



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
MITCHELL TRUSTEES, LTD.)

Appearances:

For Appellant: J. H. Mauk, Trustee

For Respondent: W. M. Walsh, Assistant Franchise Tax
Commissioner; James J. Arditto, Franchise
Tax Counsel

OPINION

This appeal is made pursuant to Section 2 of the Massachusetts or Business Trust Tax Act (Chapter 211, Statutes of 1933, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Mitchell Trustees, Ltd., to proposed assessments of additional tax in the amounts of \$1,636.22 and \$460.25 for the taxable years ended December 31, 1937, and December 31, 1938, respectively.

Prior to November 30, 1935, Alfred D. Mitchell and Virginia Mitchell owned certain oil leases and oil-properties. On that date they created a trust pursuant to a copyrighted plan known as the "Hulbert Plan". Under this plan Alfred D. Mitchell and Virginia Mitchell, as grantors; (1) conveyed these properties to three trustees; (2) the grantors and trustees entered into a contract with reference to the administration of the trust; (3) the trustees contracted with each other regarding its administration; and (4) one of the trustees, with the approval of the grantors, issued instructions for the registration of the beneficial interests, designated as "Expectancy Fractions". Seven hundred and sixty-eight "Expectancy Fractions" were allotted to one beneficiary and eight to each of four others. All the interests were given for life with remainder over to the grantors under certain circumstances and to other persons under different conditions. None of the trustees was a beneficiary. The trustees were given discretion as to the distribution of income and were not required to make any distribution until the termination of the trust. The trust could continue, in the discretion of the trustees, until the death of the last surviving grantor, trustee or beneficiary.

The trust was to operate under the trade name of Mitchell Trustees, Ltd., and originally the trustees were authorized, inter alia, to "...do collectively, in their discretion, any lawful things which citizens may lawfully do ...". In 1936, however, amendments were made to the powers granted in the "Contract Containing Articles of Administration" whereby the powers were restricted as follows:

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"The powers herein granted are restricted to the conservation, improvement, administration protection and disposition of property now included in, and that hereafter added to, the Estate Holding and the proceeds thereof under administration ..., the intent and object herein being that the said Trustees, their possible associate and/or successor Trustees have such powers as are necessary for the administration of the Estate properties, but are restricted from engaging in the carrying on of a business."

During the year 1936 the trustees operated at least eight oil wells and made sales of oil and gas in the amount of \$104,401.34 with operating expenses of \$35,787.90. During 1937, after the amendment to their powers, the trustees continued the same operations with 12 wells and sales in the amount of \$135,345.78. Operating expenses for the year were \$40,749.42 and wells were drilled at an expense of \$15,946.89.

The question presented by this appeal is whether the Appellant was a Massachusetts or business trust as defined in Section 3 of the Massachusetts or Business Trust Tax Act. This Section read as follows:

"The term Massachusetts or business trust as herein used shall include every business organization consisting essentially of an arrangement whereby property is conveyed to trustees where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise."

Aside from the question of the effect of the amendment to the trustees powers in 1936, it seems clear that under the original trust instruments the trust came within this definition. Section 3797 of the Internal Revenue Code dealing with taxation of associations as corporations has been interpreted by the Federal courts to apply to business trusts and the tests used by those courts are for the most part pertinent. Koenig v. Johnson, 71 Cal. App. 2d. 739, citing Morrissey v. Commissioner, 296 U.S. 344. "Hulbert Plan" trusts have been considered by the Federal courts and have been held to be taxable as corporations. Porter v. Commissioner, 130 F. 2d. 276; Lombard Trustees, Ltd. v. Commissioner. 136 F. 2d 22. In the Porter case, the terms of the trust and its operations were substantially the same as in the case of the original trust involved in this appeal. The trust had entered into leases and had received payments on installment contracts and payments on an oil lease. The purpose of the trust was held to be the conducting of business operations aside from such business as might have been merely incidental to the liquidation or preservation of the trust estate and the distribution of income therefrom.

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There are two differences, however, between the trust involved in that case and the original Mitchell trust which the Appellant claims make the Porter case distinguishable. The properties held by the trustees in the Porter trust had originally been held by a corporation and the stockholders of the former corporation were also parties to the trust. The decision was not based on this factor, however, and the form in which the property was formerly held is not determinative under the Federal law. There is, moreover, nothing in the California Act to indicate such prior form is significant and its present form need not even be comparable to that of a corporation. Koenig v. Johnson, supra.

The other distinction relied on by the Appellant relates to the fact that two of the beneficiaries were both trustors and trustees in the Porter case. None of the beneficiaries was either a trustee or trustor in the instant trust. To constitute a business trust for tax purposes, however, it is not necessary that the beneficiaries be trustees or that the trust property be supplied by them. Commissioner v. Vandegrift Realty & Investment Co., 82 F. 2d.387.

A third distinction between the two trusts relates to the 1936 amendment to the trust instrument in the instant case. In the Porter case the trustees were authorized to engage in any 'business. Since December 30, 1936, the trustees of Mitchell Trustees have purportedly been restricted by the amendment to their powers "from engaging in the carrying on of a business." Nevertheless, the activities of the trustees did not change and there is no doubt that they actively engaged in business operations after that date. The selling of oil and gas from oil leases alone constitutes such business sufficient to subject the trust to taxation as a business trust. Commissioner v. Security First National Bank, 148 F. 2d. 937, 939. Can the parties by adoption of such an amendment with which they have not complied thus avoid tax liability as a business trust?

The California statute defines a business trust as a business organization for the purpose of carrying on some business enterprise. Likewise, under the Federal income tax law the principal test is whether the trust is formed for the transaction business of Morrissey v. Commissioner, supra, cited with approval in Koenig v. Johnson, 71 Cal. App. 2d 739 at 749, see also 2 Nossaman Trust Administration and Taxation, Section 669. It is true that in Helvering v. Coleman-Gilbert Associates, 296, U.S. 369 at 374, the Court stated that the parties to the trust "... 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 that case, however, the purpose set forth in the instrument was not narrower but rather, if anything, broader than the activities actually conducted and we have not been referred to any case holding that the Commissioner may not go beyond the trust instrument when restrictions in that instrument are being ignored by the trustees. In National Bank of Commerce et al, Trustees, 34 B.T.A. 119, where the trust instrument indicated that the purpose was merely liquidation,

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the fact that the trustees failed to liquidate the trust property and engaged in business operations was held sufficient to support taxation as an association.

The trust originally having been formed for business purposes and constituting a business trust within the meaning of Section 3 of the Massachusetts or Business Trust Tax Act, the trustees should not be permitted, in our opinion, to engage actively in the carrying on of business without the tax liability of a business trust merely because of a restrictive amendment to their powers with which they have not complied.

ORDER

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of Charles J. McColgan, Franchise Tax Commissioner, in overruling the protest of Mitchell Trustees Ltd., to proposed assessments of additional tax in the amounts of \$1,636.22 and \$460.25 for the taxable years ended December 31, 1937, and December 31, 1938, respectively, pursuant to Chapter 211, Statutes of 1933, as amended, be and the same is hereby sustained.

Done at Los Angeles, California, this 19th day of November, 1946, by the State Board of Equalization.

Wm. G. Bonelli, Member
J. H. Quinn, Member
Thomas H. Kuchel, Member

ATTEST: F. S. Wahrhaftig, Acting Secretary