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TAX INFORMATION RELEASE No. 94-1

RE: Taxation of Interest Income Earned by Trusts Under the Hawaii General Excise Tax Law

After publication of Tax Information Release (TIR) 93-7, relating to revocable living trusts, questions have arisen about whether interest income from nonbusiness assets that have been transferred to such trusts, or to other trusts commonly used as estate planning vehicles, is taxable under the General Excise Law solely because the assets are held by a trust rather than an individual.

In TIR 42-74, issued on April 19, 1974, the Department issued guidance on whether interest income is subject to the general excise tax. In that TIR, the Department listed several examples of interest considered to be business income, which is subject to general excise tax, and interest not considered to be business income, which is not subject to the tax.

TIR 42–74 also states: “Business entities, such as corporations, partnerships, joint ventures, sole proprietorships, are generally created for the purpose of making profits, and practically all interest income earned by such business entities are considered business income subject to the general excise tax.” The Supreme Court of Hawaii recognized this principle in In re C. Brewer & Co., 65 Haw. 240, 649 P.2d 1155 (1982). In concluding that charges for services provided between corporations with common ownership were subject to the general excise tax, the court observed that all of the corporations were organized for business purposes, and that transactions of the type that produced the income in dispute ordinarily resulted in taxable gross income. Id. at 245, 649 P.2d at 1158. Thus, if an entity is organized for business purposes, such as a for profit corporation, partnership, or joint venture, the Department will presume that the entity’s interest income is subject to general excise tax.

TIR 42–74 holds that interest earned by a sole proprietorship is almost always business income subject to the general excise tax. A sole proprietorship is not a legal entity separate from the individual, however. TIR 42-74, Taxable Situations, Example 2, holds that an individual sole proprietor can have nonbusiness interest income if the nonbusiness assets on which the interest income is paid are clearly segregated from the business assets and are not in fact used as business capital.

Interest income earned by trusts is not discussed in TIR 42-74, and the issue also was left open in TIR 93–7. For the following reasons, the Department will use the standard applicable to an individual, rather than the standard applicable to a corporation, partnership, or joint venture, to determine whether interest income earned by a trust is subject to the general excise tax.

In Morrissey v. Commissioner, 296 U.S. 344, 356-57 (1935), the United States Supreme Court stated that a business profit objective is not characteristic of an ordinary trust, which traditionally is created to protect and preserve property for the benefit of others. This principle was incorporated into the Treasury Regulations that contain the principles for distinguishing corporations, partnerships, and trusts. Section 301.7701-2(a) of these regulations states that having associates and an objective to carry on business and divide the gains therefrom are common to corporations and partnerships but are not characteristics of trusts.

The same traditional characteristics of trusts discussed in Morrissey v. Commissioner, and in the Treasury Regulations, have been recognized in Hawaii. Bishop v. Pittman, 33 Haw. 647, 654 (1935), explained that the primary duty of a trustee is "to preserve and protect the trust property for all the beneficiaries and to administer it strictly in compliance with the tenor of the trust." Ahuna v. Department of Hawaiian Home Lands, 64 Haw. 327, 340, 640 P.2d 1161, 1169 (1982), held that the trustee under a trust is generally obligated under the reasonable prudent person standard to protect and care for the property, which does not permit the trustee to "prudently speculate for instance."

Thus, for-profit corporations and partnerships are generally organized for the purpose of conducting business and sharing profits. Trusts are different because they are generally organized for the purpose of protecting or conserving property. Because of this difference, the Department will not presume that all interest income earned by a trust is subject to the general excise tax, unless the trust is a "business trust" classifiable as a corporation under Treasury Regulations sections 301.7701-2 and 301.7701-4.

At the same time, the Department recognizes that many trusts are authorized under their governing instruments to conduct business. As in the case of an individual, then, the Departmet will examine the activities of the trust to determine whether its income is from the safekeeping of nonbusiness property or the conduct of business activity (which includes the investment of business capital). If a trust is found to be engaging in business, interest it earns will be subject to the general excise tax unless the trust can prove to the satisfaction of the Department that business assets are clearly segregated from nonbusiness assets, in which case the interest paid on the nonbusiness assets will not be subject to the general excise tax.

> Example 1: G is the grantor of a revocable living trust (RLT). The RLT's trust instrument provides that G, while living, may withdraw any or all of the income or principal of the RLT at any time. G transfers $10,000 from G's personal savings account to an interest-bearing account held by the RLT. The RLT conducts no business and receives no income other than interest. The RLT received the interest because it deposited nonbusiness assets in the bank for safekeeping, not because of any business activity or because of the investment of business capital. The interest is not business income subject to the general excise tax.

Example 2: G is the grantor of a charitable remainder annuity trust (CRAT). The CRAT's trust intrument provides that the trust will pay a fixed amount every month to G as long as G is alive, and upon G's death the trust will distribute its assets to charity. The CRAT holds title to residential property which is rented to tenant T. The CRAT also holds as several income-producing bonds for investment purposes. The CRAT maintains separate business and investment accounts. Business receipts, including the monthly rent checks from T, are deposited into the business account. Business expenses, such as the general excise tax for which the CRAT is liable, are paid out of the business account. Income from the bonds is deposited into the investment account. There are no facts indicating that funds in the two accounts are commingled. None of the assets in the investment account is used as business capital. Interest paid on the business account is subject to the general excise tax. Interest paid on the bonds, and interest paid by the bank on the investment account, are not subject to the general excise tax.

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HRS Sections Explained: HRS §§237-1, 237-3(a)

CORRECTION NOTICE

Tax Information Release No. 93-7, issued December 23, 1993, is corrected as follows: The words “Example 2” on the third line of page 4 should instead read “Example 3”.