lack of any express provision concerning liability, the court made the following observation: "There was an effort to limit personal liability by the agreement among the

<sup>267</sup> *Supra* note 101.

<sup>268</sup> *Helvering v. Combs*, *supra* note 36; *Pelton v. Comm'r*, *supra* note 206.

<sup>269</sup> *Kilgallon v. Comm'r*, *supra* note 54; *McKean v. Scofield*, *supra* note 101; *Jackson v. United States*, *supra* note 155; *Cleveland Trust Co. v. Comm'r*, *supra* note 33.

<sup>270</sup> *Bert v. Helvering*, *supra* note 24.

<sup>271</sup> *Keating-Snyder Trust v. Comm'r*, *supra* note 13, at 862.

parties that the operation should not be construed as constituting a partnership."<sup>272</sup>

It has been said that "there was a purpose to limit the liabilities of the shareholders" in a case where the governing instruments expressed the hope that the income from the first oil well to be drilled by the parties would be sufficient to pay all further expenses;<sup>273</sup> and in *Del Mar Addition v. Commissioner*<sup>274</sup> the court went even further in this direction when it said: "The fifth characteristic is the limitation of the personal liability of participants. The trust agreement did not specially include such a provision, but the record is clear that it was not included only because, in the judgment of the participants, it was unlikely, due to the nature of the enterprise, that any contingency would arise requiring it."<sup>275</sup>

The courts seldom make any serious study of the question of whether or not a provision purporting to limit liability is legally effective, or whether or not liability is actually limited by law in the absence of an express provision on the subject.<sup>276</sup> In *Helm & Smith Syndicate v. Commissioner*<sup>277</sup> the court dismissed the question as follows: "Petitioner claims and respondent denies that the liability of each beneficiary is that in a partnership. Even if so, limitation of the beneficiary's liability is not a sine qua non of the corporate analogy." Although other courts have not been so definite in the expression of their views, the sentiment expressed in the preceding quotation seems to be implied in many of the courts' brief references to the question of the attribute of limited liability.

The attribute of limitation of personal liability has reference pri-

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<sup>272</sup> *Comm'r v. Fortney Oil Co.*, *supra* note 54, at 998.

<sup>273</sup> *Thrash Lease Trust v. Comm'r*, *supra* note 13, at 928. *Cf.* *Poplar Bluff Printing Co. v. Comm'r*, *supra* note 206.

<sup>274</sup> *Supra* note 172.

<sup>275</sup> *Ibid.* at 411.

<sup>276</sup> But *cf.* *Solomon v. Comm'r*, *supra* note 36, where the governing instrument apparently provided limited liability for the trustee alone, but the court referred to state statutes limiting the liability of both the trustee and beneficiaries; *Kilgallon v. Comm'r*, *supra* note 54, where the court declared that "as an actual result of the set-up there was considerable limitation in fact"; *Comm'r v. N. B. Whitcomb Coca-Cola Syndicate*, *supra* note 24, where the court questioned the effectiveness of the effort to limit personal liability. In *Marshall's Heirs v. Comm'r*, *supra* note 24, the court recited the provision limiting the liability of the trustee, but apparently paid no attention to the Board of Tax Appeals' observation in the same case that "it appears that under the law of Pennsylvania the liability of the beneficiaries was probably limited . . . even though there was no such specific provision in the trust instrument." (1939) 39 B. T. A. 101, 109.

<sup>277</sup> *Supra* note 230, at 441. *Cf.* *Bert v. Helvering*, *supra* note 24, at 495.

marily to the distinction between a corporation and a partnership. In a general partnership all the members are subjected to unlimited liability, but in most business corporations none of the members are liable for the debts of the corporation. In a limited partnership the managing partners are not protected, but the passive limited partners enjoy limited liability. But in a class of corporation which was well known a few years ago<sup>278</sup> the managing directors were not subjected to personal liability, while the stockholders were subject to secondary liability for the debts of the corporation. Under this analysis, the limitation of the liability of the managing trustees seems to bear a more important analogy to corporations than does the limitation of the liability of the beneficial owners; while unlimited liability of the trustees and protection of the passive beneficial owners bears a closer resemblance to a limited partnership. The foregoing discussion of the decisions indicates that the courts have given only limited recognition to these analogies.

In any event, it seems that if the courts are going to assign any serious significance to the attribute of limited liability they should determine whether or not liability is in fact limited under the applicable state law, regardless of whether or not the governing instrument contains any provisions on the subject.

#### COMBINATION OF INGREDIENTS REQUIRED TO CREATE AN ASSOCIATION

In the following language Mr. Mertens has made the categorical statement that an unincorporated organization must comply with all three of the basic tests before it can be classified as a corporation:

"The cases and the regulations clearly establish three essential tests for determining whether a particular organization is taxable as an association. If (1) two or more individuals are *associated* together in a *joint* enterprise (2) for the carrying on of a *business* for *profit* and (3) the enterprise has substantial *resemblance* to a corporation, it falls within the provisions of the income tax statutes as an association taxable as a corporation. All of these elements are essential, no one of them standing alone being sufficient to characterize an organization as an association taxable as a corporation."<sup>279</sup>

Few of the judicial decisions contain any such forthright declaration that all three of these basic tests must be met before it can be

<sup>278</sup> See *Liverpool Ins. Co. v. Massachusetts*, *supra* note 1, at 575; *Roberts v. Anderson*, *supra* note 17, at 13; *Comm'r v. Security-First Nat. Bank*, *supra* note 163, at 939.

<sup>279</sup> 7A MERTENS, *op. cit. supra* note 3, § 43.10.

held that an "association" exists.<sup>280</sup> Some of the commentators of both the bench and the bar seem to imply a narrower interpretation of the *Morrissey* case by emphasizing "business purpose" to the virtual exclusion of everything else.<sup>281</sup>

In the present regulations of the treasury department, the general section on associations<sup>282</sup> lists two of the attributes of corporate resemblance but says nothing about business purpose. However, the sections on trusts and partnerships<sup>283</sup> seem to imply rather clearly that compliance with all three tests is necessary to create an association.

Although the Chief Justice may not have said it quite as obviously as Mr. Mertens, it is clearly implicit in the language of the *Morrissey* case that (at least so far as trusts are concerned) reasonable compliance with all three of the basic tests is necessary to justify classification as a corporation. After the discussion of business purpose and a few introductory remarks concerning corporate resemblance, the opinion in the *Morrissey* case proceeds as follows: "What, then, are the salient features of a trust—when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains—which may be regarded as making it analogous to a corporate organization?"<sup>284</sup> Next, after stating the five "salient features" of corporate resemblance, the opinion continues: "It is no answer to say that these advantages flow from the very nature of trusts. For the question has arisen because of the use and adaptation of the trust mechanism. The suggestion ignores the postulate that we are considering those trusts which have the distinctive feature of being created to enable the participants to carry on a business and divide the gains which accrue from their common undertaking,—trusts that thus satisfy the primary conception of association and have the attributes to which we have referred, distinguishing them from partnerships."<sup>285</sup>

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<sup>280</sup> The most definite statements to this effect in the appellate court opinions are found in the following cases: *Wellston Hills Syndicate Fund v. Comm'r*, *supra* note 111, at 925; *Sears v. Hassett*, *supra* note 86, at 962; *Comm'r v. Gibbs-Preyer Trusts*, *supra* note 13, at 623.

<sup>281</sup> *Comm'r v. Vandegriff R. & Inv. Co.*, *supra* note 24; *Helvering v. Washburn*, *supra* note 156; *Sherman v. Comm'r*, *supra* note 191, at 226; *Fletcher v. Clark* (D. Wyo. 1944) 57 F. Supp. 479, 481, *aff'd*, (C. C. A. 10th, 1945) 150 F. (2d) 239, *cert. den.*, (1945) ..... U. S. ...., 66 S. Ct. 144; Warren, *The Reduction of Income Taxes Through the Use of Trusts* (1936) 34 MICH. L. REV. 809, 838; Lowndes, *The Tax Burden of the Supreme Court 1935 Term* (1936) 5 FORDHAM L. REV. 426, 441-2.

<sup>282</sup> U. S. Treas. Reg. 111, § 29.3797-2.

<sup>283</sup> *Ibid.* §§ 29.3797-3 and -4.

<sup>284</sup> 296 U. S. at 359.

<sup>285</sup> *Ibid.*

The *Morrissey* case was concerned with the status of a trust, and the language of the opinion is directed primarily to the question of the classification of trusts for purposes of taxation. Are the tests any different when the organization in question is a partnership, syndicate or joint venture?

The opinion in the *Morrissey* case expressly declares that the corporate-resemblance test "points to features distinguishing associations from partnerships as well as from ordinary trusts."<sup>286</sup> But the discussion of business purpose seems to be directed entirely to a distinction between ordinary trusts and business trusts, without reference to other types of unincorporated organizations. The question of whether or not the business-purpose test is strictly relevant to the classification of a partnership is probably wholly academic, because both as a matter of historical development and current experience partnerships seem to be exclusively instruments of business both in practice and by common definition.<sup>287</sup>

In principle, the general characteristics which require that an unincorporated organization be classified as a corporation should be substantially the same regardless of the nominal form of the unincorporated enterprise. When a trust is under consideration, the business-purpose test attains an apparent prime importance merely because it is the common nature of trusts to have most of the attributes of corporate resemblance. The question of business purpose automatically becomes the principal subject of discussion in respect to the classification of a trust, simply because there is often no serious issue concerning the typical corporate attributes. On the other hand, if some form of partnership or syndicate is under consideration, business purpose is frequently conceded and the corporate-resemblance test becomes the crucial issue. But as a general proposition it is incorrect and misleading to say that any one of the three basic tests is more important than the others, because a lack of reasonable compliance with any one of the three should be sufficient to forbid the conclusion that an association has been created.

In all the cases examined in the present study, wherever it has been held that an unincorporated organization was properly classified as a corporation (whether it was a trust or otherwise) the court appears

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<sup>286</sup> *Ibid.* at 357.

<sup>287</sup> See *Wild v. Comm'r* (C. C. A. 2d, 1933) 62 F. (2d) 777, 779; *BURDICK, op. cit. supra* note 99, at 34; *MECHEM, op. cit. supra* note 97, § 1.

to have been satisfied that there was substantial compliance with all three of the basic tests set forth in the *Morrissey* case.

*Combinations of attributes of corporate resemblance.*

The remaining question is what combination of the five "salient features" of corporate resemblance is necessary to justify the conclusion that the corporate-resemblance test has been satisfied. The courts have decided each case as it came up, carefully refraining from any attempt to declare a definite formula. Nevertheless, the current regulations of the treasury department contain some unmistakable implications which are helpful to a solution of the problem.

In the general section entitled "Associations"<sup>288</sup> the regulations tell us that an association is an organization "which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity." That is all the section says about specific features of corporate resemblance. The minimum implication is that continuity and centralized management are the most vital elements.

Likewise, in the section entitled "Partnerships"<sup>289</sup> the regulations say: "If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation." A similar statement is made in the section on limited partnerships.<sup>290</sup>

In all four of the association cases decided by the Supreme Court in 1935,<sup>291</sup> business trusts were held to be taxable as corporations; and in all these cases the Court clearly was of the opinion that all five of the salient features of corporate resemblance were present. It may be noted, however, that in the final summing up of the facts in the *Morrissey* case the Court saw fit to make specific mention of all of the five salient features except that of title vested in a single entity.<sup>292</sup>

The last case decided by the Supreme Court on this subject is

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<sup>288</sup> U. S. Treas. Reg. 111, § 29.3797-2.

<sup>289</sup> *Ibid.* § 29.3797-4.

<sup>290</sup> *Ibid.* § 29.3797-5.

<sup>291</sup> *Supra* note 9.

<sup>292</sup> 296 U. S. at 360.

*Lewis & Co. v. Commissioner*,<sup>293</sup> where a trust was held not to be taxable as a corporation upon the double ground that "there are no associates and no feature 'making [the trust] analogous to a corporate organization.'" In respect to corporate resemblance, the Court concluded: "There is to be found in the operation of the business no essential characteristic of corporate control—nothing analogous to a board of directors or shareholders, no exemption from personal liability, no issue of transferable certificates of interest."<sup>294</sup> The Court thus denied the existence of all of the five corporate attributes except title vested in a single entity and the feature of continuity, and the Court concluded that these two features alone were not sufficient to constitute corporate resemblance.

The most illuminating decisions of the circuit courts of appeals may be tabulated as follows:

- A. Organizations were held properly classified as corporations where the court apparently believed all attributes of corporate resemblance were present except:
  1. Title vested in a single entity.<sup>295</sup>
  2. Transferability of beneficial interests.<sup>296</sup>
  3. Limitation of personal liability.<sup>297</sup>
- B. Organizations were held *not* properly classified as corporations in cases where the court apparently based its decision primarily upon the absence of the following attributes of corporate resemblance:
  1. Continuity.<sup>298</sup>
  2. Centralized management and limitation of liability.<sup>299</sup>

<sup>293</sup> *Supra* note 225.

<sup>294</sup> *Ibid.* at 389.

<sup>295</sup> *Comm'r v. Fortney Oil Co.*, *supra* note 54. *Cf. Nashville Trust Co. v. Cotros*, *supra* note 67, at 159, where the trial court held that title was vested in the associates as tenants in common. The appellate court said "the conclusion is unimportant", but decided that for all practical purposes legal title was held by trustees.

<sup>296</sup> In *Wholesalers Adjustment Co. v. Comm'r*, *supra* note 206, the court recited that interests were transferable only with consent of the manager. In holding that there was adequate corporate resemblance the court relied primarily on continuity, centralized management and limited liability. *Cf. supra* notes 257-260, and accompanying text.

<sup>297</sup> *Nashville Trust Co. v. Cotros*, *supra* note 67; *Del Mar Addition v. Comm'r*, *supra* note 172; *Fletcher v. Clark*, *supra* note 206. In *Helm & Smith Syndicate v. Comm'r*, *supra* note 230, at 441, and *Bert v. Helvering*, *supra* note 24, at 495, the court assumed *arguendo* that there was no limited liability, but held the organizations should be classified as corporations.

<sup>298</sup> In *United States v. Carter* (C. C. A. 5th, 1939) 101 F. (2d) 811, continuity is the only corporate attribute discussed by the court in holding that the organization was a partnership.

<sup>299</sup> *Comm'r v. Gibbs-Preyer Trusts*, *supra* note 13.

3. Title vested in a single entity, continuity and limited liability.<sup>300</sup>
4. Title vested in a single entity, continuity and transferability.<sup>301</sup>
5. Title vested in a single entity, continuity, transferability and limited liability.<sup>302</sup>
6. Title vested in a single entity, centralized management, transferability and limited liability.<sup>303</sup>

It is significant that in all the cases referred to in the foregoing tabulation the courts held that no association had been created only where they doubted the presence of either continuity or centralized management. These are also the elements which are emphasized in the present regulations of the treasury department.<sup>304</sup> It should also be observed that, although some of the cases indicate that transferability is not very important,<sup>305</sup> nevertheless in the only case where transfers were absolutely prohibited it was held that no association had been created.<sup>306</sup>

Many characteristics which are generally thought to be typical of corporations are not always vital corporate attributes either as a matter of law or business effectiveness. A determination of the really vital corporate attributes will serve to confirm the holdings in the cases tabulated above.

First, it should be noted that nonvoting stock, irrevocable proxies and voting trusts are well known today.<sup>307</sup> By such devices it is possible in most of our states for the stockholders to delegate their voting rights to others, at least for a substantial period of time, or even to relinquish such rights altogether; and under some circumstances arrangements of that sort promote, rather than impede, the business effectiveness of the organization. Therefore, the absence of control by the beneficial owners of an enterprise is not a matter of fundamental importance in classifying an organization for taxation.<sup>308</sup>

Varying technical arrangements for the holding of title to property are not important as an end in themselves. The lack of the attribute of title vested in a single entity is important only insofar as

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<sup>300</sup> *Comm'r v. Horseshoe L. Syndicate*, *supra* note 13; *Comm'r v. Rector & Davidson*, *supra* note 100.

<sup>301</sup> *McKean v. Scofield*, *supra* note 101.

<sup>302</sup> *Comm'r v. N. B. Whitcomb Coca-Cola Syndicate*, *supra* note 24.

<sup>303</sup> *Comm'r v. Gerstle*, *supra* note 185. See *supra* note 230, and accompanying text.

<sup>304</sup> See *supra* notes 288-290.

<sup>305</sup> *Supra* note 296.

<sup>306</sup> *Supra* note 301.

<sup>307</sup> 5 FLETCHER, *CYC. CORPS.* (Perm. ed. 1931) §§ 2026, 2029, 2050, 2054, 2065, 2075.

<sup>308</sup> See *supra* notes 23 and 24.



it may add to or detract from some other attribute which has substantive importance.<sup>309</sup> Therefore, the only effect of lack of title vested in a single entity should be to stimulate a critical examination of the facts with reference to such attributes as continuity and centralized management which are usually supported by the centralized holding of title.

Although limitation of personal liability is considered to be a *typical* corporate attribute today, it is not an *essential* corporate characteristic.<sup>310</sup>

Reasonable restrictions on the transfer of corporate stock are both lawful and common, but it seems that any absolute prohibition against all transfers of stock would be void as against public policy, at least under all normal conditions.<sup>311</sup> This requires the conclusion that reasonable restrictions on the transfers of beneficial interests in an unincorporated enterprise are not very important; but it would not be unreasonable to hold that a "spendthrift trust", which contains an absolute and inescapable prohibition against transfers of beneficial interests, is so unlike both the law and the practice of corporations that it should not be classified as a corporation for purposes of taxation.<sup>312</sup>

We are told by a leading writer on corporation law that: "Almost universally, the management is vested by a general statute or charter provision in a board of directors or trustees; and in such a case, the powers so vested in the directors or trustees must be exercised by them, and cannot be exercised by the stockholders . . ." <sup>313</sup> Directors cannot vote by proxy, but must exercise their own personal judgment on issues within the jurisdiction of the board.<sup>314</sup> Any contract by which a director seeks to delegate or enable others to control his powers is void as against public policy.<sup>315</sup> Thus, the law of corporations demonstrates that one of the most vital and fundamental of all the attributes of a business corporation is centralized management by a governing board acting in a representative capacity.

It may be said without fear of serious disagreement that some degree of compulsory continuity is an indispensable element of a

<sup>309</sup> See *supra* note 210, and accompanying text.

<sup>310</sup> See *supra* note 278.

<sup>311</sup> 12 FLETCHER, *op. cit.* *supra* note 307, §§ 5452-5455.

<sup>312</sup> See Silbert, *Voluntary Trusts and Federal Taxation* (1937) 17 B. U. L. REV. 1, 29.

<sup>313</sup> 5 FLETCHER, *op. cit.* *supra* note 307, § 2097.

<sup>314</sup> 2 *ibid.* § 427.

<sup>315</sup> 3 *ibid.* § 1000.

corporation. The attribute of easy and fortuitous terminability contributed substantially to the failure of the typical common-law partnership to maintain its place as an instrument of modern business.

A business corporation may or may not provide for selection of directors by all the beneficial owners, or for unlimited transferability of its stock, or for limitation of the personal liability of officers, directors or stockholders. A corporation may or may not hold legal title to the property used in its business. All these matters may be molded by charter provisions, by-laws and contracts into almost any form which the particular parties believe will best serve the needs of their particular enterprise. But continuity, centralized management and something less than an absolute prohibition against all transfers of beneficial interests, are fundamental functional traits of a corporation which cannot be eliminated by the parties without doing violence to well-established principles of corporation law.

The foregoing discussion of corporate law and practice indicates that a substantial degree of continuity, centralized management and transferability should be essential to the classification of an unincorporated organization as a corporation for purposes of taxation. The remaining two of the five "salient features" listed in the *Morrissey* case—title vested in a single entity and limitation of personal liability—seem to be almost wholly irrelevant. Virtually all the decided cases fit into this pattern.

No importance whatever should be given to the question of whether or not an enterprise maintains an office, holds meetings, has a seal, keeps minutes, etc. Activities of this nature are typical not only of business corporations but also of many other organizations which bear no fundamental resemblance to corporations. It should be noted, however, that both the courts and the Commissioner still seem to think these items are sometimes worth mentioning.

#### CONCLUDING COMMENTS

Much of the elusiveness of this subject is directly attributable to the courts' preoccupation with the idea that, in the nature of things, it is impossible to state a general formula for the classification of unincorporated organizations, and that therefore the most that can be said is that each case must depend upon its own particular facts. Undoubtedly it was necessary for the courts to take this position in earlier days because of the vagueness of the statutes, but the subject has now been developed to a point of maturity—by judicial decisions,

departmental regulations, and unofficial commentary—where it is both possible and desirable for the courts to state a formula with more definiteness and in somewhat more detail.

It must be recognized that there may be exceptions to any general rule for the classification of associations; but this susceptibility to exceptions is not an exclusive attribute of this particular branch of the law, and it should not prevent the courts from giving more express recognition to the rules which they are in fact following in all but the most unusual of cases.

There is no longer any reason for judicial opinions to be clouded with vague and indefinite language which seems to take into account all the superficial and irrelevant elements of the organization under consideration. Each case should be frankly and clearly analyzed with reference to the standard of associates in a joint enterprise for a business purpose, with a reasonable degree of continuity, centralized management and transferability. Such an analysis will give the correct answer in almost every case, but there may always be a possible recourse to a remaining question as to whether or not there are any unusual features which require a deviation from this *prima facie* formula. There may still be difficult questions of degree, but almost no room is left for the exercise of a vague judicial discretion in regard to "all the facts of the particular case."

Much uncertainty and some mistakes have been caused by the failure of the courts and the Commissioner to follow the clear teaching of the *Morrissey* case in regard to the nature of the business-purpose test. The law would be greatly clarified, and the decisions would rest upon sounder policy, if the courts would uniformly recognize that a business trust is one that has been adapted to a business purpose by vesting in the trustee substantial business powers which he would not otherwise have under the general law of trusts. Under such a rule there will still be difficult borderline cases, but the question in regard to business purpose will be no more troublesome than the law of trusts.

Finally, although it may still be impossible "to translate the statutory concept of 'association' into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create",<sup>316</sup> nevertheless there seems to be no reason for resorting to any "tests involving great subtlety."<sup>317</sup>

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<sup>316</sup> *Morrissey v. Comm'r*, *supra* note 9, at 356.

<sup>317</sup> See *supra* note 14.