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Untangling the Web of Gift-Leaseback Jurisprudence

Robert J. Peroni*

INTRODUCTION

Attempts by taxpayers to avoid the rigors of the progressive rate structure of the federal income tax are as American as apple pie.[1] Using a variety of devices, taxpayers have endeavored to deflect a portion of their income to favored relatives in lower tax brackets while retaining various degrees of control over the source of that income.[2] One increasingly attractive assignment-of-income device involves the transfer of low-basis or nondepreciable property used in a taxpayer's business[3] to a

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* Assistant Professor of Law, Tulane University.

1. Judge Learned Hand articulated the following, often-quoted defense of tax avoidance:

> [A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). *See generally* Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968) (extensive analysis of Judge Hand's opinions on the issue of form and substance in the federal tax law). Although courts repeatedly have disavowed using tax-avoidance motive as a ground for deciding federal tax cases, much of the strained reasoning in gift-leaseback jurisprudence is attributable to the courts' uneasiness with the conspicuous tax-avoidance motive underlying the transaction. *See* Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 740-42 (1978); *infra* notes 30-37 and accompanying text.

2. For excellent general discussions of the assignment-of-income doctrine, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293 (1962); Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes*, 64 YALE L.J. 991 (1955); Soll, *Intra-Family Assignments: Attribution and Realization of Income* (pts. 1 & 2), 6 TAX L. REV. 435 & 7 TAX L. REV. 61 (1951); Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 COLUM. L. REV. 791 (1933).

3. A high bracket taxpayer should consider using the gift and leaseback of business property as a tax-savings device at the point when the annual fair rental value of the property exceeds the taxpayer's annual depreciation and other deductions from the property that would be shifted to the lower-bracket donee. Accordingly, nondepreciable property and property that the taxpayer has completely depreciated are the most attractive subjects of a gift-leaseback arrangement. With the introduction of the accelerated cost recovery system of

trust[4] for the benefit of immediate family members, usually the taxpayer's minor children.[5] The trust is carefully designed to comply with the grantor trust provisions of the Internal Reve-

depreciation in new § 168, enacted as part of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 203 (codified as amended at I.R.C. § 168 (1982)), the gift-leaseback transaction should become even more widely used as a tax-savings device.

Although most of the gift-leaseback cases have involved transfers of real property (such as an office building) or depreciable equipment owned by the donor and used in his or her business, other types of business property can be the subject of a valid gift-leaseback, such as furniture and items of decoration located on the donor's business premises, business supplies, professional libraries, and patents, copyrights, and other forms of intellectual property. *See* Lerner v. Commissioner, 71 T.C. 290 (1978) (physician's deduction of rental payments in a gift-leaseback of medical equipment, business supplies, office furnishings, and items of decoration sustained by Tax Court), *acq. in result* 1984-17 I.R.B. 5; Banoff, *Reducing the Income Tax Burden Of Professional Persons by Use Of Corporations, Joint Ventures, Subpartnerships and Trusts,* 58 TAXES 968, 998-99 (1980); Simmons, *Resisting Continuing IRS Attacks on The Use of "Gift and Leaseback" in Tax Planning for the Professional,* 56 TAXES 195, 198 (1978); Comment, *Gift and Leaseback: Planning Perspectives in an Unlegislated Field,* 63 KY. L.J. 205, 209 (1975) [hereinafter cited as Kentucky Comment]. One commentator has even suggested that the donor's interest as lessee in a lease on real property used in the donor's business can be the subject of a valid gift-leaseback. Banoff, *supra,* at 998-99. If this latter arrangement is respected, the donor-sublessee deflects income to the trust in the amount of the difference between the presumably higher current rental value of the property owed by the donor to the sublessor trust under the terms of the leaseback and the rent paid by the trust to the lessor under the original lease.

4. Although this Article focuses primarily on gift-leaseback transactions in which the property is placed in trust, the gift-leaseback arrangement can be effected without interposing a trust between the donor-lessee and the related donee-lessor. It is much more difficult, however, for the donor to establish that sufficient control over the property has been relinquished for the transaction to be respected for tax purposes when a trust is not involved. *See, e.g.,* White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951) (disallowing the rental deductions for a gift-leaseback effected without a trust), *cert. denied,* 343 U.S. 928 (1952); *see also* Cohen, *Transfers and Leasebacks to Trusts: Tax and Planning Considerations,* 43 VA. L. REV. 31, 37-40 (1957) (discussing non-trust leaseback cases and concluding that the rental deductions generally will be disallowed if the gift-leaseback is effected without a trust); Comment, *Gift-Leaseback Transactions: An Unpredictable Tax-Savings Tool,* 53 TEMP. L.Q. 569, 571-73 (1980) (discussing court decisions in which the gift-leaseback transaction was accomplished without using a trust).

5. By redirecting income to a trust for the benefit of a lower-bracket child, the parent can provide the child with items of support at a lower after-tax cost, provided that such items are not considered part of the donor's legal support obligation and the donor has not become obligated by contract (express or implied) to pay the expenses. If the trust is used to satisfy the donor's contractual obligations or legal obligation of support, its income will be taxed to the donor under I.R.C. § 677 (1982). For example, a gift-leaseback can be used by a taxpayer to accumulate funds to pay for a child's college and graduate school educational expenses because such expenses generally are not considered part of the donor's support obligation. *See* McGaffey, *College Education with Pre-Tax Dollars,* 15 INST. ON EST. PLAN. ¶¶ 300, 302.4, 306 (1981).

nue Code[6] so that none of its income will be taxed to the gran-

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6. I.R.C. §§ 671-679 (1982). Under these provisions, all or a portion of the income of a trust is taxed to the grantor if (1) the grantor retains a reversionary interest in the trust corpus that will take effect within ten years of the conveyance of the corpus to the trust, I.R.C. § 673 (1982); (2) the grantor retains the power to control the beneficial enjoyment of the trust corpus or income (with certain exceptions), I.R.C. § 674 (1982); (3) the grantor retains certain administrative controls exercisable primarily for personal benefit, I.R.C. § 675 (1982); (4) the grantor retains the power to revoke the trust, I.R.C. § 676 (1982); or (5) the income of the trust may be used for the benefit of the grantor or the grantor's spouse, I.R.C. § 677 (1982). The grantor trust provisions are complicated in operation and any detailed discussion of them, except to the extent pertinent to an analysis of the gift-leaseback transaction, is beyond the scope of this Article. For comprehensive discussions of these provisions that include planning considerations, see J. PESCHEL & E. SPURGEON, FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES ¶¶ 4.01-.09, 5.01-.05, 6.01-.04 (1979); Ervin, *Income, Estate and Gift Tax Problems in Planning Family Trusts Under the 1954 Internal Revenue Code,* 29 S. CAL. L. REV. 1 (1955); Hundley, *The Clifford Trust and Other Grantor Trusts—From the Draftman's Viewpoint,* 4 S. TEX. L.J. 16 (1958).

If the trust arrangement does not satisfy all of the grantor trust rules, the donor-lessee will remain the owner of the trust property for federal income tax purposes and be taxed on its income, and the court will not have to reach the issue whether the rental deductions on the leaseback are allowable under § 162(a)(3). *See* Duffy v. United States, 487 F.2d 282 (6th Cir. 1973) (holding that income from the trust remained taxable to the donor-lessee under § 677(a)(2), but not deciding whether the rental deductions on the leaseback were allowable under § 162(a)(3)), *cert. denied,* 416 U.S. 938 (1974).

If the donor's rental deduction is disallowed, either because the donor retained substantially the same control over the property as prior to the gift transfer or because the transaction as a whole lacked a business purpose under the government's integrated transaction approach, *see infra* notes 67-96 and accompanying text, the donor should be treated as the owner of the property and should receive the depreciation and maintenance expense deductions from the property, and the donor's rent payments should be treated, for income tax purposes, as gifts to the trust. *See* Rev. Rul. 54-9, 1954-1 C.B. 20 (disallowing rental deduction in a gift-leaseback transaction involving a ten-year trust, and treating grantor-lessee as owner of the trust property and the rent payments as gifts to the trust), *modified on other grounds,* Rev. Rul. 57-315, 1957-2 C.B. 624 (ruling that the value of the right to receive the rentals during the term of the trust is a completed gift, for federal gift tax purposes, at the time that the property is transferred in trust); *see also, e.g.,* Wiles v. Commissioner, 59 T.C. 289, 295 (1972) (Commissioner conceding that trust's income should be reduced to the extent that the rental payments are not deductible by the donor-lessee), *aff'd mem.,* 491 F.2d 1406 (5th Cir. 1974); J. FREELAND, S. LIND & R. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 407 (4th ed. 1982). Despite the logical nature of this approach, there is some risk of double taxation of the rental income if the grantor's rental deduction is disallowed, either because the rent payments may be treated as taxable income to the trust or because the grantor may be taxed on the trust's income (including the grantor's own rent payments). *See, e.g.,* Oliver, *Income Tax Aspects of Gifts and Leasebacks of Business Property in Trust,* 51 CORNELL L. REV. 21, 41-43, 45-46 (1965); Kentucky Comment, *supra* note 3, at 321-35; *cf.* Lerner v. Commissioner, 71 T.C. 290, 296 (1978) (upholding the validity of a three-party gift-leaseback transaction with the donor's professional corporation as lessee and allowing the corporation to deduct the rent paid to the trust; Commissioner argued that the rent paid by the corporation to the trust was taxable to the donor, either as a dividend from the corporation or under the theory that the donor remained the owner of the

tor. The taxpayer then leases back the property for continued business use and deducts the rental payments as a business expense under section 162(a)(3) of the Code.[7] This arrangement, if respected for tax purposes, transfers a portion of the taxpayer's business income to the lower-bracket trust beneficiaries[8] through the rental payments, with ownership of the property remaining within the family unit and possession of the property remaining with the taxpayer.[9]

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trust for tax purposes), *acq. in result* 1984-17 I.R.B. 5. The conservative tax planner may want to avoid using the gift-leaseback as a planning tool because of this risk.

7. Section 162(a)(3) of the Code provides, in pertinent part:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —
>
> . . . .
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

I.R.C. § 162(a)(3) (1982). The regulations promulgated under § 162 concerning the rental deduction do not discuss the deductibility of rent paid under a gift-leaseback arrangement. *See* Treas. Reg. § 1.162-11 (1958).

8. For federal income tax purposes, a trust is treated as a separate tax-paying entity. *See* I.R.C. §§ 1(e), 641 (1982). The trust, however, can deduct the amount of its income that is required to be distributed currently, or is actually distributed, to the trust beneficiaries, *see* I.R.C. §§ 651, 661 (1982), and the beneficiaries must include such income in their gross income for the year, *see* I.R.C. §§ 652, 662 (1982). Thus, unlike a regular C corporation, the trust's income generally is taxed only once, either at the trust or beneficiary level. *See generally* J. PESCHEL & E. SPURGEON, *supra* note 6, ¶¶ 3.01-.04.

9. The actual tax savings achieved by this arrangement roughly are equal to the net rental income from the property (rental payments less deductible expenses), multiplied by the difference in the marginal tax rates of the donor and trust beneficiaries (assuming that the income is distributed or required to be distributed to the beneficiaries), minus any gift tax that the donor incurs on the transfer of the property. The maximum tax savings on a gift-leaseback transaction may be achieved by having the donor-lessee lease back the property on a "net-lease" basis with the donor-lessee agreeing to pay all taxes, utilities, insurance, and other operating expenses of the trust property. The donor-lessee's payment of these expenses would be treated as an additional rental payment by the lessee and as additional rental income to the donee-trust. Furthermore, the donee-trust would be treated as constructively paying these expenses and would be entitled to deduct the expenses if they are otherwise deductible. *See, e.g.,* Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929); Treas. Reg. § 1.61-8(c) (1957); Treas. Reg. § 1.162-11(a) (1958); *see also* G. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE ¶ 4.05 (3d ed. 1979). Accordingly, these deductions, in effect, would remain with the higher-bracket donor (through an increased rental deduction) and only the depreciation deduction would shift to the donee. Leasing the property back on a net-lease basis should not affect the validity of the gift-leaseback arrangement because the net lease is a commercially acceptable method of renting property. *See* Oakes v. Commissioner, 44 T.C. 524, 530-31 (1965), *nonacq.* 1967-1 C.B. 3. *But cf.* Rosenfeld v. Commissioner, 706 F.2d 1277, 1288 (2d Cir. 1983) (MacMahon, J., dissenting); Arlinghaus, *Uncertainty in Gift-Leaseback Area Continues After Tax Court's Decision in*

This relatively simple transaction has precipitated a vigorous and persistent attack by the Internal Revenue Service[10] and a resulting stream of confusing and conflicting court decisions as to the standards to be used in testing the propriety of the donor's rental deductions on the leaseback. The Fourth[11] and Fifth[12] Circuits have followed the government's position[13] that no rental deduction is allowable, because the gift and leaseback, viewed as an integrated whole, have no business purpose and lack economic reality. The Tax Court[14] and the

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May, 9 J. REAL EST. TAX. 245, 256 (1982) (suggesting that donee-lessor's payment of taxes, insurance, repair costs, and related expenses indicates the donee's ownership of and control over the trust property). In theory, however, the reasonableness of the rent paid by the donor-lessee to the trust should be evaluated in the light of the net-lease arrangement, although courts have largely ignored this fact. *See* Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983) (ignoring donor-lessee's agreement to pay utility and other incidental expenses, other than taxes); May v. Commissioner, 76 T.C. 7 (1981) (same), *aff'd,* 723 F.2d 1434 (9th Cir. 1984). *But see* Rosenfeld v. Commissioner, 43 TAX CT. MEM. DEC. (CCH) 1353, 1356 n.7 (1982) (questioning, but not deciding, whether it was "reasonable" for the donor-lessee to pay a gross rental based on the entire value of the property in the net lease situation), *aff'd,* 706 F.2d 1277 (2d Cir. 1983); *May,* 76 T.C. at 40 (Wilbur, J., dissenting) (mentioning net basis of the leaseback as a factor evidencing the unreasonableness of the rental).

10. The Internal Revenue Service designated the gift-leaseback transaction in which the grantor-lessee retains a reversionary interest in the property a "prime issue" in 1973. National Office List of Prime Issues, 737 STAND. FED. TAX REP. ¶ 6527 (Jan. 1, 1973). Prime issues are those that the Service ordinarily will litigate and not settle by closing agreement or compromise. Accordingly, the tax adviser must approach the area with caution and should warn the client that litigation is possible. *Cf.* Simmons, *New Developments in the "Gift and Leaseback" in Tax Planning for the Professional,* 51 TAXES 654, 658 (1973) (advising counsel not to plan their clients into litigation and suggesting that no reversion be retained by the donor and that the lease terms by negotiated with an independent trustee after the transfer by gift).

11. *See* Perry v. United States, 520 F.2d 235 (4th Cir. 1975), *cert. denied,* 423 U.S. 1052 (1976).

12. *See* Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *cert. denied,* 424 U.S. 967 (1976); Wiles v. Commissioner, 491 F.2d 1406 (5th Cir. 1974), *aff'g mem.* 59 T.C. 289 (1972); Audano v. United States, 428 F.2d 251 (5th Cir. 1970); Chace v. United States, 422 F.2d 292 (5th Cir. 1970), *aff'g per curiam* 303 F. Supp. 513 (M.D. Fla. 1969); Furman v. Commissioner, 381 F.2d 22 (5th Cir. 1967), *aff'g per curiam* 45 T.C. 360 (1966); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied,* 382 U.S. 814 (1965). The new Eleventh Circuit presumably will treat these decisions of the old Fifth Circuit as binding precedent, unless they are overruled by the Eleventh Circuit sitting en banc. *See* Bonner v. City of Prichard, 661 F.2d 1206, 1207 (11th Cir. 1981) (holding that Fifth Circuit decisions handed down on or before September 30, 1981, are binding as precedent in the Eleventh Circuit).

13. *See, e.g.,* Rev. Rul. 54-9, 1954-1 C.B. 20, *modified on other grounds,* Rev. Rul. 57-315, 1957-2 C.B. 624; 323 IRS LETTER RULINGS REP. 8318079 (CCH) (Feb. 2, 1983).

14. *See, e.g.,* Rosenfeld v. Commissioner, 43 TAX CT. MEM. DEC. (CCH) 1353 (1982), *aff'd,* 706 F.2d 1277 (2d Cir. 1983); May v. Commissioner, 76 T.C. 7 (1981), *aff'd,* 723 F.2d 1434 (9th Cir. 1984); Lerner v. Commissioner, 71 T.C. 290 (1978),

Second,[15] Third,[16] Seventh,[17] Eighth,[18] and Ninth[19] Circuits have allowed the taxpayer to deduct the rentals on the leaseback, but without developing any consistent theoretical approach for deciding the issue.

Courts allowing the rental deduction generally agree that only the leaseback portion of the transaction must serve a business purpose and then only in the sense that use of the leased property must be necessary in the taxpayer's business. These courts also generally agree, but with less harmony, that the leaseback portion of the transaction must have the earmarks of a bona fide rental transaction, that is, the leaseback "normally" should be in writing[20] and must require payment of a reason-

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acq. in result 1984-17 I.R.B. 5; Quinlivan v. Commissioner, 37 TAX CT. MEM. DEC. (CCH) 346 (1978), *aff'd,* 599 F.2d 269 (8th Cir.), *cert. denied,* 444 U.S. 996 (1979); Mathews v. Commissioner, 61 T.C. 12 (1973), *rev'd,* 520 F.2d 323 (5th Cir. 1975), *cert. denied,* 424 U.S. 967 (1976). The Tax Court continues to follow its four-part test announced in *Mathews*, despite the reversal of *Mathews* by the Fifth Circuit, except in those cases in which the appeal would lie to the Fourth, Fifth, and, presumably, Eleventh Circuits. Under the rule established in Golsen v. Commissioner, 54 T.C. 742, 757 (1970), *aff'd,* 445 F.2d 985 (10th Cir.), *cert. denied,* 404 U.S. 940 (1971), the Tax Court is bound to follow the precedent of the court of appeals to which the appeal would lie, if that precedent is "squarely in point." *See* Butler v. Commissioner, 65 T.C. 327 (1975) (Tax Court following Fifth Circuit's business-purpose test); *see also* Zumstein v. Commissioner, 32 TAX CT. MEM. DEC. (CCH) 198 (1973) (Tax Court following Fifth Circuit precedent).

15. *See* Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983). *But cf.* White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951) (disallowing rental deductions in a gift-leaseback effected without a trust), *cert. denied,* 343 U.S. 928 (1952); Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962) (citing *White v. Fitzpatrick* and disallowing rental deduction in a trust-leaseback).

16. *See* Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied,* 340 U.S. 814 (1950); *see also* Engel v. United States, 400 F. Supp. 5 (W.D. Pa. 1975) (upholding the donor's deduction of the rental payments in a gift-leaseback transaction involving a Clifford trust), *aff'd mem.,* 562 F.2d 41 (3d Cir. 1977). The affirmance by the Third Circuit in *Engel* was decided by an evenly divided court sitting en banc, indicating that support for the *Brown* decision has been eroded in the Third Circuit.

17. *See* Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).

18. *See* Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied,* 444 U.S. 996 (1979).

19. *See* May v. Commissioner, 723 F.2d 1434 (9th Cir. 1984); Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (only implicitly rejecting the government's integrated transaction business-purpose test).

20. As the modifying word "normally" suggests, the requirement of a written lease is not absolute, and there have been cases in which the rental deduction was allowed in a gift-leaseback transaction without a written lease when the taxpayer presented sufficient other evidence to prove the existence of a binding lease agreement. *See Brooke,* 468 F.2d at 1157; May v. Commissioner, 76 T.C. 7 (1981), *aff'd,* 723 F.2d 1434 (9th Cir. 1984). For a criticism of these courts' rather lax application of the written lease requirement, see *infra* notes 119-25 and accompanying text.

Disagreement about the requirement of a written lease surfaced in the Tax

able rent. The judicial consensus dissolves when the courts consider whether the taxpayer has surrendered sufficient control over the property to warrant treating the gift portion of the transaction as a valid transfer of ownership to the donee for purposes of section 162(a)(3). Using an approach reminiscent of the Supreme Court's decision in *Helvering v. Clifford*,[21] the courts have looked at several factors in deciding the control issue, including whether the trustee is independent, whether the leaseback has been prearranged, whether the initial term of the leaseback is coextensive with the trust's duration, and whether the grantor has retained a reversionary interest in the trust property, but the courts have not agreed on the significance of these factors or even why they are relevant to the deductibility of rentals under the Internal Revenue Code. The result of this judicial confusion is a body of incoherent case law that seems to change with each new court decision, an absence of clear guidelines for taxpayers and their advisers,[22] and a misalloca-

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Court's decision in *May*. Three dissenting judges viewed the absence of a written lease in that case as a factor supporting disallowance of the rental deduction. 76 T.C. at 34 (Simpson, J., joined by Parker, J., dissenting); *id.* at 36-37 (Wilbur, J., joined by Parker, J., dissenting). On appeal, the Ninth Circuit affirmed the Tax Court's allowance of the rental deductions on the leaseback, without discussing the written lease issue. 723 F.2d at 1436-37.

21. 309 U.S. 331 (1940). In *Clifford*, the taxpayer transferred income-producing securities to a five-year reversionary trust for the benefit of his wife, naming himself as trustee. The taxpayer retained the right to accumulate income in his "absolute discretion" and broad administrative powers over the trust corpus. The Court held that the income from the trust corpus remained taxable to the taxpayer because he retained dominion and control over the trust corpus that was tantamount to ownership of the property for federal income tax purposes. The uncertainty created by the *Clifford* case and the inconsistent application of the *Clifford* decision by lower courts was the primary catalyst for the Treasury's issuance in 1946 of detailed regulations on the subject of grantor trusts, and ultimately, for enactment of the grantor trust rules of the 1954 Code. *See* 3 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 80.1.1 (1981); Ervin, *supra* note 6, at 2-3.

22. This continuing uncertainty has led a number of commentators to give only very tentative approval to the arrangement as a planning device. *See, e.g.*, Elder, *Gifts and Leasebacks: The Current Scene*, 11 INST. ON EST. PLAN. ¶¶ 1400, 1405 (1977); Peschel, *New Developments in Estate Planning*, 28 MAJOR TAX PLAN. 1, 7-8 (1976); Comment, *Intrafamily Trust Leasebacks: A Fifth Circuit Perspective*, 11 CUM. L. REV. 47, 72-73 (1980); Comment, *The Deductibility of Rentals in the Context of Gifts and Leasebacks of Income-Producing Property in Trust*, 47 TENN. L. REV. 601, 627-30 (1980).

Because reasonable certainty of tax consequences is very important to the planner, any solution to the gift-leaseback controversy must take into account this need for certainty. As four prominent scholars stated in the context of a discussion of the American Law Institute's proposal that influenced the formulation of the grantor trust rules of the 1954 Code:

> The family property planners . . . have also realized that the prime requirement for their planning is that of tax certainty. As long as the pol-

tion of judicial and administrative resources to the inevitable litigation that such confusion engenders. To date, the Supreme Court and Congress have refused to resolve this judicial quagmire.

Although the gift-leaseback transaction has generated a flood of legal commentary,[23] the issue remains a worthy target for criticism and analysis. This Article suggests that the courts have failed to resolve satisfactorily the gift-leaseback issue because they have unduly emphasized the tax-avoidance motive underlying the transaction and other similarly misplaced concerns, and because they have not properly recognized the doctrinal relationship between the deduction of rent under section 162(a)(3) in a gift-leaseback transaction and the grantor trust rules developed for gifts to trusts,[24] the statutory rules for assigning income through a family partnership,[25] and the more

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> icy line is chartered within the general area of acceptable policy compromise, it is relatively unimportant that here and there the precise location of the line may have produced a sharp but limited disagreement. Much more important than the terms of the resolution of that disagreement is the fact that the disagreement has been resolved and a definite tax answer provided. The family property planner thus knows for certain the tax price tag attached to each of his techniques. He is not forced to plan today and then find out years later which tax price tag the administrator or the judge decides to place on the technique utilized. Moreover, many of the family property planners allow an appreciable margin to exist between their course and the dividing line. They are therefore usually untroubled by the slight bends in that line thought necessary by the Treasury to catch the tax avoider who charts his course as close to the line as possible.

Holland, Kennedy, Surrey & Warren, *A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft,* 53 COLUM L. REV. 316, 360 (1953).

23. *See, e.g.,* Friedlander, *Gift-Leaseback: The IRS' Misguided Campaign,* 19 CAL. W.L. REV. 288 (1983); Froehlich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements,* 52 CALIF. L. REV. 956 (1964); Price, *"Eat, Drink and Be Merry" at the Expense of the Federal Fisc,* 49 TAXES 175 (1971); Shurtz & Harmelink, *Trust-Leasebacks After Quinlivan,* 16 CAL. W.L. REV. 1 (1980); Note, *Clifford Trusts: A New View Towards Leaseback Deductions,* 43 ALB. L. REV. 585 (1979) [hereinafter cited as Albany Note]; Note, *Gifts and Leasebacks: Is Judicial Consensus Impossible?,* 49 U. CIN. L. REV. 379 (1980) [hereinafter cited as Cincinnati Note]; Note, *Tax Consequences of an Intrafamily Transfer of Business Property into Trust for Dependents with a Leaseback by the Grantor's Business,* 73 COLUM. L. REV. 1420 (1973) [hereinafter cited as Columbia Note]; Note, *Gift and Leaseback—Tax Planning in the Shadows of Assignment of Income and Business Purpose,* 62 GEO. L.J. 209 (1973); Note, *Finding the Key to the Deductibility of Rental Payments Under a Gift and Leaseback,* 10 LOY. U. CHI. L.J. 767 (1979).

24. As noted earlier, the grantor trust rules are contained in I.R.C. §§ 671-679 (1982).

25. *See* I.R.C. § 704(e) (1982). Subject to certain limitations, § 704(e) allows an owner of a business in which capital is a material income-producing factor to deflect a portion of the business income to a lower-bracket family member by giving that family member a partnership interest in the business.

general judge-made rules for assigning income through transfers of income-producing property.[26] The courts also have misread congressional intent concerning the gift-leaseback issue and have misapplied the amorphous substance-over-form, business-purpose, and step-transaction doctrines.[27] That the gift-leaseback transaction remains controversial is evidenced by the five different opinions in the Tax Court's 1981 decision in *May v. Commissioner*[28] and by the Second Circuit's 1983 decision in *Rosenfeld v. Commissioner*,[29] which upheld the validity of the gift-leaseback transaction but with a vigorous dissenting opinion that criticized the generally favorable treatment accorded the gift-leaseback transaction in the recent case law.

This Article first considers the sources of confusion in the gift-leaseback controversy. It then analyzes the various approaches that the government and the courts have used to resolve the problem, indicating the inconsistencies in reasoning that characterize these approaches. Finally, this Article presents a suggested approach for deciding the validity of the rental deduction in a gift-leaseback transaction and concludes

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Id. For this income-splitting device to be effective, the donor must transfer ownership of, and dominion and control over, the donated partnership interest to the donee. Treas. Reg. §§ 1.704-1(e)(1)(iii), -1(e)(2) (1956). *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ch. 14 (1977) (extensive discussion of family partnerships); 3 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation pt. 17 (3d ed. 1981) (same).

26. Under the principles developed in the Supreme Court's decisions in Blair v. Commissioner, 300 U.S. 5 (1937), Helvering v. Horst, 311 U.S. 112 (1940), Harrison v. Schaffner, 312 U.S. 579 (1941), and their progeny, to effectively assign income from property to a lower-bracket donee, the higher-bracket donor must transfer to the donee an interest in the property coextensive in time with the interest the donor owns. If the assigned interest is for a shorter duration than the donor's interest but is for a period of at least ten years, it remains unclear whether the assignment will be effective by analogy to the ten-year cutoff in I.R.C. § 673 (1982). *See* Rev. Rul. 55-38, 1955-1 C.B. 389 (ruling that a lifetime income beneficiary of a testamentary trust who irrevocably assigned a certain portion of the trust income for a period of at least ten years had made an effective assignment of income to the donee, and treating the assignment as a disposition of a "substantial interest in the trust property" by analogy to the ten-year cutoff in the Clifford trust regulations of the 1939 Code). Of course, under the doctrine of Helvering v. Clifford, 309 U.S. 331 (1940), and its progeny, the donor also must surrender effective control over the transferred property interest to the donee to avoid taxation on the income from that interest. For an extensive discussion of these principles, see Lyon & Eustice, *supra* note 2.

27. *See infra* notes 67-96 and accompanying text.

28. 76 T.C. 7 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984). The Tax Court issued one concurring opinion and three dissenting opinions in the *May* case.

29. 706 F.2d 1277 (2d Cir. 1983). United States District Judge MacMahon, sitting by designation, wrote the dissenting opinion in the *Rosenfeld* case. *Id.* at 1283-88.

with some recommendations for structuring the gift-leaseback transaction.

I. SOURCES OF CONFUSION

A. Spurious Concerns of the Courts and the Government

The confusion surrounding the gift-leaseback case law can best be understood by first identifying what about the transaction so concerns the government and the courts. Only by demonstrating the irrelevance or misplaced emphasis of these concerns in resolving the gift-leaseback controversy can a more logical approach be developed.

First and foremost among these concerns is the obvious tax-avoidance motive underlying the transaction. Although courts have often stated that a tax-avoidance motive is not to be held against the taxpayer,[30] they clearly are uncomfortable with upholding tax-motivated transactions and will strain their interpretation of statutory language, legislative history, and case precedent to strike down perceived tax-avoidance devices. In the gift-leaseback area, this concern with tax-avoidance motive is evident in those decisions adopting the government's questionable business-purpose test. These courts have used the amorphous judge-made doctrines of "business purpose," "step transaction," and "substance over form" to rationalize disallowing the rental deduction, but plainly their real message is that tax avoidance, particularly through the reallocation of income within the family unit, is an unacceptable objective in structuring one's affairs.[31] Even some courts upholding the deduction have exhibited their undue concern with the tax-avoid-

30. In *Gregory v. Helvering*, the case in which the Supreme Court first enunciated its amorphous business-purpose doctrine, the Court stated:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

293 U.S. 465, 469 (1935) (citations omitted). The supposed neutrality of tax-avoidance purpose in deciding federal tax cases has been extensively analyzed elsewhere. *See, e.g.,* authorities cited *supra* note 1; R. Paul, *Restatement of the Law of Tax Avoidance,* in Studies in Federal Taxation 9 (1st series 1937); Angell, *Tax Evasion and Tax Avoidance,* 38 Colum. L. Rev. 80 (1938); Blum, *Motive, Intent, and Purpose in Federal Income Taxation,* 34 U. Chi. L. Rev. 485 (1967); Cahn, *Taxation: Some Reflections on the Quest of Substance,* 30 Geo. L.J. 587 (1942); Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation,* 37 Tul. L. Rev. 355 (1963); Rice, *Judicial Techniques in Combating Tax Avoidance,* 51 Mich. L. Rev. 1021 (1953).

31. For example, in *Van Zandt v. Commissioner*, the first appellate decision to adopt the government's business-purpose test in the context of a gift-

ance aura of the transaction by searching for elusive nontax purposes for the arrangement.[32]

The concern with tax-avoidance motive evidences the government's and the courts' misunderstanding of the nature of the issue involved in the gift-leaseback controversy. The issue in the gift-leaseback cases is not why the transaction was undertaken—clearly, as in most assignment-of-income cases, it was primarily for tax-avoidance purposes—but rather what the transaction accomplished.[33] In other words, the issue is

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leaseback transaction effected with a trust, the court indicated its view of the role of tax-avoidance motive in deciding the gift-leaseback cases:

> However, in determining whether the Tax Court correctly held that these deductions could not be recognized, the fact that it has a salutary effect for the taxpayer is not of prime consideration. There is no principle of law that has been more clearly established than that a taxpayer may avail himself of all provisions established by the statutes for minimizing his taxes. The effect, however, does become of some significance when, as viewed by the Tax Court, and as we must view it, a payment between two closely related individuals can be explained *only* because of the salutary effect it has on the affairs of one of the two parties.
>
> . . . .
>
> . . . Thus viewing it, we conclude that the *obligation* to pay rent resulted not as an ordinary and necessary incident in the conduct of the business, but was in fact created solely for the purpose of permitting a division of the taxpayer's income tax.

341 F.2d at 441-42, 443 (emphasis in original). Thus, although the Fifth Circuit disavowed any concern with the taxpayer's desire to save taxes, the tax-avoidance purpose for initiating the gift-leaseback transaction was in fact the primary rationale for the court's decision to disallow the rental deduction. *See also Mathews,* 520 F.2d at 324-25; *Perry*, 520 F.2d at 238; Gunn, *supra* note 1, at 742 n.34.

32. For example, in *Brooke v. United States*, the majority strained to find nontax purposes for the transaction, without explaining the relevancy of such nontax motives to either determining the sufficiency of the property interest transferred, the test seemingly adopted by the majority, or determining whether there was a business purpose for the transaction viewed as an integrated whole, the test advanced by the government and accepted by the dissenting judge. The nontax motives that the court recognized were avoidance of friction within the medical practice, insulation of the property from liability, and diminished ethical conflict arising from the ownership of a medical practice with an adjoining pharmacy. 468 F.2d at 1158; *see also Rosenfeld,* 706 F.2d at 1282 (describing the taxpayer's desire to guarantee his children's financial wellbeing as a "legitimate non-tax motive" for the creation of the trust and leaseback); *cf. May,* 723 F.2d at 1437 (emphasizing that the purpose of the trust transfer was "to provide for the health, care and educational needs of the taxpayers' children" in concluding that the gift-leaseback transaction was not a "sham or a fraud"). As one commentator has aptly noted, if such self-serving assertions of nontax motives are treated as satisfying the government's business-purpose test, the test is rendered "largely useless." Friedlander, *supra* note 23, at 297-98 & n.57.

33. In *Stearns Magnetic Mfg. Co. v. Commissioner*, the corporate taxpayer distributed a patent to its two shareholders as a dividend and then entered into a nonexclusive licensing agreement with the shareholders to sell the patented device. The issue was whether the royalties paid by the corporation to the

whether the donor surrendered sufficient control over the property to the donee-trust to permit the latter to be treated as the owner of the property for purposes of section 162(a)(3). The court's basic task in deciding that issue is the same as in any case involving an attempted assignment of income from property with which the donor has not completely severed his or her relationship—drawing the line between those retained controls that require the property's income still to be taxed to the donor and those that permit the tax to be shifted to the donee. The taxpayer's tax-avoidance motive for entering into the transaction has little relevance in that determination.

Furthermore, using a tax-avoidance motive as a basis for deciding federal tax cases is particularly inappropriate when Congress has sanctioned a particular tax-minimization device, as it has by enacting the grantor trust rules to govern the taxation of the Clifford trust.[34] As the Eighth Circuit in *Quinlivan* and the Second Circuit in the *Rosenfeld* case recognized,[35] the real question in such a situation is whether the transaction falls within the approved class of tax-minimization devices. The other courts' refusal to use this approach, by relying on an ambiguous and inconclusive piece of legislative history dis-

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shareholders under the licensing agreement were deductible as ordinary and necessary business expenses under the statutory predecessor to § 162 of the 1954 Code. In upholding the corporation's deduction of the royalties, the court aptly stated: "If the parties deal fairly with one another, it matters not whether their aim be . . . 'to avoid taxes or to regenerate the world.'" 208 F.2d 849, 852 (7th Cir. 1954) (quoting Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir.), *cert. denied,* 296 U.S. 641 (1935)).

34. A Clifford trust, which takes its name from Helvering v. Clifford, 309 U.S. 331 (1940), is a grantor trust whereby the grantor retains the right to possess again the property transferred in trust on the occurrence of some event, such as the beneficiary's death or the expiration of a period of time. Unless the requirements of I.R.C. § 673 (1982) are satisfied, the income will be taxed to the grantor rather than to the trust and its beneficiaries.

35. In *Quinlivan*, the Eighth Circuit considered § 162(a)(3) and §§ 671-678 (the grantor trust rules) *in pari materia* and concluded that the gift-leaseback device was sufficiently similar to the Clifford trust that it too should be viewed as a congressionally-sanctioned tax minimization device. 599 F.2d at 273-74. Likewise, the Second Circuit in *Rosenfeld* concluded that Congress, in enacting the grantor trust rules, had made a policy judgment to sanction the use of Clifford trusts as tax-avoidance devices and that the government's proposed business-purpose test in the gift-leaseback area was inconsistent with that policy judgment. 706 F.2d at 1281-82; *see also* Engel v. United States, 400 F. Supp. 5, 6 (W.D. Pa. 1975) (rejecting the government's integrated transaction business-purpose test, stating that "[a]ny reduction of the plaintiffs' taxes which resulted from this packaged business arrangement has been sanctioned by Congress in Sections 671-678 . . . which allow creation of Clifford trusts as income-splitting devices"), *aff'd mem.,* 562 F.2d 41 (3d Cir. 1977); *cf.* Lerner v. Commissioner, 71 T.C. 290, 301-02 (1978) (transaction valid because taxpayer did not violate any of the restrictions in §§ 673-677), *acq. in result* 1984-17 I.R.B. 5.

cussed later in this Article, may evidence their displeasure with the lines Congress has drawn in the grantor trust rules and their preference for the more flexible, common law approach of *Helvering v. Clifford*.[36] The uncertainty engendered by the *Clifford* approach, however, led Congress to draw reasonably certain boundaries in the grantor trust area and thus to sanction ten-year trusts as tax-avoidance devices.[37] It is not within the province of the courts to ignore that legislative determination.

A second concern expressed by the government and some courts[38] is with the voluntariness of the rental obligation—that is, since the taxpayer voluntarily created the need for the rental obligation by giving the property away, the rental payments were not "required to be made as a condition to the continued use or possession" of the property and consequently should not be deductible under section 162(a)(3). This concern may simply reiterate the concern with the tax-avoidance motive underlying the transaction. If so, it has little relevance in analyzing the gift-leaseback transaction for the reasons stated above.

On the other hand, if the concern with the voluntary nature of the transaction actually means that a rental expense is not deductible if the taxpayer voluntarily created the situation necessitating the rental, the government and those courts concerned with voluntariness are adding a requirement to the rental deduction that plainly is not in the statute. Nothing in the tax law requires a taxpayer to retain ownership of existing property rather than dispose of the existing property and rent

36. 309 U.S. 331 (1940); *see also supra* note 21 (discussion of *Clifford*). Under § 671, enacted in 1954, the grantor of a trust shall not be taxed on trust income "solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified" in the grantor trust rules. I.R.C. § 671 (1982); *see* H.R. REP. No. 1337, 83d Cong., 2d Sess. A212, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4351-52; S. REP. No. 1622, 83d Cong., 2d Sess. 365, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5006.

37. *Cf.* Edward L. Stephenson Trust v. Commissioner, 81 T.C. 283, 290-92 (1983) (treating grantor's two trusts as separate taxable entities, despite the grantor's tax-avoidance purpose in setting up the multiple trusts, and holding Treas. Reg. § 1.641 (a)-0(c) (1972) invalid); Estelle Morris Trusts v. Commissioner, 51 T.C. 20, 39 (1968) (stating that since the Revenue Act of 1916, "the tax laws have recognized implicity that trusts may be used as income splitting devices"), *aff'd per curiam*, 427 F.2d 1361 (9th Cir. 1970). For a discussion of the use of Clifford trusts as tax-saving devices, see Yohlin, *The Short-Term Trust—A Respectable Tax-Saving Device*, 14 TAX L. REV. 109 (1958).

38. *See, e.g., Perry*, 520 F.2d at 238; *Van Zandt*, 341 F.2d at 442-43; *Skemp*, 8 T.C. at 421.

replacement property. If that were the law, a rental deduction would never be allowed when the taxpayer decided to sell or give away existing property and rent replacement property from a third party. Since no court would disallow the rental deduction in these latter situations, courts should not disallow the rental deduction in a gift-leaseback merely because the rent dollars go to a trust for the benefit of the lessee's family members rather than to some third party.[39] As some courts properly have recognized, the issue is not whether the taxpayer voluntarily created the situation, but rather whether the taxpayer relinquished sufficient control over the property to require leasing the property back to retain possession.[40] In other words, has an actual obligation to pay rent been created? The taxpayer's volition in creating the rental obligation is another red herring which courts should ignore in deciding gift-leaseback cases.

A third concern of the government and the courts is the potential for abuse inherent in a transaction between related taxpayers, whether that transaction is structured as a sale, a lease, or some other arrangement. Although this concern has some validity,[41] the familial relationship between lessor and lessee in a gift-leaseback should not mean that the rental deduction is per se invalid or that it must satisfy any special business-pur-

39. *See Rosenfeld,* 706 F.2d at 1282-83; *Quinlivan,* 599 F.2d at 274 n.5; Engel v. United States, 400 F.Supp. 5, 5-6 (W.D. Pa. 1975) ("Had the trustee of the property conveyed by plaintiff to the Clifford trust rented out this property to a third-party while the plaintiff rented similar premises on the open market for the same rent, the tax consequences would be the same as the result here if the plaintiff's deduction is upheld."), *aff'd mem.,* 562 F.2d 41 (3d Cir. 1977); *see also* Friedlander, *supra* note 23, at 296, 298. *But see Rosenfeld,* 706 F.2d at 1286 (MacMahon, J., dissenting).

40. *See Brown,* 180 F.2d at 929-30; *Skemp,* 168 F.2d 598.

41. *See, e.g.,* Commissioner v. Culbertson, 337 U.S. 733, 746 (1949); Commissioner v. Tower, 327 U.S. 280, 291 (1946). One commentator has aptly described the tendency of courts to approach business transactions between members of a family with suspicion:

> If the deduction reduces the tax liability of the payor more than it increases the liability of the recipient . . . the courts scrutinize the underlying transaction closely, demanding proof that its terms are equivalent to an arm's length bargain and that it serves a purpose other than tax avoidance. Whether the language of "presumption" is used or not, their working hypothesis is that transactions with outsiders have a built-in guarantee of good faith and business purpose, but that intrafamily transactions are less likely to be what they purport to be. The ultimate source of this doubt is, of course, a judicial view of social behavior, not an explicit statutory direction to the courts.

Bittker, *Federal Income Taxation and the Family,* 27 STAN. L. REV. 1389, 1458 (1975).

pose test.[42] It means only that the court must scrutinize carefully the parties' allocation of the benefits, burdens, and risks of the ownership of the property after the leaseback transaction to determine whether that allocation is consistent with traditional business dealings between lessors and lessees and with the assignment-of-income rules. To be sure, Congress has on occasion decided to disallow entirely deductions of losses or expenses resulting from transactions between related persons when there is great potential for abuse and significant difficulty in determining whether the loss or expense is bona fide.[43] Congress likewise could adopt a per se disallowance rule in the gift-leaseback area. But it has not yet done so, and it is not within the province of the courts to adopt standards equivalent to a per se disallowance of the deduction.[44]

Some courts have hinted at a fourth concern, that allowing a rental deduction in a gift-leaseback transaction would violate the basic tax policy principle of equity. Apparently, these courts believe that since only taxpayers in high-income brackets benefit from this assignment-of-income device, allowing the

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42. An example of some courts' failure to recognize the distinction between approaching intrafamily transactions with a watchful eye and automatically assuming that such transactions can never be bona fide because of the lack of arm's length bargaining is the Fifth Circuit's opinion in *Mathews*: "[T]he fact rent negotiations produced 'reasonable' results is totally irrelevant. Any bargaining is simply not at arm's length, because any rent exceeding expenses stays in the Mathews family." 520 F.2d at 325. Given the Fifth Circuit's confusion about this distinction, it is not surprising that it has adopted the government's questionable business-purpose test.

43. *See, e.g.,* I.R.C. § 267(a)(1) (1982) (disallowing the deduction of losses on sales and exchanges of property between specified related persons); I.R.C. § 267(a)(2) (1982) (disallowing the deduction of expenses and interest owed by a taxpayer to a related person if the payor uses the accrual method of tax accounting and the related payee uses the cash method of tax accounting, unless the debt is paid within two-and-one-half months after the close of the payor's taxable year). *See generally* Hertz, *Dealing with Related Persons: Salaries and Other Compensation; Sales of Property; Interest Accruals and Other Deductions,* 23 INST. ON FED. TAX'N 577 (1965) (discussion of unfavorable tax treatment accorded to transactions between related parties). For a critique of the congressional prohibition of deductions based solely on familial relationships, see Bittker, *supra* note 41, at 1462-63. *But cf.* Reilly, *An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership,"* 15 TAX L. REV. 253, 262-63 (1960) (broad application of the disallowance provisions based on familial relationships necessary to prevent tax avoidance in transactions controlled by closely related economic units).

44. Professors Lyon and Eustice have criticized the government for seeking disallowance of the rental deduction in a gift-leaseback through litigation, rather than by asking Congress to draft legislation prohibiting the deduction analogous to the rules in § 267 of the Code. Lyon & Eustice, *supra* note 2, at 340; *see also* White v. Fitzpatrick, 193 F.2d 398, 402 (2d Cir. 1951) (Chase, J., dissenting), *cert. denied,* 343 U.S. 928 (1952).

rental deduction violates vertical equity principles[45] because it undermines the intended degree of progressivity in the federal income tax system.[46] Under this view, the rental deduction in a gift-leaseback would never be proper, however carefully the parties structured the transaction.

This argument, however, demonstrates a misunderstanding of the function of the vertical equity criterion. Since the purpose of all assignment-of-income devices, including those involving transfers of income-producing property, is to mitigate the effects of the progressive rate structure, it is difficult to see how the vertical equity criterion can assist in distinguishing between deflection devices that will be respected for tax purposes and those that will not. In this area, the vertical equity criterion must yield to considerations of administrative practicality[47]—at some point, the donor will have transferred sufficient control over the property to the donee to warrant taxing the donee on the property's income and treating the donee as the owner of the property for purposes of the assignment-of-income doctrine and section 162(a)(3), despite the possible detrimental effect of the transaction on the vertical equity of the tax system.

In addition, the argument ignores the possible tax policy objectives furthered by permitting a rental deduction in a gift-leaseback transaction. Horizontal equity—another basic tax policy principle—requires that taxpayers in equal economic circumstances receive equivalent tax treatment.[48] Since a business taxpayer who pays rent to a third party for business

45. Vertical equity dictates that there be appropriate differentiations between taxpayers on each income level and those on the income levels above and below. What constitutes an "appropriate differentiation" depends on the theorist's views of the merits of a progressive tax system. *See* 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 3.1.4, at 3-10 to 3-11 (1981). *See generally* Sneed, *The Criteria of Federal Income Tax Policy,* 17 STAN. L. REV. 567, 581-86 (1965) (discussion of vertical equity criterion).

46. *See, e.g., Rosenfeld,* 706 F.2d at 1286 (MacMahon, J., dissenting); *Mathews,* 520 F.2d at 324; *Brooke,* 468 F.2d at 1161 (Ely, J., dissenting); Columbia Note, *supra* note 23, at 1448-49.

47. *See generally* Gunn, *supra* note 1, at 760-65.

48. *See* 1 B. BITTKER, *supra* note 45, ¶ 3.1.4, at 3-11 to 3-12; Sneed, *supra* note 45, at 579. For a different horizontal equity argument regarding allowance of the rental deduction in a gift-leaseback transaction, see Columbia Note, *supra* note 23, at 1444-45.

One commentator has forcefully argued that *allowance* of the rental deduction in a gift-leaseback transaction violates horizontal equity principles if the income of the trust is used for the benefit of close relatives of the donor-lessee. *Id.* at 1447-48. Under this view, the donor and the trust beneficiaries are viewed as one economic unit for tax purposes.

property only pays tax on the business income net of the rental expense, a similarly-situated taxpayer who pays the same rental expense to a trust in a gift-leaseback should also be allowed a deduction, provided the taxpayer has transferred control over the property to the trust. Disallowing the deduction under such circumstances arguably would result in horizontal inequity, at least in a tax system that recognizes the trust and its beneficiaries as separate taxpaying units from the grantor-lessee.

Further, the gift-leaseback transaction arguably makes the tax system more equitable by availing the Clifford tax-savings device to a broader range of taxpayers.[49] High-income taxpayers can afford to transfer dividend-paying stocks or other income-producing investment assets to a Clifford trust and thereby shift taxation of the income to the trust and its beneficiaries. The gift-leaseback transaction is the only tax-savings device of this type available to many professionals and other middle-income taxpayers who simply do not have sufficient income-producing investment assets to form a Clifford trust.[50] Thus, the gift-leaseback transaction can be viewed as helping to promote equity in the tax system.[51]

Finally, the courts seem concerned that the taxpayer has transferred title to the property to the trust but retained physical possession of the property.[52] Nothing seems to have hap-

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49. *See Rosenfeld*, 706 F.2d at 1281-82; *Quinlivan*, 599 F.2d at 274.

50. *See* Simmons, *supra* note 3, at 196-97.

51. *See* Oliver, *supra* note 6, at 45. The dissenting judge in the *Rosenfeld* case pointed out several infirmities in this contention. 706 F.2d at 1286 (MacMahon, J., dissenting). First, he criticized the *Rosenfeld* and *Quinlivan* majorities for not citing any legislative history in support of this argument. Such a citation, however, is hardly necessary, given the obvious tax-avoidance potential of the short-term trust revealed in the case law history preceding the adoption of the grantor trust rules and presumably known by Congress at the time it adopted those rules.

In addition, the dissenting judge urged that the unfairness argument ignores that a majority of taxpayers do not have assets lying around that they can give away for ten-year periods and that taxpayers who do not own any business or income-producing assets cannot take advantage of the Clifford trust provisions. Further, he argued that disallowing the deduction would not be unfair if the taxpayer-lessee owned other assets that could form the corpus of a Clifford trust.

These criticisms, however, all miss the point of the fairness argument. The issue is not whether Congress intended all taxpayers to be able to take advantage of the Clifford trust provisions, but whether Congress intended the Clifford trust to be used as a tax-savings device and, if so, whether the gift-leaseback is similar enough to the Clifford trust to warrant treating it as a valid device for shifting income. The dissenting judge's opinion in *Rosenfeld* does not address that issue.

52. *See, e.g., Mathews,* 520 F.2d at 325.

pened except a paper transfer of title and a shift of income from the donor to the donee in the form of the rental payments. The taxpayer has uninterrupted use and possession of the property; thus, the transaction arguably lacks economic substance.

This argument evidences a misunderstanding of how the tax law determines ownership of trust property for purposes of equitably allocating the income tax burden on the income produced by that trust property. Under the grantor trust rules, if the donor of the property transfers it to a trust for at least ten years and complies with all of the other provisions of the grantor trust rules, the trust is treated as the owner of the property for federal income tax purposes for the duration of the trust.[53] As long as the donor in a gift-leaseback situation has relinquished ownership of and control over the property under those rules and uses the property during the term of the trust strictly as a tenant under the terms of a binding lease agreement, the donor's possessory interest should not be treated as a retained interest in the property, but rather as a right or privilege conferred by the new owner, the trust, in exchange for the rental payments. Under the tax law, the shift of ownership to the trust, combined with the subsequent leaseback of the property under the terms of a binding lease agreement, is sufficient to permit the court to treat the taxpayer as having severed any previous relationship to the property and as having instituted a new relationship as a mere user-for-value of the property. Accordingly, interruption of the taxpayer's physical possession of the property should not be a necessary prerequisite to creating a valid rental deduction, and courts should ignore this concern in formulating a solution to the gift-leaseback controversy.

B. AMBIGUOUS CONGRESSIONAL INTENT

The other major source of confusion in the gift-leaseback area is the absence of a clear statement of congressional intent. No Internal Revenue Code provision specifically addresses the gift-leaseback transaction. The only reference to the gift-lease-

53. *See* I.R.C. §§ 671-679 (1982); *cf.* Keesling, *Conflicting Conceptions of Ownership in Taxation,* 44 CALIF. L. REV. 866, 869-70 (1956) (for income tax purposes, the legal title or indivisible theory of ownership generally has been followed; a lessee's interest in leased property, even in the sale-leaseback situation, is in the nature of a privilege or license rather than a property interest). *But cf.* Rice, *supra* note 2, at 1013 n.83, 1015 (donor's retention of use, rights, or other indicia of ownership justifies taxing donor on the income from the property).

back transaction in the committee reports accompanying enactment of the 1954 Code appears in the report of the Senate Committee on Finance, which stated that "[t]his subpart [the grantor trust rules] also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement."[54] The House report contains no similar statement,[55] and neither the Senate nor House report refers to the gift-leaseback transaction in discussing the rental deduction and the requirements of section 162(a)(3).[56] Consequently, the ambiguous statement in the Senate report has been subject to varying interpretations as to its meaning and importance.

The government and the Fourth Circuit[57] have used this language to block taxpayers' attempts to base the standards for deductibility of rent in a gift-leaseback on the grantor trust rules.[58] The argument is that Congress indicated that the grantor trust rules were inappropriate to resolve the tax consequences of a gift-leaseback transaction in order that different (and presumably, more stringent) standards would apply in deciding the gift-leaseback issue. From this argument flows the government's business-purpose test, a test that virtually ensures that a rental deduction will never be allowed in a gift-leaseback transaction.[59]

This interpretation of congressional intent is unconvincing. The language is ambiguous, and neither the government nor those courts adopting the government's position have identified

54. S. Rep. No. 1622, 83d Cong., 2d Sess. 365, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 5006. This same language was incorporated into the regulations promulgated under § 671 of the Code. *See* Treas. Reg. § 1.671-1(c) (1956).

55. *Cf.* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A212, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4017, 4351-52.

56. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 196, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 4652; H.R. Rep. No. 1337, 83d Cong., 2d Sess. A43-44, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4017, 4352.

57. *See Perry,* 520 F.2d at 237 n.2; *see also, e.g., Rosenfeld,* 706 F.2d at 1285 (MacMahon, J., dissenting) ("the legislative history plainly states that the Clifford trust sections are irrelevant in determining the deductibility of [the donor-lessee's] rental payments"); Wiles v. Commissioner, 59 T.C. 289, 298 (1972) (quoting the language from the Senate Report), *aff'd mem.,* 491 F.2d 1406 (5th Cir. 1974).

58. A number of commentators have argued that compliance with the grantor trust rules of the Code (I.R.C. §§ 671-679 (1982)) should suffice to allow the deduction of rental payments in a gift-leaseback transaction. *E.g.,* Comment, *Gift-Leaseback Transactions: An Unpredictable Tax-Savings Tool,* 53 Temp. L.Q. 569, 588-89 (1980); Albany Note, *supra* note 23, at 594-95; Cincinnati Note, *supra* note 23, at 394-95.

59. *See infra* text accompanying notes 94-96.

why the gift-leaseback transaction so differs from the typical Clifford trust transfer that the grantor trust rules should not apply, at least by analogy, in formulating the standards for the rental deduction in a gift-leaseback transaction. One sentence buried in a lengthy committee report, and an ambiguous sentence at that, hardly provides persuasive authority for ignoring the application of the grantor trust rules if the gift-leaseback transaction is sufficiently similar to the typical grantor trust transfer.

On the other hand, the Eighth Circuit's conclusion in *Quinlivan v. Commissioner*[60] that this statement indicates congressional approval of the pre-1954 case law also seems questionable. No reference to the pre-1954 cases appears in the reports, even though Congress has not hesitated to refer to court decisions of which it approves. Indeed, if the language of the Senate report indicates congressional approval of the pre-1954 appellate decisions in *Skemp v. Commissioner*[61] and *Brown v. Commissioner*,[62] it is difficult to understand exactly what Congress approved, since the *Skemp* and *Brown* decisions provide few definite standards for resolving the gift-leaseback controversy.

Skemp involved a gift-leaseback in trust, in which the grantor appointed an independent bank as the trustee and retained no reversionary interest in the trust property. The grantor clearly arranged the leaseback prior to transferring the property to the trust. The Seventh Circuit upheld the taxpayer-donor's deduction of the rentals on the leaseback, rejecting the government's argument that rent payments were not "required" within the meaning of section 23(a)(1)(A) of the 1939 Code,[63] the statutory predecessor to section 162(a)(3), because the taxpayers voluntarily created the situation.[64] Nonetheless, the Seventh Circuit did not emphasize that the trustee was a corporate trustee clearly independent of the grantor, nor did it discuss the significance of the prearranged nature of the leaseback or the grantor's failure to retain a reversionary interest in the trust property, factors arguably important in the gift-leaseback situation.

60. 599 F.2d 269, 274 (8th Cir.), *cert. denied,* 444 U.S. 996 (1979).

61. 168 F.2d 598 (7th Cir. 1948).

62. 180 F.2d 926 (3d Cir.), *cert. denied,* 340 U.S. 814 (1950).

63. Internal Revenue Code, ch. 2, § 23(a)(1), 53 Stat. 1, 12 (1939) (current version at I.R.C. § 162(a)(3) (1982)).

64. 168 F.2d at 599-600. For a discussion of the "voluntariness" issue, see *supra* notes 38-40 and accompanying text.

In *Brown*, the taxpayers effected a gift-leaseback by transferring coal-producing property and the adjoining railroad siding to a trust for the benefit of their minor children and then leasing back the property for use in their coal-mining business. The donors retained no reversionary interest in the trust property and appointed their attorney as trustee. In upholding the taxpayers' deduction of the rents and royalties on the leaseback, the Third Circuit stressed that the trustee was independent and that the grantors retained no reversionary interest.[65] The Court did not suggest an approach for determining whether a trustee was independent, however, nor did it discuss the significance of the prearranged nature of the leaseback.

Thus, a reading of the *Brown* and *Skemp* decisions alone provides few definite guidelines for testing the propriety of a rental deduction in a gift-leaseback. It is, therefore, difficult to believe that Congress, by enacting section 162(a)(3) without significant change from its 1939 Code predecessor, intended to approve the uncertain approach of these decisions.

A more plausible explanation of the sentence in the senate committee report is that Congress was aware of potential abuses in gift-leaseback transactions that the grantor trust rules were not designed to remedy, namely, using the leasehold relationship to retain controls over the transferred property that the grantor could not retain directly in the trust instrument under the grantor trust rules and assigning a greater amount of income to the donee than the fair rental value of the property. Congress left it to the courts to design requirements to remedy those abuses, and the courts can use by analogy, but are not expressly bound by, the grantor trust rules in formulating those requirements.

Two last points can be made with relative certainty concerning congressional intent. First, Congress gave at least some consideration to the gift-leaseback transaction and decided not to disallow the rental deduction in all cases. Therefore, the integrated transaction business-purpose approach of the government and the Fourth and Fifth Circuits, which results in the almost certain disallowance of the rental deduction,[66] violates congressional intent. Second, the grantor trust provisions evidence congressional intent that assignment-of-income transactions involving transfers in trust be governed by a set of statutory guidelines that provide certainty regarding the

65. 180 F.2d at 929.

66. *See infra* text accompanying notes 94-96.

lines drawn. The approach currently used by the courts in the gift-leaseback cases, which results in a set of confusing and sometimes contradictory standards, violates that policy. Therefore, another approach must be developed, one that takes into account the policy considerations underlying the assignment-of-income doctrine and yet provides the certainty evidenced by the grantor trust provisions.

II. EXAMINATION OF THE DIFFERENT JUDICIAL TESTS

The government and the courts have developed various tests to evaluate the propriety of the rental deduction in a gift-leaseback transaction. A thorough analysis of these tests is vital to devising a logical and reasonably clear approach to this transaction.

A. The Government's Integrated Transaction Business-Purpose Test

When challenging the rental deduction in a gift-leaseback transaction, the government has argued that the deduction should be disallowed because the transaction, viewed as an integrated whole, lacks a business purpose. That is, since the property is essential to the business, the donor would not have transferred it to a trust unless the donor had prearranged the leaseback or at least was reasonably certain that the property could be leased back for continued business use. Thus, the gift and leaseback are interrelated steps of a single transaction and, under the step-transaction doctrine,[67] the business purpose inquiry required by section 162(a)(3) must apply to both parts of the integrated transaction. Since no business purpose existed for making the gift of the business property to the trust, the gift part of the transaction fails the business-purpose test and no rental deduction is allowed on the leaseback.[68]

The genesis of this business-purpose test in the gift-leaseback area can be traced to the first two appellate decisions involving a gift and leaseback transaction: *Skemp v. Commissioner*[69] and *Brown v. Commissioner.*[70] In both cases,

67. "The step transaction doctrine . . . is a determination that some of the several steps are part of a single overall integrated transaction, and the interim transactions are denied tax significance." American Potash & Chem. Corp. v. United States, 399 F.2d 194, 203 (Ct. Cl. 1968).

68. *See* authorities cited *supra* notes 11-13.

69. 168 F.2d 598 (7th Cir. 1948), *rev'g* 8 T.C. 415 (1947).

70. 180 F.2d 926 (3d Cir. 1950), *rev'g* 12 T.C. 1095 (1949), *cert. denied,* 340 U.S. 814 (1950). The *Skemp* and *Brown* decisions are criticized in Note, *The Gift*

the Tax Court disallowed the deduction of the rentals on the leaseback, essentially treating the gift and leaseback as integrated parts of a single transaction in which the donor-lessee had not surrendered control over the property transferred to the trust.[71] On appeal the government argued that the rental deduction should not be allowed because it was incurred voluntarily and therefore did not satisfy the requirements of the statutory predecessor of section 162(a)(3).[72] In effect, the government asserted that since the gift and leaseback were interrelated parts of the same transaction, the rental obligation arose not out of business necessity but out of the taxpayer's desire to deflect income to members of his family. The Seventh Circuit in *Skemp*[73] and the Third Circuit in *Brown*[74] both cor-

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and Leaseback: A New Tax Avoidance Gimmick, 59 YALE L.J. 1529, 1533-36 (1950). That Note is representative of much of the early commentary on the gift-leaseback transaction, which somewhat simplistically attacked the arrangement as an abusive tax-avoidance device for high-income taxpayers, regardless of whether the transfer was made into a trust with an independent trustee. *See also* Note, *Use of a Trust and Lease-back as a Tax Avoidance Device*, 51 COLUM. L. REV. 247, 248-49 (1951) (criticizing the *Brown* decision as inconsistent with the *Clifford* short-term trust, sale-leaseback, and dividend-leaseback lines of decisions). For a more analytical early critique of the court's favorable treatment of the gift-leaseback transaction, see Cary, *Current Tax Problems in Sale, or Gift, and Lease-Back Transactions*, 9 INST. ON FED. TAX'N 959, 974-78 (1951).

71. Both decisions reasoned that the "gift" was conditioned on the grantors' ability to immediately lease the property back, which the grantors did. *Skemp*, 8 T.C. at 421; *Brown*, 12 T.C. at 1101. If the gift and leaseback are treated as interrelated parts of a single transaction, the overall transaction can be viewed as a gift by the donor to the trust of a remainder interest only with a reservation of a possessory term for years. Under this view, because the donee trust never owns the possessory term, the donor's subsequent payments to the trust cannot be consideration for the continued use and possession of the property but rather are additional gifts to the trust. Accordingly, no deduction is allowable under § 162(a)(3) for these gifts. *See Brown*, 12 T.C. at 1100; *Skemp*, 8 T.C. at 420-21; Cary, *supra* note 70, at 976; Froehlich, *supra* note 23, at 969-70; *cf.* Keesling, *supra* note 53, at 869-70. Curiously, none of the courts of appeals decisions following the government's integrated transaction approach in analyzing the gift-leaseback transaction even mention this theory.

In a different context, one commentator has argued persuasively that the sale and leaseback transaction, undertaken as a financing device, is in substance nothing more than a sale of a remainder interest in the property with a reservation of a possessory term for years. Under this view of the sale-leaseback transaction, the amount purportedly paid by the buyer to the seller for the posessory term is in economic reality a secured loan. Accordingly, any rentals the seller pays to the buyer for the possessory term are really an amortization of that loan together with interest. *See* Del Cotto, *Sale and Leaseback: A Hollow Sound When Tapped?*, 37 TAX L. REV. 1 (1981).

72. *See* Internal Revenue Code, ch. 2, § 23(a)(1), 53 Stat. 1, 12 (1939) (current version at I.R.C. § 162(a)(3) (1982)); *see also supra* notes 38-40 and accompanying text.

73. 168 F.2d at 600.

74. 180 F.2d at 929-30.

rectly rejected this argument, noting that the business deduction provision focuses on whether an obligation to pay rent for the use of business property exists, not on how that obligation was created.

The first appellate court to give at least tentative approval to the government's business-purpose argument in the gift-leaseback area was the Second Circuit in *White v. Fitzpatrick*.[75] There the taxpayer gave his wife a valuable patent used in his manufacturing business and agreed to pay royalties to her for a license-back of exclusive manufacturing rights. At about the same time, the taxpayer's wife purchased the real property where the business was located and orally leased it to him for the same rent that he had paid the previous owner. On the day after her purchase of the property, the taxpayer gave his wife cash in an amount very close to the purchase price of the property. The issue before the court was whether the taxpayer could deduct the rental and royalty payments as ordinary and necessary business expenses under the 1939 Code predecessor to section 162 of the current statute.[76] Although the court resolved the deduction issue on the basis of the donor's failure to relinquish sufficient control over the property, it intimated its view of the business-necessity doctrine:

> Gift and retained control must be regarded as inseparable parts of a single transaction, especially since it was only in their sum total that they had any reality in regard to the conduct of plaintiff's business. To isolate them . . . is to hide business reality behind paper pretense.
>
> . . . .
>
> . . . The Clifford rule is clear, that this direct control, when fused with the indirect control which we must imply from a formal but insubstantial assignment within the closed family group displaying no obvious business purpose, renders the assignment ineffective for federal tax purposes.[77]

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75. 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *cf.* Finley v. Commissioner, 225 F.2d 128, 133 (10th Cir. 1958) (disallowing the rental deductions in a gift-leaseback effected without a trust and in which formalities were not observed, finding that the transaction neither served a business purpose nor resulted in creation of a new economic unit); Kirschenmann v. Westover, 225 F.2d 69, 70-71 (9th Cir.) (disallowing rental deduction in gift-leaseback of farmland to donors' minor daughter when husband's brother was appointed guardian of the daughter's estate, finding that the rent on the leaseback was unreasonably high and that the transaction lacked "business meaning" for tax purposes), *cert. denied*, 350 U.S. 834 (1955).

In *Rosenfeld*, the Second Circuit rejected the government's business-purpose test but offered no explanation for its change of position and, in fact, treated the issue as one of first impression in the circuit. 706 F.2d at 1279.

76. *See supra* note 72.

77. *White*, 193 F.2d at 400-01. Prior to 1948, spouses could not split income through the filing of a joint return. *See* Internal Revenue Code, ch. 2, § 51(b)(1), 53 Stat. 1, 27 (1939). Today, they can file a joint return. *See* I.R.C.

The court neither cited authority nor offered any rationale to support its intimation that the gifts required a business purpose. The court simply jumped from finding that the gift and leaseback were parts of an integrated transaction to the conclusion that the gift part of the transaction must satisfy the business-necessity requirement of the business expense deduction provision. Finding that there was, of course, no business purpose for the gift and further concluding that the leaseback indicated that the donor had retained administrative control of the property, the court proceeded to hold that the transaction lacked economic substance and disallowed the taxpayer's deductions for the rents and royalties. Thus, in *White v. Fitzpatrick*, there began to appear a meshing of the business-purpose, integrated-transaction, and economic-reality rationales.

Although *White v. Fitzpatrick* was important in the development of the government's business-purpose argument, the Fifth Circuit's decision in *Van Zandt v. Commissioner*[78] was the first clear appellate court adoption of the argument in the gift-leaseback situation. In *Van Zandt*, the taxpayer-physician and his wife transferred real property and equipment used in his medical practice to two irrevocable trusts established for the benefit of their two children for terms of ten years and two months. The taxpayer was sole trustee of both trusts. On the same day that the property and equipment were transferred to the trusts, the taxpayer leased them back for use in his practice. The Fifth Circuit affirmed the Tax Court's disallowance of the rental deductions on the leaseback,[79] holding that since the gift and leaseback were interrelated parts of a single transaction, both must have a business purpose. Because the only purpose of the gift was to divert income to lower-bracket family members, the court concluded that the transaction failed the business-purpose test.[80]

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§§ 6013, 1(a) (1982). Accordingly, no income tax incentive currently exists for spouses eligible to file a joint return to engage in income-splitting transactions, such as the gift-leaseback, with each other.

78. 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

79. 40 T.C. 824 (1963). The Tax Court used the government's integrated transaction business-purpose argument as an additional ground for disallowing Dr. Van Zandt's rental deductions. *Id.* at 830-31.

80. In finding that the transaction lacked a business purpose, the Fifth Circuit pointed to the short term of the trust, the taxpayers' retention of a reversionary interest, and the prearranged nature of the leaseback—all factors with little or no relevance to a business-purpose inquiry. 341 F.2d at 444. The *Van Zandt* court apparently confused the issue of whether the taxpayer surrendered control over the property to the trust with the issue of how to apply the business-purpose standard in the gift-leaseback situation.

The *Van Zandt* court cited no statutory or judicial authority for its application of a business-purpose standard to a gratuitous transfer, other than its own decision in *W.H. Armston Co. v. Commissioner*,[81] a case involving the sale and leaseback of equipment by a corporation to the wife of its president and treasurer. In *Armston*, the court found that the purported sale to the wife, the majority shareholder, lacked economic substance and affirmed the Tax Court's disallowance of the rental deductions. Although the *Armston* court briefly discussed the lack of business purpose for the corporation's sale of the property to the wife as a factor supporting disallowance of the rental deduction,[82] a careful reading of the decision indicates that the basis for the court's holding was the artificially-low purchase price that the wife paid for the equipment—less than one-half of the first year's rent.[83] In other words, there was not even the semblance of a real sale from the corporation to its shareholder. Thus, because *Armston* is hardly persuasive authority for a broad-scale requirement that the gift portion of a gift-leaseback transaction need satisfy the business-purpose standard, the murky business-purpose test of *Van Zandt* was constructed with precedent that has little relevance to the issues involved in the gift-leaseback transaction.

Despite the *Van Zandt* court's lack of supporting authority for its business-purpose test, its approach was approved by the Fourth Circuit in *Perry v. United States*.[84] In *Perry*, two physicians transferred their interests in the office building used in their medical partnership to newly-created trusts for the benefit of their children, naming an independent bank as the trustee and retaining a reversionary interest in the corpus of the trust. As part of a prearranged transaction, the physicians simultaneously leased the building back for use in their practice. In announcing its adoption of the *Van Zandt* business-purpose test, the *Perry* court further explained the test's logic. The creation of the trust and subsequent leaseback are mutually dependent steps of a multistep transaction; accordingly, the taxpayer must show a business purpose for the transaction as a whole before any expenses incident to part of the transaction can be de-

81. 188 F.2d 531 (5th Cir. 1951).

82. *Id.* at 533.

83. *Id.* at 532-33.

84. 520 F.2d 235 (4th Cir. 1975), *cert. denied*, 423 U.S. 1052 (1976). For detailed discussions of the *Perry* decision, see Note, *Taxation—Deductibility of Rent Paid to Grantor Trust*, 51 TUL. L. REV. 192 (1976); Note, *Taxation—Allowance of Rental Deductions in the Gift-and-Leaseback Transaction*, 11 WAKE FOREST L. REV. 740 (1975).

ducted under section 162.[85] Since no business purpose justified the creation of the trusts, the court disallowed the deduction of the rental expenses on the leaseback.[86]

The Fourth Circuit in *Perry*, like the Fifth Circuit in *Van Zandt*, seemed to confuse the business-purpose issue with the question of whether the donor surrendered sufficient control over the property to the donee, by focusing on factors such as the reversionary interest retained by the donor and the portion of the trust property rented for the donor's own use in determining whether there was a business purpose for the gift transfer.[87] Moreover, even correctly applied, the business-purpose test posited by the government and adopted by the Fourth and Fifth Circuits has a number of problems, the most serious of which is that it evidences a misunderstanding of the appropriate role of the business-purpose and related step-transaction doctrines in the development of federal tax law.

Courts developed the business-purpose doctrine to prevent distortion of technical statutory provisions through tax-motivated transactions that satisfied the literal requirements of the statute but lacked the basic purpose for which Congress granted the favored tax treatment.[88] In *Gregory v. Helvering*,[89]

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85. 520 F.2d at 238-39.

86. *Id.* at 238-40.

87. The *Perry* court distinguished the Seventh Circuit's decision in *Skemp* on the ground that the donor in *Skemp* may have had a business purpose for the gift portion of the transaction because he leased back less than all of the property transferred to the trust and did not retain any reversionary interest. *Id.* at 239. According to the *Perry* court, these two factors may add up to a business purpose for the gift portion of the transaction—namely, " 'conveying the property to the trustees for management and payment of income to the beneficiaries.' " *Id.* (quoting *Van Zandt*, 341 F.2d at 442). In other words, the *Perry* court speculated that the donor-lessee in *Skemp* may have had the business purpose of divesting himself of the burden of managing the entire building and its consequent interference with the conduct of his medical practice. Again, this interpretation is a rather strained application of the business-purpose test. *See supra* note 32.

88. *See* Summers, *A Critique of the Business-Purpose Doctrine*, 41 OR. L. REV. 38, 42-43 (1961).

89. 293 U.S. 465 (1935). In *Gregory*, Corporation A, wholly owned by Ms. Gregory, transferred 1,000 shares of stock that it owned in Corporation B to a new corporation, Corporation C, which then issued all of its shares to Ms. Gregory. Within a few days, Corporation C was dissolved and the shares of Corporation B stock were distributed to Ms. Gregory, who immediately sold them at a substantial gain. The Supreme Court affirmed the court of appeals's treatment of the transaction as an ordinary dividend distribution by Corporation A to Ms. Gregory of the Corporation B shares, holding that the transaction did not qualify for treatment as a tax-free divisive reorganization because it had no business purpose.

For an excellent early discussion of the business-purpose rule enunciated

the case credited with originating the judicial business-purpose doctrine, the taxpayer attempted to effect an ordinary dividend distribution through the guise of a divisive reorganization qualifying as a tax-free reorganization. The Supreme Court devised the business-purpose requirement to ensure that only corporate adjustments accomplished for business reasons would receive the favored treatment of the reorganization provisions, thereby effectuating the congressional policy underlying those provisions.[90]

In contrast, the courts have not identified any policy objective that will be served by requiring a taxpayer to show a business purpose for the gift portion of the gift-leaseback arrangement. Indeed, there is none. The donor's transfer of the income-producing property and consequent shift of the tax on the rental income to the trust is consistent with the congressional policy underlying the enactment of the grantor trust provision.[91] The donor is doing what Congress envisaged when it formulated those rules.

Further, the government is missing a logical step in its application of the business-purpose test. The government's argument assumes that since the gift and leaseback are interrelated steps in an overall plan, the step-transaction doctrine applies, and thus both steps of the transaction must satisfy the business-necessity requirement of section 162(a)(3). But the step-transaction doctrine, requiring that separate steps be taken together in attaching tax consequences, does not automatically apply whenever there is an interrelationship between two formally separate steps. In some areas, tax law does not require combination of the mutually dependent steps even though they were taken separately to reduce the taxpayer's income taxes;[92]

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in the *Gregory* case, see R. PAUL, STUDIES IN FEDERAL TAXATION 121-34 (3d series 1940).

90. 293 U.S. at 469-70.

91. *See supra* notes 35, 49-51, and accompanying text; *cf.* Estelle Morris Trusts v. Commissioner, 51 T.C. 20, 43 (1968) (rejecting the government's argument that the taxpayers' tax-avoidance motive and lack of business purpose for setting up multiple trusts should invalidate the arrangement, stating "courts should be wary of broad-scale incorporation of the doctrine of 'tax avoidance,' or 'business purpose,' or 'sham' in an area . . . fraught with its own . . . problems and nuances. At the very least, we are required to limit those judicially developed doctrines to the situations which they were intended to cover."), *aff'd per curiam*, 427 F.2d 1361 (9th Cir. 1970).

92. *See* Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485, 535-36 (1967). For an excellent survey discussion of the step-transaction doctrine, see Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 INST. ON FED. TAX'N 247 (1954).

in effect, form is permitted to control and the tax consequences of each step are separately analyzed. Deciding when the formal separateness of the steps will control requires an analysis of the policies underlying the income tax provision in question.

Looking at the gift-leaseback transaction, one sees a gift of income-producing property to a trust in compliance with the grantor trust provisions and an interrelated leaseback of the property at fair rental value for use in the donor's business. Nothing in the policy underlying the enactment of the grantor trust rules or the policy underlying allowance of a rental deduction requires aggregation of these steps. In fact, the grantor trust rules evidence congressional intent that form will control assignments of income made through a trust, provided the donor satisfies the requirements of sections 673 through 679 of the Code. In effect, a transfer meeting those requirements will be treated as a transfer of income-producing property rather than a transfer of only the income from the property, even though in substance the trust receives nothing more than the right to receive the income from the property for a period of at least ten years. Requiring the gift and leaseback portions of the transaction to be analyzed together in applying the business-purpose standard is inconsistent with that congressional judgment.[93]

Finally, as others have noted,[94] the income tax definition of "gift" is incompatible with the business-purpose concept. In *Commissioner v. Duberstein*,[95] the Supreme Court held that the transferor's dominant motive controlled the determination of whether the transfer was a gift for federal income tax purposes and that a gift must proceed from a " 'detached and disinterested generosity' " rather than from " 'the incentive of anticipated benefit' of an economic nature."[96] Thus, if the donor established a business purpose for the transfer to the trust, it would no longer constitute a gift for income tax purposes. The government proposes a test that could never be satisfied in any gift-leaseback transaction, because if there is a business purpose for the transfer to the trust it is no longer a gift, and if the transaction is truly gratuitous the transaction fails the govern-

93. *See Rosenfeld,* 706 F.2d at 1281-82.

94. *See, e.g., May,* 76 T.C. at 21 (Goffe, J., concurring); Friedlander, *supra* note 23, at 297.

95. 363 U.S. 278 (1960).

96. *Id.* at 285 (quoting Commissioner v. LoBue, 351 U.S. 243, 246 (1956) and Bogardus v. Commissioner, 302 U.S. 34, 41 (1937)). For a persuasive criticism of the § 102 gift exclusion and the *Duberstein* approach to defining the term "gift" for federal income tax purposes, see Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 MINN. L. REV. 215 (1963).

ment's business-purpose test. The government in reality is proposing a per se disallowance of the rental deduction in all gift-leaseback transactions. Any such rule of law should come only from Congress.

B. THE "ECONOMIC-REALITY" TEST OF *MATHEWS*

Mathews v. Commissioner[97] presented yet another opportunity for the Fifth Circuit to scrutinize the gift-leaseback transaction and clarify its business-purpose test. Instead, it added to the confusion in gift-leaseback jurisprudence by applying yet another test to evaluate the propriety of the rental deduction in a gift-leaseback transaction. *Mathews* involved the taxpayers' transfer of interests in real property used in their funeral business to separate irrevocable trusts created for each of their four minor children and a simultaneous leaseback of the property, with year to year renewal options, for use in their business. The trusts were created for terms of ten years plus one day, with the property reverting to the taxpayers upon termination of the trust. The taxpayers' attorney served as trustee. The Tax Court upheld the deduction of the rental payments,[98] announcing a four-part test that generally has been followed in other circuits.[99] The Fifth Circuit, however, refused to follow this test and reversed, disallowing the rent deductions because the trusts were "economic nullities" and the transaction, viewed as an integrated whole, lacked "economic reality."[100] The *Mathews* court considered it irrelevant that the trustee acted independently of the grantors and that the rent negotiations between grantors and the trustee produced a reasonable rent. The crucial element, according to the court, was that the prearranged nature of the leaseback virtually guaranteed the grantors the use of the property for the term of the trusts.[101] Interestingly, the court cast further doubt upon the validity of its own business-purpose test enunciated in *Van Zandt* by intimating that not even a valid business purpose for the gift would validate the transaction.[102] The court offered only a citation to its own per curiam affirmance in *Furman v. Commis-*

97. 520 F.2d 323 (5th Cir. 1975), *cert. denied,* 424 U.S. 967 (1976).
98. Mathews v. Commissioner, 61 T.C. 12 (1973).
99. *See supra* notes 14-19 and accompanying text.
100. 520 F.2d at 325.
101. *Id.*
102. The Fifth Circuit noted:

> We think *Van Zandt* teaches that it is not sufficient merely to serve up some 'business purpose' as some of the cases put it. The fact taxpayers can conjure up some reason why a businessman would enter into

sioner[103] and the dissenting opinion in the Ninth Circuit's *Brooke v. United States*[104] decision as authority for its new economic-reality standard.

The Fifth Circuit's *Mathews* decision contributed little to the development of gift-leaseback jurisprudence except to muddy the waters even further within the Fifth Circuit. After *Mathews*, it was possible to discern three different approaches to the gift-leaseback issue within that circuit: the business-purpose test of *Van Zandt*; the economic-reality test of *Mathews*; and a second economic-reality standard adopted in the pre-*Mathews* decision of *Audano v. United States*,[105] which considered factors similar to those used by the Tax Court and those courts of appeals that have rejected the government's integrated-transaction business-purpose test. Since the *Mathews* court did not decisively reject the *Van Zandt* and *Audano* approaches, it is unclear whether they retain any vitality even within the Fifth Circuit.

> this sort of arrangement—tax consequences aside—does not foreclose inquiry. Rather there must be 'economic reality' . . . .

Id. (footnotes and citation omitted). The business purposes proffered by the taxpayers in *Mathews* were insulating the transferred property from the taxpayers' creditors and discouraging employees from aspiring to partnership in the business. *Id.* at 325 n.7. The Fifth Circuit found that the trust-leaseback arrangement in *Mathews* fulfilled neither purpose because the taxpayers' reversionary interests and leasehold rights in the property were probably attachable by creditors, and the profitable nature of the taxpayers' business, rather than the identity of the owners of the business assets, was the prime motivating factor for employees who aspired to partnership. The court did not decide whether the stated purposes would establish a business purpose for the transaction in a case in which the taxpayer could establish that the gift-leaseback actually served such purposes. The *Mathews* court, however, seemed to reject the business-purpose test in favor of a more vaguely defined economic-reality standard. *Id.* at 325.

103. 381 F.2d 22 (5th Cir. 1967), *aff'g per curiam* 45 T.C. 360 (1966).

104. 468 F.2d 1155, 1159 (9th Cir. 1972) (Ely, J., dissenting).

105. 428 F.2d 251 (5th Cir. 1970). In *Audano*, the Fifth Circuit disallowed the taxpayer's rental deductions in a gift-leaseback transaction involving medical equipment on the ground that the trusts were "economic nullities." The court based its conclusion on the absence of a written lease evidencing the leaseback tradition, the excessive amount of the rent, and the failure of the trustee to act independently of the donor-lessee. As suggested in the text of this Article, it is possible to read the *Audano* analysis consistently with the majority approach used by the Tax Court and by the Second, Third, Seventh, Eighth, and Ninth Circuits.

In *Quinlivan*, the Eighth Circuit questioned whether the split of judicial opinion on the gift-leaseback transaction was within the Fifth Circuit itself, rather than among the different courts of appeals, since the Fourth Circuit's *Perry* decision, the only appellate decision outside of the Fifth Circuit expressly adopting the government's business-purpose test, could be distinguished from the majority approach on the basis of the illusory nature of the *Perry* trustee's independence. 599 F.2d at 273 n.4.

Apart from its detrimental effect on the clarity of precedent within the Fifth Circuit, the *Mathews* decision suffers from another major defect. It offers nothing in the way of definitive guidelines or even an analytical framework to be used in deciding subsequent cases, and the court gave no indication of how a gift-leaseback transaction could be structured to satisfy its economic-reality standard. Since the court ignored that the trustees were independent of the grantor and charged reasonable rental amounts and focused instead on the prearranged nature of the leaseback, a factor that is at least implicitly present in virtually every gift-leaseback transaction,[106] the inescapable conclusion is that the *Mathews* economic-reality test is another attempt by the Fifth Circuit to formulate a per se disallowance rule for the deductibility of rent in a gift-leaseback transaction.

C. THE MAJORITY VIEW OF THE GIFT-LEASEBACK AS A BIFURCATED TRANSACTION

Those courts rejecting the government's integrated transaction business-purpose test have variously weighted a number of factors, including the reasonableness of the rental, the absence of a written lease, the independence of the trustee, the presence of a reversionary interest in the grantor-lessee, and the prearranged nature of the leaseback, in analyzing the validity of the gift-leaseback transaction. This section of the Article critically analyzes the use of these factors in deciding the gift-leaseback issue.

Until its recent multiple-opinion decision in *May v. Commissioner*,[107] the Tax Court led attempts to develop a coherent approach for analyzing the gift-leaseback transaction. After its initial hostile decisions in the gift-leaseback area had been reversed on appeal,[108] the Tax Court began to devise a more theo-

106. *See Rosenfeld,* 43 TAX CT. MEM. DEC. (CCH) at 1357.

107. 76 T.C. 7 (1981), *aff'd,* 723 F.2d 1434 (9th Cir. 1984). In *May*, there were five opinions: majority, concurring, and three dissents. Two judges joined Judge Goffe's concurring opinion and four judges dissented. For a detailed discussion of the Tax Court's decision in *May*, see Comment, *Grantor Control and its Effect on Gift-Leaseback Rental Deductions*—May v. Commissioner of the Internal Revenue Service, 15 SUFFOLK U.L. REV. 1067 (1981).

108. *See* Brown v. Commissioner, 12 T.C. 1095 (1949), *rev'd,* 180 F.2d 926 (3d Cir.), *cert. denied,* 340 U.S. 814 (1950); Skemp v. Commissioner, 8 T.C. 415 (1947), *rev'd,* 168 F.2d 598 (7th Cir. 1948). In both cases, the Tax Court disallowed the rental deductions on the gift-leaseback transactions, reasoning that, because the leaseback was prearranged, the donor-lessees had not transferred any present interest in the property to the donee trusts and thus their supposed rental payments could not be required for the use of the property during the retained leasehold term. *See supra* note 71. For extensive discussions of

retically sound approach to analyzing the transaction,[109] culminating in a test first applied in *Mathews v. Commissioner*[110] and further developed in subsequent Tax Court decisions. The Tax Court's *Mathews* test has four parts: (1) the leaseback should normally be in writing and must require payment of a reasonable rent; (2) the leaseback (as distinguished from the gift) must have a bona fide business purpose; (3) the grantor must not possess a disqualifying "equity" in the property within the meaning of § 162(a)(3); and (4) the grantor must not retain substantially the same control over the property that he or she had before the gift transfer.[111]

The *Mathews* test reflected a careful analysis by the Tax Court of its own gift-leaseback jurisprudence as well as an examination of those appellate court decisions that had already considered the issue. Accordingly, the *Mathews* four-part test has been used by the Tax Court,[112] the Eighth Circuit in *Quinlivan*,[113] and the Second Circuit in *Rosenfeld*,[114] as a focal point for analyzing the gift-leaseback transaction. The test provides a useful frame of reference for analyzing the various factors considered by the courts in deciding the propriety of the rental deductions in a gift-leaseback transaction.

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the early cases in the gift-leaseback area, including the Tax Court cases, see Webster, *Transfers to Trusts with Leasebacks—Drafting and Other Suggestions for the Trust and Lease Agreements*, 8 MAJOR TAX PLAN. 319 (1956).

109. *See, e.g.*, Oakes v. Commissioner, 44 T.C. 524 (1965), *nonacq.* 1967-1 C.B. 3; Potter v. Commissioner, 27 T.C. 200 (1956), *acq.* 1957-2 C.B. 6; Felix v. Commissioner, 21 T.C. 794 (1954), *nonacq.* 1956-2 C.B. 10.

110. 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

111. 61 T.C. at 18-20.

112. *See, e.g.*, *Rosenfeld*, 43 TAX CT. MEM. DEC. (CCH) 1353; *May*, 76 T.C. 7; *Lerner*, 71 T.C. 290; *Quinlivan*, 37 TAX CT. MEM. DEC. (CCH) 346; Serbousek v. Commissioner, 36 TAX CT. MEM. DEC. (CCH) 479 (1977). Because the *Golsen* principle requires the Tax Court to follow the precedent of the circuit in which the taxpayer's appeal would lie, the Tax Court has followed the business-purpose and economic-reality standards of *Van Zandt*, *Mathews*, and *Perry* in cases appealable to the Fourth or Fifth Circuits. *See* authorities cited *supra* note 14.

113. *Quinlivan*, 599 F.2d at 273.

114. *Rosenfeld*, 706 F.2d at 1280-82. The Ninth Circuit in *May* sustained the taxpayer's deduction of the rentals on a leaseback but did not explicitly adopt the four-part *Mathews* test. Instead, the court used the "sufficiency of the property interest transferred" test that it first enunciated in the *Brooke* decision and focused on the following four factors: the duration of the transfer; the controls retained by the donor; the use of the gift property for the benefit of the donor; and the independence of the trustee. 723 F.2d at 1436. This approach is similar to the *Mathews* test.

1. Reasonable Rent Payment and Written Lease.

To establish the validity of the gift-leaseback arrangement, the donor must sever his or her ownership interest in the leased property for at least the duration of the trust and must enter into a new relationship as lessee under a bona fide rental agreement. The key indicator of the bona fide nature of the leaseback is the reasonableness of the rent paid by the grantor to the trust. As long as the rent paid is reasonable, the grantor assigns only the inherent income-producing potential of the property to the donee trust. In essence, the amount of income assigned is the same as it would be were the trust to rent the property to some third party and the donor rent replacement property for his or her business.

That a grantor pays less than the reasonable rental value of the property, an unlikely occurrence in a gift-leaseback transaction,[115] suggests that the grantor has not relinquished sufficient control over the beneficial enjoyment of the property. In other words, the grantor has retained one of the indicia of property ownership, enjoyment of use of the property without having to pay a fair rent for it. On the other hand, that the grantor pays more than the reasonable rental value of the property, a more likely problem with the gift-leaseback arrangement, suggests that the grantor has not entered into a bona fide lease arrangement but instead is using the lease as a subterfuge for the assignment of income from sources other than the transferred property. The excess of the rent paid over the reasonable rental value of the property represents a gift to the donee of a portion of the income accruing from the value of the grantor's services or other business property, rather than a transfer of income from the property that has been transferred to the trust. Thus, the reasonableness of the rental should be a key factor in the courts' analysis of the validity of the gift-leaseback transaction.

Unfortunately, this portion of the *Mathews* test has not received the attention it deserves from the government, courts, or

115. It is unlikely that the donor-lessee will pay less than a reasonable rental because the donor's objective is to shift income to the lower-bracket donee in the form of the rental payments. The greater the rental payment is, the greater the amount of income that is assigned. *See* Froehlich, *supra* note 23, at 970; Simmons, *supra* note 3, at 203. A donor might pay less than a reasonable rental, however, if the donor were having cash flow problems and could not afford to pay the full fair rental value of the property but nonetheless wanted to assign at least some income to the donee through the gift-leaseback transaction.

commentators. Only a few gift-leaseback cases actually have used the unreasonableness of the rental as one of the bases for disallowing the rental deduction.[116] In other cases, the government surprisingly has conceded that the rental is reasonable, and the court has correspondingly refused to consider the issue, despite strong evidence that the rental actually was excessive.[117] Some commentators have argued that at most an unreasonably high rental requires that the court disallow the deduction of that portion of the rental payment that is excessive.[118] All of these authorities, however, have essentially missed the purpose of the *Mathews* requirement that the rent be reasonable in amount. An unreasonably high or low rental indicates the grantor's disrespect of the substance of the gift-leaseback arrangement. As in other transactions involving related parties, if the parties themselves do not respect the formalities of the arrangement or treat the transaction as a real one, they can hardly expect the government or a court to do so. Accordingly, although not conclusive, the presence of an unrea-

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116. *See Audano,* 428 F.2d at 257; Penn v. Commissioner, 51 T.C. 144, 152-53 (1968); *cf. Kirschenmann,* 225 F.2d at 70-71 (finding that the rent on the leaseback was unreasonably high and that the transaction lacked "business meaning" for tax purposes).

117. *See Rosenfeld,* 706 F.2d 1277 (gross rent determined to be reasonable in amount); *May,* 76 T.C. 7 (government conceding the reasonableness of the rental for the tax year in issue). *But see Rosenfeld,* 706 F.2d at 1284 (MacMahon, J., dissenting) (concluding that rental payments exceeded the reasonable rental value of the property, particularly in light of donor's agreement to remain liable on the mortgage encumbering the property); *May,* 76 T.C. at 40 (Wilbur, J., dissenting) (characterizing the annual rental as "outrageously high" and concluding that the deduction of the rentals on the leaseback should have been disallowed).

118. *See, e.g.,* Friedlander, *supra* note 23, at 303-04; *cf.* Commissioner v. Greenspun, 156 F.2d 917, 921 (5th Cir. 1946) (upholding the validity of a leaseback transaction effected through a trust, with the donor's wholly-owned corporation as lessee, but treating the excessive portion of the rentals paid by the corporation to the trust as nondeductible dividends to the donor).

Another argument in favor of disallowing only that portion of the donor's rental deduction that exceeds a reasonable rental charge for the property can be made by analogizing to the approach the Internal Revenue Code takes in the family partnership area with respect to partnerships in which capital is a material income-producing factor. Under § 704(e)(2), if the donee-partner's share of the family partnership's income is excessive because the donor has not been adequately compensated for his or her services to the partnership or retained share of the partnership capital, the remedy is reallocation of a portion of the partnership income from the donee-partner to the donor to compensate the donor for those services or capital. I.R.C. § 704(e)(2) (1982); Treas. Reg. § 1.704-1(e)(3)(i) (1956). In other words, an excessive allocation of partnership income to the donee-partner generally does not, in and of itself, invalidate the family partnership arrangement under § 704(e). *Cf.* I.R.C. § 1366(e) (1982) (reallocation of income among shareholder family group for services or capital rendered to subchapter S corporation).

sonably high or low rental on the leaseback should bear heavily against the taxpayer's attempt to demonstrate the economic substance of the arrangement.

Another objective indicator of the parties' good faith in creating a bona fide rental arrangement is the existence of a written lease. As noted by a dissenting judge in the Tax Court's *May* decision,[119] parties entering into a commercial lease as part of an arm's length transaction normally insist that the terms of their rental agreement be reduced to writing. The rights and obligations of the lessor and lessee, the amount of the rent, the circumstances under which the rent may be increased, and the other terms of the rental relationship "are sufficiently complex and the legal consequences important enough" to dictate executing a written lease.[120] The absence of a written lease in a gift-leaseback situation, therefore, strongly indicates that the arrangement lacks economic substance.

The written lease also serves as a benchmark for the court in deciding whether the donor has actually relinquished control over the property for the term of the trust. If the terms of the leasehold relationship are not reduced to writing, it is more difficult for a court to determine whether the donor has actually dealt with the property in the way that an arms-length tenant would. Without a writing, there is a problem of proving the existence of a binding leasehold relationship that limits the donor's use of the property to a use consistent with the rights and obligations of a tenant.[121]

All of this suggests that the *Mathews* requirement of a written lease is important in establishing the substance of the gift-leaseback arrangement. In the gift-leaseback transaction, as in other transactions between related parties, observance of all the formalities by the parties may be essential, although not sufficient, to establish the validity of the arrangement.[122] Unfortunately, like the reasonable rent requirement, courts have applied the written lease requirement somewhat loosely.[123] In

119. *May,* 76 T.C. at 36 (Wilbur, J., dissenting).

120. *Id.*

121. *Id.* at 18-19 (Goffe, J., concurring).

122. *See, e.g.,* Penn v. Commissioner, 51 T.C. 144, 152 (1968); *cf.* Wiles v. Commissioner, 59 T.C. 289, 298-99 (1972) (informality of rent arrangement indicative of donors' retained control over the trust property), *aff'd mem.,* 491 F.2d 1406 (5th Cir. 1974).

123. *See May,* 76 T.C. at 14 (no written lease agreement; court satisfied that terms of the lease were "clearly understood by the trustees and faithfully observed by the parties" and thus sustained deduction of the rentals on the leaseback); *Brooke,* 468 F.2d at 1157 (stating that the absence of a written lease tends

fact, in the pre-*Mathews* decision of *Brooke v. United States*,[124] the court treated the absence of a written lease as a *positive* factor evidencing the economic substance of the gift-leaseback arrangement, reasoning that the absence of a written lease negated any argument that the donor-lessee's tenancy amounted to a reversion since the trustee could terminate the oral lease at any time.[125] The logic of this approach is difficult to fathom.

In sum, to provide the leaseback relationship with the attributes of a bona fide leasehold relationship there should be a written lease agreement binding the lessee to pay a reasonable rent for continued use of the property. The absence of such attributes strongly suggests that the parties have not treated the transaction as one with economic substance, usually a fatal flaw in transactions between closely-related parties.

2. Business-Purpose.

As has been discussed earlier in this Article,[126] judicial opinion is split as to how the business-purpose test applies to gift-leaseback transactions. The Fourth and Fifth[127] Circuits consider the gift and leaseback as integrated parts of a single transaction and thus require a business purpose for both the gift of the property to the trust and the leaseback.[128] In contrast, the Tax Court and the Second, Third, Seventh, Eighth, and Ninth Circuits have treated the gift-leaseback as a bifurcated transaction and applied the business-purpose standard only to the leaseback portion of the transaction.[129] Under this view, a showing that the use of the property was necessary in the donor-lessee's business, a factor which apparently has never been challenged in any of the reported gift-leaseback cases, satisfies the business-purpose test. The bifurcated treatment of the gift-leaseback transaction is the clear majority view and is likely to be followed in subsequent cases for the reasons previously discussed.

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to help establish the substance of the gift-leaseback transaction and sustaining the deduction of the rentals); *see also* Friedlander, *supra* note 23, at 304-05 (neither a written lease nor a binding lease agreement necessary to sustain the deduction of the rentals on the leaseback; only payment by the donor of a reasonable rental for whatever period the property is actually used is necessary).

124. 468 F.2d 1155 (9th Cir. 1972).
125. *Id.* at 1157.
126. *See supra* notes 11-19 and accompanying text.
127. *See* cases cited *supra* notes 11-12.
128. *See supra* notes 68-96 and accompanying text.
129. *See* cases cited *supra* notes 14-19.

3. Disqualifying Equity and the Control Issue.

The last two requirements of the *Mathews* test are interrelated and should be analyzed together.[130] In jurisdictions that reject the government's business-purpose test, the crux of the gift-leaseback issue is whether the donor-lessee has surrendered sufficient control over the property for the transaction to be respected for federal income tax purposes. If the donor-lessee has not relinquished control over the trust property, the principles developed under the assignment-of-income doctrine require that the leaseback and the consequent assignment of the grantor's income through the rental payments be disregarded for tax purposes. Likewise, if the donor has not relinquished sufficient control over the property, he or she remains the owner of the property for tax purposes and possesses disqualifying equity interest in the trust property within the meaning of section 162(a)(3). The remainder of this section focuses on the factors courts have used in analyzing these two parts of the *Mathews* test.

a. *Grantor's Retention of a Reversionary Interest*

The grantor's retention of a reversionary interest in the trust corpus has surfaced in two different contexts in gift-leaseback jurisprudence. First, the grantor's retention of a reversionary interest has been considered a factor in determining whether the grantor relinquished sufficient dominion and control over the leased property.[131] This analysis is a throwback to *Helvering v. Clifford*,[132] in which the five-year duration of the trust was one of the factors the Supreme Court used in finding that, in substance, the grantor remained the owner of the trust property. Logically, at some point the trust's duration is so short that the grantor actually remains the substantial owner of

130. For a good discussion of the interrelationship between the disqualifying equity and control requirements of the *Mathews* test, see *May*, 76 T.C. at 22-33 (Goffe, J., concurring).

131. *E.g., id.* at 25-33 (transfer of reversion by grantor necessary to ensure that no disqualifying equity in the property exists, if the trustee is not independent), *aff'd*, 723 F.2d 1434 (9th Cir. 1984) (Ninth Circuit emphasizing the absolute nature of the transfer in upholding the taxpayer's rental deductions); *see also Brooke*, 468 F.2d at 1157 (emphasizing the absolute nature of the transfer as a factor distinguishing the case from the *Clifford* and *Van Zandt* decisions); *cf. Perry*, 520 F.2d at 239 (following Fifth Circuit's integrated transaction business-purpose test, disallowing the rental deductions on the leaseback, and pointing to the donor's retention of a reversionary interest as a factor evidencing the lack of business purpose for the gift transfer).

132. 309 U.S. 331 (1940).

the property. In the context of a gift-leaseback, this means that no rental deduction is allowed since a person cannot be both lessor and lessee. The issue is where to draw the line—five years, ten years, ninety-nine years, or in perpetuity—as the minimum amount of time that the grantor must transfer the property to the trust to avoid being treated as the owner of the trust property for income tax purposes.

Congress answered this question in the grantor trust provisions, somewhat arbitrarily drawing the line at ten years. If the reversionary interest is not intended to take effect for at least ten years, the grantor will not be treated as the owner of the trust property because of the duration of the interest transferred.[133] In a broader sense, Congress is saying that a transfer for ten years or longer will be treated as a transfer of the property, rather than as a mere transfer of income from the property, thus effectively assigning any income from the property for the trust's duration.[134] Although the grantor trust rules are not binding on a court in deciding gift-leaseback cases,[135] the congressional determination that shifting property to a trust for at least ten years also shifts ownership of the property and taxation of any rental income to the trust supports the argument that the donor's reversionary interest in a gift-leaseback situation should not be treated as an indication of the donors' retained control over the trust property. Since the gift-leaseback is merely another means of assigning income from property through use of a trust, there is no sound policy reason to treat the question of duration differently when the issue is whether the trust is the owner of the property for rental deduction purposes than when it is determining the owner for income attribution purposes.

The grantor's retention of a reversionary interest has surfaced in a second, more technical sense in the courts' analysis of the language of section 162(a)(3), which allows a rental deduction only for property in which the taxpayer has no equity. The government has argued that a grantor who retains a reversionary interest in the property automatically has a disqualifying equity interest within the meaning of section 162(a)(3) and is thereby precluded from deducting the rental payments on

133. I.R.C. § 673(a) (1982); *cf.* Rev. Rul. 55-38, 1955-1 C.B. 389 (treating an irrevocable assignment of trust income for a minimum of ten years as a disposition of a "substantial interest in the trust property" by analogy to the ten-year cutoff in the Clifford trust regulations of the 1939 Code).

134. *See, e.g.,* J. PESCHEL & E. SPURGEON, *supra* note 6, ¶ 12.02, at 12-4.

135. *See supra* notes 54-66 and accompanying text.

the leaseback. The Tax Court's decision in *Oakes v. Commissioner*[136] supported this argument, broadly defining the term "equity" as "a right of redemption, a reversionary interest, a right to specific performance, or in general any right respecting property which traditionally would have been enforceable by means of an equitable remedy."[137] Although this definition of "equity" later was rejected decisively by the Tax Court in *Mathews v. Commissioner*,[138] it was inexplicably resurrected by the majority in the Tax Court's *May*[139] decision, which upheld the donor's rental deductions on the leaseback but emphasized that he had not retained any reversionary interest in the trust property. Three other courts have accepted this argument as a ground for disallowing the rental deduction in a gift-leaseback transaction, with little or no analysis or supporting authority,[140] while several other courts, including the Second Circuit in the recent *Rosenfeld* decision, have pointed to the grantor's relinquishment of the reversionary interest or failure to retain any such interest in the original gift transfer as a fact supporting

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136. 44 T.C. 524 (1965), *nonacq.* 1967-1 C.B. 3.

137. *Id.* at 531. In *Oakes*, because the donor-lessee transferred his reversionary interest to his wife midway during the first of the three tax years in issue, the court held that he had not retained any "equity" in the leased property. *Id.* at 530.

138. 61 T.C. at 19-25.

139. *May,* 76 T.C. at 13. As the *Mathews* court explained, the *Oakes* definition of equity, if taken to its logical conclusion, can never be satisfied because every lessee arguably has enforceable rights of an equitable nature in the leasehold interest. *Mathews,* 61 T.C. at 21. The Tax Court in *May*, however, found that the donor-lessee, who had not retained any reversionary interest in the trust property, possessed no such equitable rights in the leased property. It therefore remains unclear whether the *May* court intended to suggest that a grantor's reversionary interest in the trust property would be treated as a disqualifying equity. Although the Ninth Circuit did not discuss the disqualifying equity issue in its affirmance of the Tax Court's decision, the court did emphasize the absolute nature of the transfer in concluding that the transaction satisfied its "sufficiency of property interest transferred" test. *May,* 723 F.2d at 1436-37.

140. *See* Chace v. United States, 303 F. Supp 513 (M.D. Fla. 1969) (following the Fifth Circuit's business-purpose test and disallowing the rental deduction; as an alternative ground, holding that grantor's option to renew the lease and reversionary interest constituted a disqualifying equity in the property, no analysis or supporting authority), *aff'd per curiam,* 422 F.2d 292 (5th Cir. 1970); Hall v. United States, 208 F.Supp 584 (N.D.N.Y. 1962) (disallowing rental deduction in a trust-leaseback, citing White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951); as an alternative ground, holding that grantors' reversionary interests were a disqualifying equity in the property, no analysis or supporting authority); Gibbons v. United States, 70-1 U.S. TAX CAS. (CCH) ¶ 9365 (D.C.N.M. 1970) (disallowing rental deductions on a leaseback on the ground that the grantor's reversionary interest constituted a disqualifying equity, without analyzing the issue and citing only the district court's opinion in *Chace* in support of its holding).

the validity of a gift-leaseback arrangement, again without providing analysis or supporting reasoning.[141] These results are somewhat surprising given that the government's argument has scant support in the policies underlying either section 162(a)(3) or the assignment-of-income doctrine.

First, although nothing in the legislative history of section 162(a)(3) or its statutory predecessors explains the meaning of the "no equity" phrase,[142] it primarily functions as a basis for denying a deduction for rental payments that are made to acquire actual ownership, rather than mere use and possession, of the property.[143] Thus, a taxpayer may not deduct payments on a mortgage secured by the property or payments in excess of the fair rental value of the property when the lessee has an option to purchase the property and the "rental" payments are applied to the purchase price.[144] In other words, the "no equity" requirement denies rental deductions where the rental payments enlarge the payor's ownership interest in the property. Since the rental payments in a gift-leaseback do not enlarge the donor-lessee's ownership interest in the property, a number of courts have correctly held that the grantor's retention of a reversionary interest in the trust property does not constitute a disqualifying equity interest.[145]

141. *See, e.g., Rosenfeld,* 706 F.2d at 1282 (noting that the absence of any reversionary interest in the donor was a factor distinguishing the *Skemp* and *Brown* decisions from its own decision in *White v. Fitzpatrick*); *Brown,* 180 F.2d at 929; *Skemp,* 168 F.2d at 600; *cf. May,* 76 T.C. at 22-33 (Goffe, J., concurring) (donor-lessee's reversionary interest may constitute disqualifying equity if trustee not independent).

142. As noted by the Tax Court in *Mathews*, the "no equity" requirement was first enacted as part of the Revenue Act of 1916, ch. 463, § 12(a)(1), 39 Stat. 756, 767. 61 T.C. at 20 n.4.

143. *See* 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 22.3 (1981); Lutkins, *Tax Treatment of the Lease With Option to Purchase: Is Allocation the Answer?,* 11 TAX L. REV. 65, 68-73 (1955) (citing authorities).

144. *See* Lutkins, *supra* note 143, at 70-71.

145. *See Quinlivan,* 599 F.2d at 272 (upholding the validity of gift-leaseback transaction in which the grantor retained a reversionary interest in the leased property); Perry v. United States, 376 F. Supp. 15, 19-20 (E.D.N.C. 1974) (upholding the donor's rental deductions on the leaseback and rejecting the government's alternative argument that the donor's reversionary interest in the trust property constituted a disqualifying equity interest), *rev'd,* 520 F.2d 235 (4th Cir. 1975), *cert. denied,* 423 U.S. 1052 (1976); *Mathews,* 61 T.C. at 19-24 (decisively rejecting the government's "equity" argument in gift-leaseback area and holding that the term "equity" does not include a reversionary interest that "is scheduled to become possessory after the expiration of a lessor's term of years"); *see also* Engel v. United States, 400 F. Supp. 5 (W.D. Pa. 1975) (upholding validity of trust-leaseback transaction in which the donor-lessee retained a reversionary interest in the property; no discussion of the disqualifying equity issue), *aff'd mem.,* 562 F.2d 41 (3d Cir. 1977); *cf.* Lerner v. Commissioner, 71 T.C. 290 (1978) (holding that a corporate lessee did not possess a disqualifying eq-

In addition, always treating the grantor's reversionary interest in a Clifford trust as a disqualifying equity conflicts with the congressional determination that for federal income tax purposes a transfer in trust for at least ten years creates a property interest in the donee separate and distinct from the donor's reversionary interest.[146] In effect, ownership of the property is divided horizontally in accordance with the duration of the donor's and donee's interests and the trust arrangement creates two separate property interests. The donee owns the property during the term of the trust and the donor only owns the property after the trust term. Thus, after the gift transfer, the donor has no property interest in the donee's interest, although through the leaseback the donor acquires the right to use the donee's property in return for paying a fair rent. The "no-equity" requirement of section 162(a)(3) focuses on whether the lessee actually owns an interest in the leased property. Since the donor's reversionary interest—the only interest the donor actually *owns*—is not derived from the donee-lessor's property, it cannot constitute an equity in the lessor's property.[147]

In sum, the donor's retention of a reversionary interest should not preclude the donor from deducting rent in the gift-leaseback situation. The reversionary interest should not be treated as a disqualifying retention of control, if it does not take effect for at least ten years. Any other result conflicts with the congressional determination made in the grantor trust rules to treat ten-year trusts as viable entities for federal income tax purposes. For the same reason, the grantor's retention of a reversionary interest in the trust property that satisfies the re-

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uity interest in a gift-leaseback transaction in which donor's professional corporation leased the property from the donee trust and the donor retained a reversionary interest in the property), *acq. in result* 1984-17 I.R.B. 5.

One commentator posited and then rejected the argument that the grantor should be allowed a rental deduction only to the extent that the rental payments exceed the increased value of the reversionary interest. *See* Oliver, *supra* note 6, at 37-39. Professor Oliver correctly points out that such an approach to measuring the deductible rental in a gift-leaseback transaction would undermine § 673 and the entire present statutory treatment of ten-year trusts. *Id.* at 39.

146. *See supra* notes 133-35 and accompanying text.

147. *Cf. Mathews*, 61 T.C. at 22 ("equity" in "property" for purposes of § 162(a)(3) means an interest taken from the lessor or "at least overlapping a purported ownership interest of the lessor"). *But cf.* Cochran, *Gift-Leaseback Rental Deductions: A Critical Review of Three Decades of Litigation*, 6 REV. TAX'N INDIV. 307, 313 (1982) (concluding that it is logically possible for a donor-lessee to give up enough control to shift the income to the trust and its beneficiaries under §§ 671-679 and still hold an equity for purposes of § 162(a)(3)).

quirements of section 673 should not serve as a disqualifying equity interest under section 162(a)(3). In the context of a gift-leaseback transaction, the term "equity" should include only the donor-lessee's retention of an ownership interest in the term of years that is the subject of the leaseback transaction.

b. *Prearrangement of the Leaseback*

The issue of whether the leaseback of the property was prearranged prior to the gift transfer has arisen in gift-leaseback jurisprudence in a number of different ways. First, the prearranged nature of the leaseback was an important element in the Tax Court's initially hostile reaction to the gift-leaseback transaction[148] and in the government's development of the business-purpose[149] and economic-reality[150] arguments adopted by the Fourth and Fifth Circuits and followed by the Tax Court in cases appealable to those circuits.[151] The focus here, however, is the uncertain role of the donor's prearrangement of the leaseback in determining the validity of the gift-leaseback transaction in those jurisdictions that purport to follow the bifurcated transaction approach to analyzing the gift-leaseback arrangement.

The early courts of appeals decisions of *Skemp*[152] and *Brown*[153] ignored the prearrangement of the leaseback and upheld the taxpayers' deduction of the rental payments. Several recent Tax Court cases have followed this view of prearrangement in upholding the rental deductions in gift-leaseback transactions.[154] In other cases, however, the Tax Court and the courts of appeals have sustained the taxpayer's deduction of the rentals on the leaseback but emphasized that the trustees had actively negotiated the leaseback with the grantor *after* the gift transfer,[155] or, if the initial leaseback was prearranged, emphasized that it did not cover the entire term of the trust, so

148. *See supra* note 71 and accompanying text.
149. *See supra* notes 68-87 and accompanying text.
150. *See supra* notes 97-106 and accompanying text.
151. *See* authorities cited *supra* note 14.
152. Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).
153. Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied,* 340 U.S. 814 (1950).
154. *See Rosenfeld,* 43 TAX CT. MEM. DEC. (CCH) at 1357; *May,* 76 T.C. at 11; *see also Lerner,* 71 T.C. at 293. For an earlier Tax Court decision upholding the rental deductions in a gift-leaseback transaction despite the donor's implicitly prearranged leaseback for the duration of the trust, see *Oakes,* 44 T.C. at 527-28.
155. *See* Serbousek v. Commissioner, 36 TAX CT. MEM. DEC. (CCH) 479, 483 (1977) (emphasizing that the trustee had "the right and opportunity to negotiate regarding the leaseback").

that the trustee had an opportunity to actively negotiate the renewals of the leaseback.[156] The uneasy implication in such cases is that a leaseback prearranged by the donor prior to the gift transfer, particularly if it covers the entire term of the trust, may be treated as indicative of the donor's retained control over or equity interest in the trust property, even in those jurisdictions that reject the government's business-purpose test and purport to treat the gift and leaseback as a bifurcated transaction.

This emphasis on prearrangement evidences a misunderstanding by the courts of the nature of the inquiry required in analyzing the gift-leaseback transaction. The focus of the court's analysis should be on the donor's use of the leased property after the gift and whether that use is consistent with the donor's purported change in status from owner of the property to mere user for value as lessee. The court should scrutinize carefully the leaseback transaction to ensure that the donor-lessee's use of the property is conditioned on the payment of a reasonable rent and that the other terms of the leaseback likewise reflect a bona fide lease arrangement between the donor and the trust. If the leaseback satisfies these requirements, it should be irrelevant whether it was prearranged or covers the entire duration of the trust. The donor's legal and economic position with respect to the property have changed sufficiently to justify recognition of the leaseback as a bona fide transaction.

If, prior to the gift, the grantor arranged to lease the property at a fair rental to a third party for the duration of the trust and then made the gift, the gift unquestionably would shift taxation of the rental income to the donee-trust for the term of the trust. The result should not change merely because the prearranged bona fide rental arrangement is with the donor. The economic effect to the trust and its beneficiaries is the same in both cases—receipt of fair compensation from a tenant in return for the tenant's use of the trust's property. The courts have not identified any sound policy reason for ascribing differ-

156. *See Rosenfeld,* 706 F.2d at 1281-82 (emphasizing the one-year term of the amended leaseback in sustaining the gift-leaseback); *Quinlivan,* 37 TAX CT. MEM. DEC. (CCH) at 348 (emphasizing the corporate trustee's opportunity to negotiate one-year renewals of the leaseback in upholding the validity of the gift-leaseback transaction); *cf. Brooke,* 468 F.2d at 1157 (absence of fixed term for the leaseback helped establish that the donor relinquished control over the trust property).

ent tax consequences to these two economically-equivalent transactions.

Further, emphasizing prearrangement exalts form over substance, as virtually every leaseback is at least implicitly prearranged prior to the gift.[157] Thus, if the requirement that the leaseback not be prearranged were applied strictly, almost every gift-leaseback transaction would fail under the *Mathews* criteria. Moreover, even if the leaseback is not prearranged, the donor is certain to be the highest bidder for the property, since the donor has both a preexisting use that makes the property more valuable to the donor than to a third party and an incentive to pay as much rent as reasonably possible to deflect a greater amount of income to the donee-trust.[158] Accordingly, there is no sound reason to make the trustee go through the motions of negotiating the leaseback after the gift, and the donor's prearrangement of the leaseback should be ignored by the courts in deciding the validity of the transaction.

c. *Trustee Independence*

The requirement of an independent trustee has been a major source of confusion and controversy in gift-leaseback jurisprudence. Although most decisions sustaining the donor's deduction of the rentals have treated the independent trustee requirement as a pivotal factor in establishing that the donor has relinquished control over the leased property,[159] the courts have neither developed a convincing rationale for requiring any special measure of independence on the part of the trustee in a gift-leaseback transaction nor agreed on a test to decide whether the trustee is in fact independent. Courts largely have misapplied the independent trustee requirement and, thus, needlessly complicated the analysis of the gift-leaseback transaction.

The varied and conflicting tests used by the courts in determining whether a trustee is independent best illustrate the futility of using the independent trustee requirement as a basis for deciding the validity of a gift-leaseback transaction. For example, many cases focus on the trustee's identity and relationship to the grantor apart from the gift-leaseback transaction, often with little or no analysis of whether the trustee actually acted independently of the grantor in managing the leased

157. *See Rosenfeld*, 43 TAX CT. MEM. DEC. (CCH) at 1357.
158. *See supra* note 115.
159. *See, e.g., Rosenfeld*, 706 F.2d at 1281.

property. Under this view, the grantor serving as sole trustee generally has been fatal.[160] Yet, in one notable decision, *Brooke v. United States*,[161] the Ninth Circuit found the grantor to be an independent trustee because the property was managed under a court-supervised guardianship arrangement which the court treated as a trust.[162] Trustees with a familial relationship to the grantor generally have been treated as lacking independence,[163] presumably because courts assume that such trustees will follow the donor's wishes rather than exercise their own independent judgment in managing the leased property; yet professionals like the grantor's attorney or accountant have generally been treated as independent trustees, with little analysis of the nature of their relationship to the grantor or the actual independence of their actions.[164]

The very prototype of the independent trustee—the corporate trustee with which the donor has no relationship as either an officer, director, or stockholder—has been treated as in-

160. *See, e.g., Van Zandt,* 341 F.2d at 443 (donor-lessee served as sole trustee and retained a reversionary interest in the trust property; disallowing rental deductions because the transaction, viewed as an integrated whole, lacked a business purpose); Wiles v. Commissioner, 59 T.C. 289, 298 (1972) (donor-lessee served as sole trustee; rental deduction disallowed), *aff'd mem.,* 491 F.2d 1406 (5th Cir. 1974); Penn v. Commissioner, 51 T.C. 144, 153-54 (1968) (same); *cf. Audano,* 428 F.2d at 258 (grantor-physician appointed himself as co-trustee with his attorney; rental deduction disallowed). *But cf. May,* 76 T.C. at 15 (grantor appointed himself as co-trustee with his friend; majority treated grantor's friend as an independent trustee and upheld rental deduction).

161. 468 F.2d 1155 (9th Cir. 1972).

162. *Id.* at 1157-58.

163. *See* Chace v. United States, 303 F. Supp. 513, 515-16 (M.D. Fla. 1969) (grantor's wife and brother-in-law served as co-trustees; rental deduction disallowed), *aff'd per curiam,* 422 F.2d 292 (5th Cir. 1970); Furman v. Commissioner, 45 T.C. 360, 364 (1966) (grantor's wife served as sole trustee; rental deductions disallowed), *aff'd per curiam,* 381 F.2d 22 (5th Cir. 1967). *But cf.* Potter v. Commissioner, 27 T.C. 200, 213 (1956) (grantor's father, wife, and accountant served as co-trustees; validity of gift-leaseback arrangement sustained), *acq.* 1957-2 C.B. 6.

164. *See Rosenfeld,* 706 F.2d at 1281 (grantor's accountant and attorney treated as independent trustees; grantor's daughter, a beneficiary of the trust, later appointed as a co-trustee, a fact ignored in the majority opinion); *Brown,* 180 F.2d at 929 (grantor's attorney treated as independent trustee); *Lerner,* 71 T.C. at 302 (grantor's attorney served as sole trustee; court had "trouble in deciding whether the trustee in fact acted independently" of the taxpayer, but ultimately concluded that the trustee was sufficiently independent because he refused some of the taxpayer's requests to purchase additional equipment with trust funds). *But see Rosenfeld,* 706 F.2d at 1287 (MacMahon, J., dissenting) (questioning the actual independence of the trustees); *Mathews,* 520 F.2d at 324 (grantor's attorney not treated as independent trustee because of prearranged nature of the leaseback covering the entire period of the trust; transaction lacked "economic reality").

dependent in the context of a gift-leaseback transaction,[165] but even here there are exceptions based on the supposedly illusory nature of the trustee's independence as a result of the prearranged leaseback.[166] In other cases, however, the prearranged nature of the leaseback was ignored, and the court resolved the independent trustee issue by focusing on the trustee's identity and relationship to the grantor.[167]

Another factor some courts have used in deciding the trustee's independence is the extent of the powers retained by the donor-lessee over the trust property. Thus, rental deductions have been disallowed when the donor reserved either the right to settle the trust accounts[168] or to disapprove any sale of the property by the trust.[169] In this context, the independent trustee requirement seems nothing more than a reiteration of the message that the donor-lessee must surrender control over the property and not retain any nonfiduciary powers over the leased property inconsistent with the donor's status as lessee. Thus, the prior case law hardly provides strong support for a separate requirement that the trustee possess some special degree of independence from the donor and instead suggests that the required independence of the trustee is more a matter of form than substance.

The five opinions issued by the Tax Court in *May v. Commissioner*[170] starkly illustrate the confusion that exists with re-

165. *See Quinlivan,* 599 F.2d at 272 (bank trustee); *Skemp,* 168 F.2d at 599-600 (same); Duffy v. United States, 343 F. Supp. 4, 8 (S.D. Ohio 1972) (same), *rev'd on other grounds,* 487 F.2d 282 (6th Cir. 1973), *cert. denied,* 416 U.S. 938 (1974); Serbousek v. Commissioner, 36 TAX CT. MEM. DEC. (CCH) 479, 483 (1977) (same); *Oakes,* 44 T.C. at 529-30 (same); Felix v. Commissioner, 21 T.C. 794, 804 (1954) (corporate trustee), *nonacq.* 1956-2 C.B. 10.

166. *See Perry,* 520 F.2d at 238 (bank trustee's independence illusory because of limitations placed on its powers by the prearranged leaseback of the entire property for the duration of the lease); Butler v. Commissioner, 65 T.C. 327, 329-32 (1975) (even though bank served as trustee, the grantor retained control over the trust property through a prearranged leaseback; following integrated transaction business-purpose rule of the Fifth Circuit and disallowing the rental deductions); *cf.* Hall v. United States, 208 F. Supp. 584, 588 (N.D.N.Y. 1962) (independent corporate trustee; rental deductions disallowed).

167. *See supra* notes 152-54.

168. *Hall,* 208 F. Supp at 588. *But see Oakes,* 44 T.C. at 531-32 (grantor's retention of the power to settle the accounts not fatal to the rental deductions on the leaseback, since trustee had option to have account settled by a court).

169. *See* Furman v. Commissioner, 45 T.C. 360, 364-65 (1966), *aff'd per curiam,* 381 F.2d 22 (5th Cir. 1967); *see also Rosenfeld,* 706 F.2d at 1287 (MacMahon, J., dissenting) (donor-lessee's right to construct additions to the property at his own expense and to determine whether the trustees would improve the unfinished portion of the property treated as indicia of the donor's retained control over the trust property).

170. 76 T.C. 7 (1981), *aff'd,* 723 F.2d 1434 (9th Cir. 1984).

spect to the independent trustee requirement. In *May*, a physician and his wife transferred real property used in the physician's medical practice to an irrevocable trust for the benefit of their children, although the deed transferring the property to the trust was not recorded for two and one-half years after the trust's creation. The Mays retained no reversionary interest and appointed Dr. May and his friend Mr. Gross as cotrustees. On the same day that the trust instrument was executed, May leased back the property for use in his medical practice, but never signed the prepared written lease. Gross simply assumed, without conducting any investigation, that the lease was executed. Gross also never investigated whether title to the property was properly transferred to the trust, although he testified that he examined the trust's checkbook about four times a year to ascertain that the rent had been paid. Despite the personal relationship between Gross and May and Gross's rather casual attitude toward his trust duties, the Tax Court majority upheld the taxpayers' rental deduction. The majority determined that Gross was sufficiently independent to satisfy the independent trustee requirement, but then refused to decide whether an independent trustee is necessary in every case to establish the validity of the gift-leaseback transaction.[171]

Judge Goffe, in his concurring opinion, agreed that Gross was sufficiently independent to satisfy the requirement, but decided that an independent trustee was not necessary in this case because the government had conceded that the rent was reasonable[172] and the grantor had not retained a reversionary interest. Yet, Judge Goffe did not define what degree of independence would be required in a case in which the grantor *had* retained a reversionary interest in the trust property.

The three dissenting opinions agreed that the appointment of an independent trustee was essential in gift-leaseback cases to establish that the grantor had relinquished control over the trust property under the *Mathews* criteria. The three dissenting opinions also agreed that Gross did not satisfy the independent trustee requirement. Nonetheless, the dissenting opinions failed to provide any concrete guidelines for determining whether a trustee is in fact independent, except to suggest that the grantor cannot be trustee.

On appeal, the Ninth Circuit affirmed the Tax Court's deci-

171. *Id.* at 14-15.
172. *Id.* at 32 (Goffe, J., concurring).

sion and sustained the taxpayer's deduction of the rentals on the leaseback, basing its decision on the criteria enunciated in its earlier decision in *Brooke*,[173] including the independence of the trustee.[174] The court upheld the Tax Court's finding that Gross was independent with little discussion of the issue.[175] Consequently, although the Ninth Circuit implied that an independent trustee is necessary in establishing the validity of the gift-leaseback transaction, it provided no guidance as to how to determine independence or lack thereof.

All of this demonstrates the folly of attempting to formulate an extra-statutory test requiring an independent trustee in every gift-leaseback transaction. The courts cannot agree on whether such a requirement is even necessary, let alone provide a reasonably precise definition of the nature and degree of required independence. The confusion in the case law over this concept confirms the inappropriateness of using this factor as a basis for resolving the gift-leaseback controversy.

In addition, the courts and commentators advocating the independent trustee requirement have not explained adequately why the trustee in a gift-leaseback transaction should possess any greater degree of independence than required by the grantor trust rules. Since the grantor trust rules permit the grantor to serve as trustee without being taxed on the trust income, provided that those rules are otherwise satisfied,[176] why use a different approach in the gift-leaseback area? One suspects that proponents of the requirement believe the independent trustee can help assure that the donor-lessee pays a reasonable rent for the continued use of the property, as sug-

173. 468 F.2d at 1157.

174. *May,* 723 F.2d at 1436.

175. *Id.* at 1437.

176. The grantor trust rules distinguish somewhat different types of trustees. Under those rules, if the trustee is the grantor himself or a "related or subordinate party" (defined by I.R.C. § 672(c) (1982) as certain specified relatives of the grantor or an employee of the grantor, who are presumed subservient to the grantor unless the contrary is shown by a preponderance of the evidence), the powers that may be given to the trustee without causing the grantor to be taxed on the trust income are more limited in nature than those that may be given to a trustee who is an adverse party. *See* I.R.C. §§ 674, 675, 677 (1982). If the trustee is an "adverse party" (defined by I.R.C. § 672(a) (1982) as a person having a substantial beneficial interest in the trust, whose interest would be adversely affected by the exercise or nonexercise of the powers in question), his or her powers are not imputed to the grantor and hence will not cause the grantor to be taxed on the income from the trust under the grantor trust rules. *See* I.R.C. §§ 674-677 (1982). *See generally* 3 B. BITTKER, *supra* note 21, ch. 80 (1981).

gested by Judge Goffe in his concurring opinion in *May*.[177] This argument has some validity if the donor-lessee attempts to pay too low a rent since the independent trustee has a fiduciary duty to exact at least fair rental value. As previously noted, however, it is unlikely that the donor-lessee will pay too low a rental.[178] The more likely scenario is that the grantor will attempt to assign a greater amount of income by paying more than the fair rental value of the property, and thus it is difficult to see what function an independent trustee is expected to serve. If the grantor offers more than the fair rental value of the property, there would be no reason for even an independent trustee to refuse the payment, because it is the trustee's duty to exact the highest rent possible for the property.[179]

The stronger argument for requiring an independent trustee is that the grantor trust rules do not address certain potential abuses in the gift-leaseback setting. The grantor trust rules focus on powers the grantor retains over the trust property in the trust instrument that are inconsistent with the grantor's claim of transferred ownership. Although that potential abuse is present in the gift-leaseback transaction as well and can be remedied by applying the grantor trust rules, there is also the poorly articulated concern that the donor will use the relationship as lessee to retain controls over the trust property that under the grantor trust rules could not be retained directly through the trust instrument. The independent trustee thus can provide additional assurance that the donor-lessee will pay rent and otherwise respect the terms of the leasehold relationship. Arguably, since the leasehold relationship and the consequent change in the donor's economic position are all that separate the donor from the same control after as before the gift, and since the grantor trust rules do not focus on this leasehold relationship, an independent trustee is indispensable to establishing the validity of the gift-leaseback transaction.[180]

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177. 76 T.C. at 32-33 (Goffe, J., concurring).

178. *See supra* notes 115-18 and accompanying text.

179. *See* Friedlander, *supra* note 23, at 304 n.74 (positing that the trustee might violate his or her fiduciary duty in refusing such rental).

180. It could be argued that the leaseback of the trust property to the donor is analogous to a loan of trust corpus to the donor. Under I.R.C. § 675(3) (1982), the donor is taxed on the income from the loaned portion of the trust corpus, unless the loan provides for adequate interest and security and is made by a trustee other than the grantor or a related or subordinate trustee. Under this theory, an independent trustee would be necessary in the gift-leaseback transaction to avoid taxation of the donor on the income from the trust. *See* Cohen, *supra* note 4, at 41. No court has yet mentioned this argument as a basis for

This argument, however, ignores that the *trust* owns the property after the gift. The trustee, whether the grantor or a third party, has a fiduciary obligation to manage the property competently for the beneficiaries,[181] with the potential for judicial supervision of the trust should the trustee abuse those powers. The fiduciary duties imposed by state law and the trust instrument, plus the restrictions imposed on the trustee's powers under the grantor trust rules, should ensure that the trustee manages the property in the beneficiary's best interests. Of course, if the grantor, either as trustee or through a subservient trustee, does exercise control over the property in contravention of the trust instrument, the trustee's fiduciary obligations, or the limitations imposed by the grantor trust rules, the court can disregard the trust as an economic nullity or sham and disallow the grantor's rental deductions on the leaseback.

Finally, the independent trustee requirement in the gift-leaseback area is inconsistent with the approach taken in other areas where the courts have refused, absent a great likelihood of abuse, to premise a rule of tax law on the assumed abuse of a trustee's fiduciary duties. For example, in the area of assignments of income effected through a family partnership, the regulations and case authorities recognize that a donor can create a valid family partnership arrangement by contributing the partnership interest to a trust for the benefit of the donee, even if the donor serves as trustee.[182] In a different context, the Tax

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requiring an independent trustee in the gift-leaseback situation and it appears a rather strained reading of the statutory language.

181. *See generally* 2 A. Scott, The Law of Trusts §§ 169-185 (3d ed. 1967); Restatement (Second) of the Law of Trusts §§ 169-185 (1959).

182. *See* Treas. Reg. § 1.704-1(e)(2)(vii) (1956). These regulations contemplate the possibility that the donor will contribute the family partnership interest to a trust for the benefit of family members and serve as trustee, stating:

> [I]f the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor.

Id.; *see* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 14.04[1] (1977) (citing authorities); *see also* H.R. Rep. No. 586, 82d Cong., 1st Sess. 33, *reprinted in* 1951 U.S. Code Cong. & Ad. News 1781, 1815; S. Rep. No. 781, 82d Cong., 1st Sess. 40, *reprinted in* 1951 U.S. Code

Court recognized the validity of an installment sale made to a trust for the benefit of the seller's minor children, with the seller serving as trustee, stating:

> Considering our holdings in a number of other cases, we conclude that the fact that a seller of property is the trustee of the trusts to which the property is sold, standing alone, does not cause the sale to lack substance or bona fides, or the seller to constructively receive the income from the sale received by the trusts. The crucial fact is whether the trustee was acting solely as trustee and in the best interests of the trusts in making the purchase and sale of the property.[183]

Likewise, the real issue in the gift-leaseback transaction is not the trustee's identity, but whether that trustee manages the property in accordance with his or her fiduciary obligations and the limitations imposed by the grantor trust rules.[184]

In sum, the independent trustee requirement unnecessarily complicates gift-leaseback jurisprudence. The premise that the grantor, or someone close to the grantor, cannot serve as trustee in a gift-leaseback transaction is inconsistent with the judgment made in formulating the grantor trust rules and other tax laws that the limitations imposed on the trustee by state fiduciary law, the trust instrument, and the grantor trust rules sufficiently ensure that the trust property is managed for the benefit of the beneficiaries. Instead of focusing on the trustee's identity, the court should examine the trustee's actions during the term of the trust and determine whether the property is being managed in the interest of the beneficiaries. If the trustee has properly discharged all fiduciary duties, then the courts should respect the gift-leaseback arrangement regardless of the trustee's identity. To be sure, the actions and dealings of the donor or a close relative serving as trustee will require more careful scrutiny; thus, the prudent grantor who wants to reduce uncertainty as to whether the transaction will be considered

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CONG. & AD. NEWS 1969, 2009; *cf.* 3 A. WILLIS, J. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION § 172.08, at 172-15 (3d ed. 1981) (recognizing that the grantor can serve as trustee but warning that "there are acute problems if the grantor is the trustee").

183. Goodman v. Commissioner, 74 T.C. 684, 708-09 (1980), *nonacq.* 1981-1 C.B. 2, *aff'd mem.,* 673 F.2d 1332 (7th Cir. 1981); *cf.* Vaughn v. Commissioner, 81 T.C. 893 (1983). *But see* Rushing v. Commissioner, 441 F.2d 593, 598 (5th Cir. 1971) (indicating that an independent trustee is necessary in the context of an installment sale of stock to a family trust if the seller is to avoid constructive receipt of liquidation proceeds received by the trust from the corporation). These cases arose prior to the revision of the installment sale provisions to permit the use of § 453 in connection with a § 337 liquidation. *See* I.R.C. § 453(h) (1982).

184. For other critiques of the independent trustee requirement in the gift-leaseback area, see Friedlander, *supra* note 23, at 300-01; Froehlich, *supra* note 23, at 971; Albany Note, *supra* note 23, at 589-90.

bona fide will appoint an independent party as trustee. But if the donor or someone close to the donor does serve as trustee and proceeds to manage the property in accordance with all fiduciary obligations, there is simply no good reason to disregard the gift-leaseback arrangement.

III. SUGGESTED APPROACH FOR ANALYZING THE GIFT-LEASEBACK TRANSACTION

As this Article indicates, the gift-leaseback transaction properly should be viewed as a device by which a high-bracket donor attempts to assign income from property to a lower-bracket donee through the use of a trust. The standards used in analyzing the gift-leaseback transaction should be consistent with the rules developed under the case law for assignments of income from property and with the grantor trust rules of the Code. The Tax Court's four-part test in *Mathews* represents just such a workable approach. Although courts have encountered difficulties in applying the *Mathews* criteria, these difficulties are largely a result of the courts' inconsistent and illogical interpretations of those requirements rather than any inherent problems in the test itself.

First, the majority approach of analyzing the gift and leaseback portions of the transaction separately and applying the business-purpose standard only to the leaseback portion represents a logical application of the statutory requirements of section 162(a)(3). That section focuses only on the donor-lessee's use of the property during the term of the lease, and if the property is used in the donor's business, the business-necessity requirement of section 162(a)(3) is satisfied. Courts should continue to reject the government's integrated transaction business-purpose test, which requires a business purpose for the donor's gift transfer to the trust, as it has little support in logic, the case law, or the policies underlying the assignment-of-income doctrine and the grantor trust rules.

Second, the *Mathews* requirements that the lease normally be in writing and create a binding obligation on the part of the donor-lessee to pay a reasonable rental are crucial in determining whether the leaseback transaction has substance. The absence of either of these indicia of a bona fide rental arrangement strongly suggests that the donor has retained use of the property in a capacity other than as a fiduciary or tenant and that the donor should be treated as retaining ownership of the property for purposes of section 162(a)(3).

Third, the disqualifying equity requirement of the *Mathews* test is taken directly from the statute and requires nothing more than that the donor-lessee no longer own the property interest that he or she purports to rent, that the term of years covered by the leaseback be specified, and that the rent payments compensate the trust for temporary use of that property interest. If the donor retains a reversionary interest in the trust property, it should not serve as a disqualifying equity interest provided it satisfies the requirements of section 673 of the Code.

Finally, under *Mathews* the donor must surrender sufficient control over the property to warrant treating the trust as the owner of the property for purposes of section 162(a)(3). That section requires: (1) a valid and complete transfer of the property in trust for at least the period required by section 673 of the Code; (2) design of the trust to comply with all of the requirements of sections 674 through 679 of the Code; (3) the execution of a binding lease agreement that limits the donor's nonfiduciary use of the property to uses consistent with lessee status; and (4) actual management of the property by the trustee, whether that trustee is the donor or some third party, in a manner consistent with the limitations imposed upon the trustee's powers by the grantor trust rules, the trust instrument, and fiduciary obligations to manage the property for the benefit of the trust beneficiaries. Other factors, such as the duration of the leaseback, its prearranged nature, or any special measure of trustee independence, are extraneous considerations, that cannot help to achieve a satisfactory resolution of the gift-leaseback controversy.

IV. PLANNING CONSIDERATIONS

This Article has focused primarily on critically analyzing the courts' approaches to handling the gift-leaseback issue and using this analysis to develop a sensible analytic approach to the problem. Because courts have not yet adopted the approach this Article suggests, however, it is appropriate to conclude with a set of planning recommendations to aid those tax advisers who currently wish to design gift-leaseback transactions for their clients.

First, the donor-lessee should transfer the property to an irrevocable trust for the benefit of the donees, rather than directly to the donees, since gift-leasebacks involving direct transfers to donees generally have not fared well in the

courts.[185] All steps necessary to effect a valid transfer of the property to the trust under state law should be undertaken carefully prior to executing the leaseback because an incomplete transfer of the property to the trust will invalidate the gift-leaseback arrangement.[186] In addition, at a minimum, the trust must comply with all of the requirements of the grantor trust rules embodied in sections 673 through 679 of the Internal Revenue Code so that the donor-lessee will not be treated as the owner of the trust property.

Second, to qualify for a rental deduction under section 162(a)(3) of the Code, the property leased by the donor-lessee must be necessary to the conduct of the donor-lessee's trade or business. Furthermore, in those circuits adopting the governments' integrated transaction business-purpose test (the Fourth, Fifth, and, presumably, Eleventh Circuits), or in the circuits which have not yet clearly expressed their views on that test (the First, Sixth, Tenth, District of Columbia, and Federal Circuits), one should document significant nontax reasons for transferring the property to the trust, such as insulating the property from the donor's creditors or assuring proper management of the property by a competent professional trustee for the benefit of the trust beneficiaries. It is unlikely, however, that the Fourth or Fifth Circuits would accept such nontax purposes as satisfying the integrated transaction business-purpose test, although the Fourth Circuit in *Perry* did seem to keep the door ajar for such an argument.[187]

In addition, if at all possible, the donor-lessee should lease only a portion of the transferred property and allow the trust to lease the remaining portion of the property to third parties. The Fifth Circuit in *Van Zandt*[188] and the Fourth Circuit in *Perry*[189] intimated that this factor might help the donor-lessee establish a business purpose for the transfer of the property to

185. *See supra* note 4.

186. In seeking to disallow the deduction of the rentals in a gift-leaseback transaction, the government sometimes has made the alternative argument that the transfer of the property to the trust was invalid under state law and, therefore, the donor-lessee remained the legal owner of the property. *See May,* 76 T.C. at 15 (deed transferring title of the property to the trust not executed until two-and-one-half years after the date the instrument creating the trust and the leaseback agreement were executed; holding that the property had been validly transferred to the trust under state law on the date of execution of the trust instrument).

187. *See supra* note 87.

188. 341 F.2d at 442. *See also* Butler v. Commissioner, 65 T.C. 327, 332 (1975).

189. 520 F.2d at 239.

the trust, namely, assuring competent professional management.

Although some decisions have correctly downplayed the significance of prearrangement,[190] as a planning matter it is also best to avoid any formal prearrangement of the leaseback and have the donor negotiate the leaseback with the trustee only after transfer of the property to the trust. Since the donor is likely to place a rental value on the property at the high end of the reasonableness scale,[191] there is little practical risk that even an independent trustee will reject the donor's rental offer. In addition, in deference to those courts that are concerned the duration of the leaseback may evidence the donor's retained control over the property, the initial term of the leaseback should be for a one or two year period and in any event should not be coextensive with the duration of trust.[192] Admittedly, this recommendation is more a matter of form than substance.

It is also necessary that the leaseback bear all the earmarks of a bona fide leasehold relationship. The lease should be in writing and create a binding leasehold relationship between the donee-trust and the donor-lessee, should contain provisions concerning the rights and duties of parties that are standard in a commercial lease, should not give the donor-lessee any unusual rights or powers with respect to the leased property, and should require the donor-lessee to pay rent for the continued use of the property in a reasonable amount in view of all the factors involved. The reasonableness of the rental should be documented by an independent expert's appraisal of the fair rental value of the property.[193]

It is unclear whether the donor can retain a reversionary interest in the leased property without being treated as possessing a disqualifying equity interest within the meaning of section 162(a)(3). Only a few courts, including the Eighth Circuit in *Quinlivan*, have upheld the validity of gift-leasebacks

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190. *See, e.g.*, authorities cited *supra* notes 152-54.

191. *See* Froehlich, *supra* note 23, at 970 (donor "will always be the highest bidder for use of the property").

192. If the term of the leaseback is coextensive with the trust's duration, the leaseback either should have a rent escalation clause that provides for an adjustment of the rent to reflect increases in the rental value of the property or should provide for renegotiation of the rentals. *Cf. Rosenfeld*, 43 TAX CT. MEM. DEC. (CCH) at 1357.

193. *See, e.g.*, *Rosenfeld*, 706 F.2d at 1279-80 (rental paid by the grantor-lessee on the leaseback set by an independent expert's appraisal of the fair rental value of the property; government did not challenge the reasonableness of the rental); Simmons, *supra* note 3, at 203.

when the donor retained a reversionary interest.[194] Other courts have either failed to discuss the issue, used the grantor's retention of a reversionary interest as a factor weighing against the validity of the gift-leaseback transaction, or intimated that the grantor's transfer of the reversionary interest helped establish relinquishment of control over the property.[195] Accordingly, as a planning matter it is best to place the remainder interest in someone other than the donor, such as the donor's spouse or other relative.[196] Alternatively, a donor wishing to retain a reversionary interest in the trust property can more safely avoid the government's disqualifying equity argument by transferring the property to the trust and setting up a corporation to lease the property from the trust along the lines suggested by the *Lerner* case.[197] To be successful, however, the donor must respect all corporate formalities and document that he or she has a principal purpose other than effecting the gift-leaseback transaction for using the corporate form to conduct business.[198] It is also important that the property be owned by

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194. *See* cases cited *supra* note 145.

195. *See* cases cited *supra* notes 140-41.

196. Other income, estate, and gift tax considerations also militate against using the Clifford trust to effect the gift-leaseback transaction. First, the increased estate and gift tax costs of establishing a Clifford trust, resulting from the unification of the estate and gift tax rate schedules in 1977, have reduced the attractiveness of Clifford trusts as a planning device. *See* Adams & Herpe, *Clifford Trusts: Planning Opportunities under ERTA And Other Recent Developments,* 121 TR. & EST. 44, 45-46 (1982); Fiore, *Gift or Sales Coupled with Leasebacks,* 32 MAJOR TAX PLAN. ¶ 1600, ¶ 1607.1, at 16-20 n.67, ¶ 1607.2, at 16-23 (1980). The attractiveness of the Clifford trust has been further undercut by the Treasury's recent amendment of the gift tax regulations to use a 10% (as opposed to the previous 6%) rate of return in measuring the value of the gift of an income interest in property. *See* Treas. Reg. § 25.2512-5(f) (1984) (the new regulations are generally effective for transfers occurring after November 30, 1983). Second, if the donor retains no reversionary interest in the trust property, the transfer of the property to the donee-trust will shift any future appreciation in the value of the property from the donor's estate to the trust beneficiaries' estates. *See* Fiore, *supra,* ¶ 1607.1, at 16-19. Third, if the property is expected to be sold at a time when its value is in excess of the donor's adjusted basis, income tax savings will be achieved if the property is sold by the presumably lower-bracket trust or its beneficiaries rather than by the higher-bracket donor. *Id. But see* I.R.C. § 644 (1982) (if the property is sold by the trust within two years after the donor gives it to the trust, all or a part of the recognized gain on the sale may be taxable to the trust at the donor's income tax rates).

197. Lerner v. Commissioner, 71 T.C. 290 (1978), *acq. in result* 1984-17 I.R.B. 5.

198. If the grantor's principal purpose for organizing the corporation is to obtain the benefit of rental deductions on the leaseback in a situation where the deductions would not have been available if the grantor had leased back the property from the donee-trust, the government could argue that I.R.C. § 269 applies to disallow the corporation's rental deductions on the leaseback. It is

the donor as an individual, rather than by the corporation, prior to the gift transfer.[199]

Finally, although one can argue that no special degree of trustee independence should be required in a gift-leaseback transaction, prudent planning mandates the appointment of an "independent" trustee rather than the donor or a member of the donor's family. The safest course is to appoint a corporate trustee with which the donor has no relationship as an officer, director, or stockholder, although the donor's attorney or accountant probably also will be treated as independent under the case law. The trustee's powers over the trust corpus should be broad enough to mute any argument that the trustee's independence is illusory in nature.

These recommendations present an admittedly conservative approach to planning the gift-leaseback transaction. If all of the above recommendations are followed, the taxpayer should be successful in deducting the rentals on the leaseback in the Second, Third, Seventh, Eighth, and Ninth Circuits and should have a reasonable chance of prevailing in those circuits that have not yet decided the gift-leaseback issue. Taxpayers residing in the Fourth, Fifth, and Eleventh Circuits, however, have only faint hope of success on the gift-leaseback issue, unless the Supreme Court resolves the issue against the government or the taxpayers are willing to litigate the issue in the United States Claims Court.[200]

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unlikely, however, that the courts would adopt such a broad interpretation of § 269. *Cf.* Keller v. Commissioner, 77 T.C. 1014 (1981) (incorporation to obtain congressionally sanctioned I.R.C. § 401 pension plan benefits not a I.R.C. § 269 tax-avoidance purpose); Achiro v. Commissioner, 77 T.C. 881 (1981) (same). These cases were decided prior to the enactment of I.R.C. § 269A as part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 269A, 96 Stat. 324, 528. For an extensive discussion of § 269, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 16.21 (4th ed. 1979).

199. If property owned by a corporation is transferred to a trust for the benefit of a shareholder's children or other relatives, the transfer will be treated as a dividend in kind to the shareholder of the fair market value of the property. See I.R.C. §§ 301, 316 (1982).

200. The United States Claims Court is bound only by the precedent of the United States Supreme Court and the United States Court of Appeals for the Federal Circuit regardless of where the taxpayer resides. *See generally* 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 115.7, at 115-41 to -42 (1981) (discussion of the effect of precedent on choosing a forum in which to litigate a tax controversy); M. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 9.04[2], at 9-20 (1981) (same); Jones & Singer, *Changes in Procedure, Strategy Due in New Federal Circuit and Revamped Claims Court*, 57 J. TAX'N 136 (1982).

CONCLUSION

The transfer by a donor of business property to a trust, followed by the donor's leasing back of the property for continued business use, constitutes an assignment of income from the property for the duration of the trust. The transaction should be analyzed under standards consistent with the policies underlying the assignment-of-income doctrine and its codification in the trust area in the form of the grantor trust rules. Although congressional action on the issue would help clarify the matter, such action is unnecessary. The four-part test enunciated by the Tax Court in *Mathews* and developed in subsequent cases, if interpreted in a consistent manner along the lines suggested in this Article, is adequate to achieve the proper results in the gift-leaseback cases. Since the courts in the Fourth and Fifth Circuits have refused to follow this approach to date and those courts that do follow the *Mathews* test disagree about the precise nature of the *Mathews* requirements, review by the United States Supreme Court in the *Rosenfeld* or *May* cases is imperative if a sensible and reasonably clear solution to the gift-leaseback controversy is to be achieved.