

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Roland Barral
Area Counsel (Financial Services)
(Large & Mid-Size Business)

from: William P. O'Shea
Associate Chief Counsel
(Passthroughs & Special Industries)

subject: Trusts Holding Interests in a Partnership

This memorandum responds to your request for advice with respect to whether a state law trust that is established as an investment trust to hold LLC partnership interests will be classified as a trust under § 301.7701-4(c) of the Procedure and Administration Regulations. Your request for advice arises from inquiries that have been received since the publication of the reporting rules for widely held fixed investment trusts (the WHFIT reporting rules) under § 1.671-5 of the Income Tax Regulations. See TD 9241 (71 FR 4002) and TD 9308 (71 FR 78351). The purpose of these arrangements is to enable information to be provided to investors under the WHFIT reporting rules rather than have the LLC partnership issue schedule K-1's to investors.

ISSUE

Whether a state law trust that is established as an investment trust to hold interests in an LLC partnership, that has the power to vary its investments, is classified as a trust under § 301.7701-4(c).

CONCLUSION

A state law trust that is established as an investment trust to hold interests in an LLC partnership, that has the power to vary its investments, is not classified as a trust under § 301.7701-4(c).

FACTS

LLC is organized under the laws of State as a limited liability company and is treated as a partnership for federal tax purposes. LLC will acquire, hold and manage a portfolio of investments. The governing document of LLC permits the managers of LLC to sell assets in the portfolio and acquire new assets. LLC will issue two classes of interests: common interests and manager interests. Holders of common interests and holders of manager interests have different rights to the income, deductions, credits, losses, and distributions of LLC. Manager interests will be held by a select group of investors who are also responsible for managing LLC. The common interests of LLC will be held by Trust.

Trust is organized under the laws of State as a trust. The governing documents for Trust provide that Trust is only permitted to hold common interests in LLC. Trust will issue certificates and each certificate will entitle the holder to all the income, gain, profit, deductions, credits, losses, and distributions associated with one common interest in LLC. The governing documents for Trust indicate that Trust is a trust for federal tax purposes.

LAW AND ANALYSIS

Section 301.7701-1(b) provides that the classification of organizations that are recognized as separate entities is determined under §§ 301.7701-2, 301.7701-3 and 301.7701-4, unless a provision of the Internal Revenue Code provides for special treatment of that organization.

Section 301.7701-2(a) provides that a “business entity” is an entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

Section 301.7701-4(a) provides that, in general, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 301.7701-4(b) provides that there are arrangements that are known as trusts because legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts,

generally are created by the beneficiaries simply as a device to carry on a profit making business which normally would have been carried on through business organizations that are classified as corporations or partnerships (business entities) under the Code.

Section 301.7701-4(c) provides that an “investment” trust will not be classified as a trust if there is a power under the trust agreement to vary the investments of the certificate holders. See Comm’r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942). An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investments of the certificate holders.

In Morrissey v. Comm’r, 296 U.S. 344 (1935), the Court concluded that the nature and purpose of a cooperative undertaking will differentiate a business trust from an entity that is an ordinary trust.

The essential nature of an arrangement, whatever its form, as shown by the objects attained and the manner of their attainment, is what controls the classification of the arrangement as a trust. In determining the character of an arrangement, the managerial powers of all parties to an arrangement will be combined in order to arrive at the full amount of permitted managerial activity and its object. See Comm’r v. Chase Nat’l Bank, 122 F. 2d 540 (2d Cir. 1941).

To determine whether Trust is an investment trust that is classified as a trust under § 301.7701-4(c), it is appropriate to consider the nature and purpose of Trust. Trust is holding the interests in LLC for the purpose of providing investors with the benefits of the managed investments of LLC. These investment activities would result in Trust failing to be classified as a trust if Trust were permitted to engage in those activities directly. Because the nature and purpose of Trust under this arrangement is to vary the investments of the certificate holders, Trust is a business entity under § 301.7701-2(a) for federal tax purposes and not an investment trust that is classified as a trust under § 301.7701-4(c).

Please call Faith Colson at (202) 622-3060 if you have any further questions.

cc: Christopher B. Sterner
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