

Virginia Business Trusts, a Neglected Statutory Entity

By Richard Howard-Smith, Esq.

Introduction

The first business trusts originated in Massachusetts in 1827 primarily to avoid laws prohibiting the development of real estate by corporations. A Massachusetts business trust permits a business or other property to be held and managed for the benefit of persons holding beneficial interests. Business trusts remain a relatively common form of business organization in Massachusetts and have been loosely replicated in a few other states, including Virginia.

The Virginia Business Trust (“VBT”) is a rarely used, modern-style statutory trust entity first introduced in Virginia with the adoption of the Virginia Business Trust Act (the “Act”) in 2001.¹ The Act was based on earlier statutory efforts in Delaware² and based on works of the Uniform Law Commission.³ Despite being a permitted statutory entity in Virginia for over 15 years, as of the end of 2016, there were only 205 active VBTs. Only 22 VBTs were created in 2016 when over 60,000 LLCs and over 13,000 corporations were created in Virginia in that same year.⁴

VBTs resemble common law trusts but have the added benefits of certain rights and protections under the statutory regime. They have beneficiaries (“beneficial owners”⁵) who own the equity or proprietary interests in the business trust, and trustees charged with managing the underlying assets of the business trust for the benefit of the beneficial owners.⁶ As an overriding general principal that provides a distinction from a common law trust, transferring property to a business trust is usually not donative in nature but initiated by a business or other profit-making purpose. While a VBT is nominally a trust under Virginia law, the Virginia Uniform Trust Code is expressly (and significantly) not applicable to VBTs.⁷

While it is generally understood that business trusts are organized as “business” entities authorized and empowered to own and operate active businesses, there is (interestingly and significantly) no statutory

requirement in Virginia that a business trust must conduct a business. As a statutory creature, the common law cannot imply otherwise. The Act describes a VBT as a trust whose governing instrument provides that

1. Property is or will be held, managed, administered, controlled, invested, reinvested, or operated by a trustee for the benefit of persons as are or may become entitled to a beneficial interest in the trust property; or
2. Business or professional activities for profit are carried on or will be carried on by one or more trustees for the benefit of persons as are or may become entitled to a beneficial interest in the trust property.⁸

Further, the Act permissively provides that every VBT “has the purpose of engaging in any lawful business . . . unless a more limited purpose is set forth in the articles of trust.”⁹ This relatively unrestricted authority of a VBT along with broad definitions opens up possibilities for expanded uses of this versatile and under-utilized entity that are not being taken advantage of in Virginia.

The definitions of “person” and “entity” are key to determining proper and creative application of the Act to business trusts. A “person” is an individual or an “entity,” and an entity includes any domestic or foreign corporation, any domestic or foreign non-stock corporation, any domestic or foreign unincorporated entity, any estate or trust, and any state, the United States, and any foreign government.¹⁰

While substantial flexibility is possible when drafting VBTs, the Act provides default provisions that will apply unless specifically altered by the Articles of Trust or governing instrument. So as with other Virginia entities, business trusts may be created using relatively simple documents. The Act provides

default rules that will apply when the drafter is happy with simplicity. These statutory rules should be used with caution, however, as they may not always anticipate situations that alternative provisions to the basic business trust governing documents could better address.

As with statutory limited liability companies¹¹ and registered partnerships,¹² VBTs have “full shield” liability protection as shareholders do in a Virginia corporation¹³—a significant and critical benefit of the Act that puts VBTs on even footing with most other Virginia business entities. Additionally, a VBT can have two or more separate series of beneficial interests, and if they are properly maintained and accounted for separately, only the assets of a particular series may be used to satisfy liabilities of that separate series.¹⁴

Despite numerous similarities of VBTs and Virginia LLCs (arguably the VBT’s closest kin under Virginia law), the exclusive remedy of a creditor of a member of a Virginia LLC is a “charging order” against the member’s interest (similar to a garnishment).¹⁵ As such, no seizure or foreclosure-style sale of the member’s interest is available to the creditor. There is no such limitation on a creditor’s remedy against the beneficial owner of a VBT. Both entities, however, offer the same limitation that a creditor of the owner(s) has no rights against the property of the entity.¹⁶

As discussed below, business trusts have the same “check-the-box” rules for federal income taxation as other entities and may avail themselves of default classifications or elective classifications to be taxed as a corporation. Virginia is a “conformity” state,¹⁷ meaning that unless otherwise specifically provided in Virginia law, Virginia follows the federal income tax entity classification and all other federal income tax rules.¹⁸

Formation of a Virginia Business Trust

Articles of Trust are required to create a VBT. The Articles must contain similar information to that required by other statutory business entities in Virginia: (i) a name distinguishable from others on the SCC rolls (and that does not have unacceptable terms); (ii) a registered agent and office, and (iii)

which are signed and filed with the SCC by any person (which person need not be a beneficial owner).¹⁹ The Articles may (but need not) contain any other terms.

A “governing instrument” is required for a VBT.²⁰ Somewhat oddly, the Act does not require any specific terms for the governing instrument; it merely provides statutory permission for some of the terms that a governing instrument can provide. The statutory range of permitted (and perhaps contemplated) terms indicates that a governing instrument is the equivalent of corporate bylaws or an LLC’s operating agreement.

The Act generally follows other Virginia business entities’ statutory regimes that provide a wide variety of entity change choices, including conversions, mergers, and domestications to and from other entity forms.

Most Common Historical and Current Uses of Business Trusts

Virginia Real Estate Investment Trusts (“REITs”) are now governed by the Act, but existing rights and proceedings are not affected.²¹ Also, Real Estate Mortgage Investments Conduits (“REMICs”) are well-suited for a VBT, as are specialized financing structures for specific assets. Mutual funds established under and governed by the Investment Company Act of 1940 are another common use of business trusts, as are leveraged leasing structures, joint ventures, liquidating trusts, and certain private investment funds.

Creative Potential Uses of Virginia Business Trusts

The following list of potential uses of VBTs is intended to suggest and to encourage creative thinking while taking advantage of Virginia’s excellent statutory tools for business entities; it should not be taken as specific recommendations for particular circumstances. Any situation that might implicate use of a particular business entity requires careful consideration of numerous legal aspects, including the legal rights of owners and other interested parties, internal governance issues, tax issues, and compliance with other applicable law, in order to determine appropriateness to achieve as many of the intended goals as possible.

Conversion of Virginia Land Trusts: Virginia is one of the few states that has a statute that indirectly authorizes the use of “Illinois land trusts.”²² Despite Virginia’s simple statute, a Virginia land trust is a common law trust designed merely to hold title to real property. Almost all of the law related to this type of trust arises out of Illinois, where they were originally created in the 1850s for railroad land acquisitions. A unique feature of the land trust is that the trustee is primarily a record titleholder to the real property, and the beneficiaries of the land trust have the exclusive right to direct the trustee and to enjoy the rents, profits, and proceeds of the land held by the land trust. The trustee does have fiduciary duties to the beneficiaries and must act in the best interests of the beneficiaries (to the extent not expressly directed by the beneficiaries, which is their prerogative). Because record title to the real property is solely in the name of the trustee, third parties may rely on the trustee’s authority to deal with and convey the land and its proceeds without further duty of inquiry.

This unusual title-holding vehicle was often used to conceal the identity of the true beneficial owners of the land. While this identity protection could also be achieved using a common law trust or a corporation, these entities were recognized for tax purposes as separate taxpayers, and typically the treatment afforded them was not desired by the beneficiaries. So in a time before the introduction of the “check-the-box” entity classification rules, the Virginia land trust was thought to be the best way to own land without having to disclose ownership and yet not have an entity that was recognized for income tax purposes. As a consequence of the “check-the-box” entity classification rules, the Virginia land trust was no longer needed for its primary purpose, being supplanted by the single-member limited liability company (“SMLLC”), which under the default rules is disregarded and ignored for federal income tax purposes.²³ Further, the SMLLC offers liability protection that does not exist for Virginia land trusts.

Despite their substantially diminished use, there are still many “old” land trusts in existence in Virginia. The main problems with the continued use of land trusts include their lack of liability protection and the scant law guiding their use. The unique

features of a land trust also make it hard to make definitive conclusions on legal issues and interpretations that apply to land trusts. For these reasons, it is advisable to abandon the land trust vehicle in favor of a better entity with both liability protection and a body of clear statutory law to guide its administration and relations with third parties.

One very reasonable choice for a better vehicle is to convert a land trust to a VBT. While an LLC could be used, a VBT has the advantage over an LLC in that the nomenclature and style changes in conversion to a VBT are more straight-forward, and the use of the same legal name of the entity helps preserve the continuation of record title to the land (and the same entity). If the trustees are the same as the prior land trust trustees, the match is identical; if the trustees have changed, only a notice of the trustee change must be recorded prior to an event affecting record title to the real property.

Endowments: Many organizations, particularly nonprofit tax-exempt organizations such as schools, churches, hospitals, and research organizations, have restricted investment assets permanently held for the production of income to support their programs and further their purposes. These funds are often held in a trust or under rules similar to a trust by trustees or a governing board. To better insulate such assets and to provide a statutory structure for the vehicle used to hold such assets, particularly if any such assets could give rise to liability risk, a VBT can hold the endowment assets. If a single owner is involved as is normally the case, the business VBT would be disregarded, and the owner entity itself would be taxable on the income from the assets (though charitable and some other entities would be exempt).

Supporting Organizations: Similar to endowments, but often used where a more active separate entity is needed for routine fundraising and distributions to a named supported organization (usually a tax-exempt charitable organization), a VBT can be used for the supporting organization. In this circumstance, the VBT would seek IRS recognition of its own tax-exempt status based on the recognition of its supported entity. In most common cases, the supporting organization desires classification as a “public charity” supporting a recognized tax-exempt

charitable organization. A VBT can be an ideal fit for supporting organizations where the more familiar trust structure and nomenclature are preferred.

Subtrust of an “Ordinary” Common Law Trust Conducting Business Operations: In order to conduct business in an environment that offers “full shield” limited liability, a trustee of an “ordinary” common law trust could consider operating that business in a business trust. The trustee would be the trustee of the business trust, and the “ordinary” trust would be its beneficial owner. Because the business trust would have the “ordinary” trust as its single member, the VBT would be classified as a disregarded entity and ignored for federal income tax purposes (assuming no election to be taxed as a corporation). Thus, there would be no change in the federal income tax consequences of the “ordinary” trust.

Income Taxation of Business Trusts

The federal income tax rules for “ordinary trusts” are contained in Subchapter J of the Internal Revenue Code, which generally provides that trust income is taxed to the beneficiaries when trust income is distributed but to the trust when it is not, a rule more similar to corporate taxation than pass-through entity taxation. However, a “business trust” under federal income tax rules is almost always classified as a business entity and therefore taxed like other similar business entities.²⁴ Therefore, it is important to determine whether a VBT will be a business trust or an “ordinary trust.”

Classification as a Business Trust: Case law still applies classifying trusts as either ordinary trusts or business trusts, with some help from the Treasury Regulations. Prior to the 1997 “check-the-box” regulations, business trusts were taxed as a corporation or a partnership depending on whether the trust’s legal characteristics more closely resembled those of a corporation or a partnership. Whether a trust is considered an ordinary trust or a business trust depends on: (1) whether the terms of the written trust instrument grant the trustee broad powers to engage in a business with the trust property and (2) whether the trust also has associates. This is true regardless of whether the business purpose powers are necessary for a particular trust and regardless of whether the trustee actually

exercises those powers.²⁵ The Treasury Regulations basically attempt to distinguish ordinary trusts traditionally expected to be taxed under Subchapter J from business trusts by using language that is not entirely clear and that incorporates commentary on the trustees not having sufficient power and responsibility to be classified as “business associates.”²⁶

Entity Classification of Business Trusts under the “check-the-box” rules: Once a business trust is determined not to be classified as an ordinary trust, the income tax rules become rather straightforward. The “check-the-box” federal tax regulations mercifully mitigated the risks of a trust being considered a business trust (the regulations were so designated because they allowed lawyers to choose tax classification simply by checking the box relating to the most desired tax classification).²⁷

Now, under a default rule, all business trusts are considered either disregarded entities (when there is only one beneficiary) or partnerships (when there are two or more beneficiaries). Those business trusts interested in being classified as a corporation for federal tax purposes may file an election to be taxed as a corporation. Although disregarded entity status is not typical for a trust, the reporting status of the trust is essentially that of a grantor trust where trust income is taxed directly to the sole beneficiary as if received directly by the beneficiary.²⁸

Finally, all business trusts whose certificates of beneficial interests are publicly traded will be taxed as corporations under IRC § 7704.

Conclusion

VBTs are under-used entities that can be adapted to many suitable and even creative uses to the advantage of the beneficial owners. Other entities might provide similar results and consequences, so a careful choice of entity analysis is always called for when creating a new entity or changing the form of an existing entity. For existing entities or new entities that are or have been traditionally organized as a common law trust, a VBT may be the best choice of the available statutory entities. The primary benefit of a VBT is the opportunity to use its unique characteristics and contractual flexibility with a trust-style structure, documentation, and nomenclature, while

obtaining the benefit of a statutory regime and limited liability for its beneficial owners from liabilities arising from the operations or affairs of the VBT. ♣

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(Endnotes)

1. See VA. CODE ANN. § 13.1-1201 *et seq.* (2001).
2. DEL. CODE ANN. § 12-3800 *et seq.*
3. UNIF. STATUTORY TRUST ENTITY ACT (the “Uniform Act”) (UNIF. LAW COMM’N 2010); see <http://www.uniformlaws.org/> (2009 version enacted in only DC and KY; 2013 revisions not adopted).
4. See the annual report of the Virginia State Corporation Commission for 2016 at https://www.scc.virginia.gov/comm/an_rept.aspx, page 585.
5. VA. CODE ANN. § 13.1-1201.
6. *Id.* § 13.1-1228.
7. *Id.* § 64.2-700.A.1.
8. *Id.* § 13.1-1201.
9. *Id.* § 13.1-1209.
10. *Id.* § 13.1-1201, by cross-reference to VA. CODE ANN. § 13.1-603.
11. VA. CODE ANN. § 13.1-1000 *et seq.*
12. *Id.* § 50-73.132; See VA. CODE ANN. §§ 50-73, 50-78.
13. *Id.* § 13.1-1225.
14. *Id.* §§ 13.1-1219.B.1, 13.1-1231.D.
15. *Id.* § 13.1- 1041.1.D.
16. *Id.* §§ 13.1-1041.1.E; 13.1-1226.B.2.
17. *Id.* § 58.1-301.
18. *Id.* § 13.1-1207.
19. *Id.* § 13.1-1211, 1212.
20. *Id.* § 13.1-1201, 1219.
21. *Id.* § 13.1-1284.
22. *Id.* § 55-17.1.
23. Treas. Reg. § 301.7701-3.
24. *Id.* § 301.7701-4(b)
25. *Morrissey v. Commissioner*, 296 U.S. 344 (1935).
26. Treas. Reg. § 301.7701-4(a).
27. See Treas. Reg. § 301.7701-1 to -4).
28. See Treas. Reg. 1.671-2(c). ♣