



1974

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Recommended Citation

Lavelle, Charles J. (1974) "Gift and Leaseback: Planning Perspectives in an Unlegislated Field," *Kentucky Law Journal*: Vol. 63 : Iss. 1 , Article 8.
Available at: <https://uknowledge.uky.edu/klj/vol63/iss1/8>

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GIFT AND LEASEBACK: PLANNING PERSPECTIVES IN AN UNLEGISLATED FIELD

I. INTRODUCTION

During the past twenty-five years, the intra-family gift and leaseback transaction has developed into an extremely popular and successful income-shifting device. Its use, however, is fraught with peril since no provision of the Internal Revenue Code¹ of 1954 [hereinafter the Code] expressly covers such exchanges. Despite the existence of this frequently and diversely litigated tax-minimization niche, Congress has yet to pass a single piece of legislation to smooth or define its contours.² Nor has the Treasury issued an applicable Regulation.³ This complete dependence upon the common law of taxation, coupled with the few imprecise guidelines thus far judicially delineated, prompted the Internal Revenue Service [hereinafter IRS] to place transfer and leaseback cases⁴ on its

¹ 26 U.S.C. §1 *et seq.* (1972) [THE INT. REV. CODE OF 1954 is hereinafter cited as CODE].

² With each new case that is issued in the field, the law review articles invariably implore Congress to enact either prohibitive or prophylactic legislation. Some are: Cohen, *Transfer and Leasebacks to Trust: Tax and Planning Considerations*, 43 VA. L. REV. 31 (1957) [hereinafter cited as Cohen]; Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 TAX L. REV. 295 (1962) [hereinafter cited as Lyon & Eustice]; Oliver, *Income Tax Aspects of Gifts and Leasebacks of Business Property in Trust*, 51 CORNELL L. Q. 21 (1965) [hereinafter cited as Oliver]. Price, "Eat, Drink and Be Merry" at the Expense of the Federal Fisc., 49 TAXES 175 (1971) [hereinafter cited as Price]; Webster, *Transfer to Trusts with Leasebacks—Drafting and Other Suggestions for the Trust and Lease Agreements*, U. SO. CAL. 1956 TAX INST. 319; Note, *Gift and Leaseback—Tax Planning in the Shadows of Assignment of Income and Business Purpose*, 62 GEO. L.J. 209 (1973) [hereinafter cited as Note GEO.]; Note, *Gift and Leaseback: A Continuing Tax Controversy*, 4 LOYOLA L.J. 371 (1973) [hereinafter cited as Note LOYOLA]; Note, *The Gift and Leaseback: A New Tax Avoidance Gimmick*, 51 YALE L.J. 1529 (1950); COLUM. L. REV. 247 (1951); 65 HARV. L. REV. 1250 (1952).

³ Treas. Reg. §1.671-1(c) (1956) is the only regulation that mentions rent deduction under short term trusts. It specifies that compliance with §671 of the Code will not affect the deductibility of the rent.

⁴ Each issue is assigned an eight digit code by the Internal Revenue Service, designated by section, topic and subtopic. Under §162 is the topic (09) Rents and Royalties; the subtopic (06) is Conveyance and Leaseback. Presumably this is for standardization of research, litigation and legislation; it is also geared to instant computer analysis. Uniform Issue List No. 0162.09-06 (11-19-73), 1 CCH INT. REV. MANUAL: INT. REV. SERV. MANUAL MT1275-8 (10-6-72).

1973 "prime issue"⁵ list—a list of issues which the Service would rather litigate than settle. The cases thus precipitated are now emerging from the courts, and the questions around which they revolve are moving all the closer to final resolution.

Transfer and leaseback cases may turn on any of several points, but a typical fact pattern can be illustrated as follows: T, a professional who owns a highly depreciated office building and furniture, transfers it to an independent trustee for a period of 12 years for the benefit of his minor children, paying the applicable gift tax⁶ and retaining a reversion. He immediately leases the property back from the trustee for a specified amount for the first five years and by agreement of both parties thereafter.

The pertinent issue is whether the rental payments made by the lessee are deductible under §162(a)(3)⁷ of the Code. This section, entitled "Trade or Business Expense" provides:

(a) In General—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.

In the fact pattern outlined above, the lessee would deduct his

⁵ Prime issues are those that the IRS will ordinarily insist on litigating and that will not ordinarily be conceded or compromised. The wording of the "prime issue" involving trust and leaseback cases is:

[w]hether a taxpayer may deduct "rental" payments made to a family Clifford Trust where the payments are made for the use of an office building or other property which the taxpayer conveyed to the trust and simultaneously leased back under a predetermined arrangement.

National Office List of Prime Issues, July 16, 1973, 737 CCH 1973 STAND. FED. TAX REP. §6527, at 71.323 (citations omitted). See also, 1 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION §6.03(3) (Supp. 1974), citing INT. REV. SERV. MANUAL MT1277-7 (July 16, 1973). One author has noted the "unwisdom of planning one's way into litigation." He explains prime issues as "ones which, if raised, cannot, as a matter of IRS policy, be 'settled' by closing agreement or compromise and therefore *must* be litigated." He suggests that no reversion should be retained and that the leaseback should not be negotiated prior to the transfer. Simmons, *New Developments in the "Gift and Leaseback" in Tax Planning for the Professional*, 51 TAXES 654, 658 (1973).

⁶ John T. Potter, 27 T.C. 200 (1956), *acquiesced in* 1957-2 CUM BULL 6.

⁷ Same as INT. REV. CODE OF 1939, §23(a)(1)(A).

rental payments from his income because he is contractually obligated to make them "as a condition to the continued use or possession" of the premises. His minor children are in a much lower tax bracket than he, and, assuming all trust income is passed to the beneficiaries, are taxed on the amount of the rent less their deductible expenses. The difference in the marginal tax rates times the net income⁸ is the after-tax savings.⁹

The Internal Revenue Service has attacked such tax-saving procedures as elevating "form over substance,"¹⁰ stating that a mere paper-shuffling without a change of management or control of the asset should not yield a reduction in taxes. Specifically, the Commissioner has disallowed the deductions by claiming the payments were outside the provisions of

⁸ Meyer, *Tax Aspects of Lease Transactions*, 23 TAX EXEC. 616 (1971) [hereinafter cited as Meyer].

⁹ The marginal tax rate is the tax rate at which the next dollar of income will be taxed. We can illustrate the tax-savings formula in the test using *F*, the father whose marginal tax rate is 50%, and *S*, the son whose marginal tax rate is 20%. The rent paid is \$15,000 and the operating expenses of maintenance, depreciation, insurance, taxes and interest are \$10,000. *S* pays tax on the income less expenses (20%) (\$15,000 - \$10,000) = (20%) (\$5,000) = \$1000. However, since *F* now has a \$15,000 (rent) deduction rather than the \$10,000 deduction he had before giving the asset away, he saves tax on the additional \$5,000 of income offset by the deduction, thus saving (50%) (\$15,000 - \$10,000) = (50%) (\$5,000) = \$2500. The net tax savings would therefore be \$2500 - \$1000 = \$1500. The formula in the text yields the same results: the difference in marginal tax rates times the net income is (50% - 20%) (\$15,000 - \$10,000) = (30%) (\$5000) = \$1500.

If *S* is a minor child, he very likely will be below the 20% tax level. If he has no other income, then the net income from the trust will be reduced only by the personal exemption. The standard deduction and low income allowance apply only to earned income. See also Josephs & Glicker, *The Short-Term Trust: How to Capitalize on this Often Overlooked Tax-Saving Tool*, 7 PRAC. ACCT. May/June, 1974, at 36, 39-41 [hereinafter Josephs & Glicker].

One alternative to gift and leaseback is to employ the minor child. This is quite a simple technique to shift earned income. This is limited by the fact that a professional's work is normally quite skilled, and there are few tasks in the office able to be performed by a child. In addition, the IRS will scrutinize the transaction closely and strictly apply the standard of reasonable salary and compensation of CODE §162(a)(1). See, *How to Turn Your Children's Spending Money Into a Deductible Business Expense*, PLANNING CLOSELY-HELD CORPORATION IDEAS 1974, at 1 (Inst. of Business Planning). See also Rev. Rul. 73-393, 1973 INT. REV. BULL. No. 39, at 9, superceding I.T. 3812 and Rev. Rul. 59-110.

¹⁰ The taxpayer may decrease his tax liability by any legal means. "[W]hile this may be doctrine, it is not dogma and certainly it does not confer a license to substitute form for substance." 38 P-H TAX CT. MEM ¶ 69,171 at 69-917 (1969), quoting Irvine K. Furman, 45 T.C. 360, 364 (1966).

§162(a)(3). In support of this stance, he has relied upon four different theories:¹¹ (1) The payments are not "ordinary and necessary" expenses because there was no reason to make the gift and therefore no reason to incur the rental obligation of the leaseback;¹² (2) they are not "rentals," but rather a forbidden assignment of income;¹³ (3) they are not "payments required to be made as a condition for continued use" because the transfer was a sham resulting in a bare titular change with no alteration in the essence of ownership;¹⁴ and (4) the payments are made on property in which the taxpayer has an equitable interest due to his retention of the reversion.¹⁵ In general, the taxpayer has overcome these arguments and prevailed in those cases in which he has made a valid gift, has divested himself of control of the asset and has paid a reasonable rent.

In addition, the taxpayer's success usually depends on the court's determination of whether the transaction has a valid "business purpose"; if the court discerns such a purpose, the rent is ordinarily deductible as a business expense. The finding of a "business purpose" in turn depends upon whether the court examines the purpose of the entire, integrated "gift-and-leaseback" transaction or the purpose of the leaseback only. If the court separates the gift from the leaseback and then seeks to determine if there is a valid business purpose for leasing equipment used in the lessor's trade or business, it will invariably find that a valid business purpose does exist and allow the deduction.¹⁶ If, however, the court looks at the "gift-and-leaseback" as one united transaction, it will hold that there is

¹¹ Although theoretically distinct, the first three theories are often indistinguishable in their application by the courts and are different expressions of the same requirement: that the grantor relinquishes complete control of the asset and that the parties deal as if they were unrelated.

¹² See, e.g., *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir. 1955), *cert. denied*, 350 U.S. 834 (1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952).

¹³ See, e.g., *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), *cert. denied*, 382 U.S. 814 (1965).

¹⁴ See, e.g., *Sidney W. Penn*, 51 T.C. 144 (1968).

¹⁵ *Gibbons v. United States*, 25 Am. Fed. Tax R.2d 70-1332 (D.N. Mex. 1970); *Chace v. United States*, 303 F. Supp. 512 (M.D. Fla. 1969), *aff'd per curiam*, 422 F.2d 292 (1970); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962).

¹⁶ *C. James Mathews*, 61 T.C. 12 (1973); *Alden B. Oakes*, 44 T.C. 524 (1965); *Albert T. Felix*, 21 T.C. 794 (1954), *not acquiesced in*, 1956-2 CUM. BULL. 10.

no valid business purpose to be achieved by giving away an asset and then incurring an obligation to rent it back; in such cases, the deduction will be denied.¹⁷ Still, it should be noted that in a majority of courts, the deduction will not be denied *solely* on the ground that there is no valid business purpose.

The gift and leaseback device is advantageous to professionals because of (1) its simplicity, (2) the lack of disturbance to the professional-client relationships, (3) the fact that the professional has almost no other method to divert his income and (4) the attractiveness of producing a tax-savings from "locked-in" assets.¹⁸ A taxpayer who deals in goods can divert his income by giving stock in his company to his children. However, since *Lucas v. Earl*,¹⁹ in which the Supreme Court held an attorney taxable on an attempted assignment of his income, the professional has had few opportunities to effectively shift his income so that for him the gift and leaseback may well be the "only game in town".²⁰ Even though a professional produces his income through intangible personal services (*i.e.*, skill and time), he still often requires a battery of fixed assets. By saving taxes on these "non-income producing" assets, he gains an offset to the "sunken costs" they represent.

The above example dealt with an office building and furniture, but gift and leaseback can be used by doctors, dentists, engineers and architects for their equipment, and lawyers and accountants for their libraries. Similarly, it can apply to authors and inventors for their copyrights and patents. By the use of additional first year depreciation and accelerated depreciation methods,²¹ tangible assets can be depreciated to a low book

¹⁷ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952). See also *Century Elec. Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951).

¹⁸ See also J. CHOMMIE, *FEDERAL INCOME TAXATION* § 157, at 478-481 (1973); Meyer, *supra* note 7, at 634; Simmons, *The Use of Trusts in Tax Planning for the Professional*, 50 TAXES 420 (1972); Smith, *Shifting Income Within the Family Group*, 30 TAXES 995, 1000-1001 (1952) [hereinafter cited as Smith]; Note, *The Use of Business Property as Short-Term Corpus*, 19 VAND. L. REV. 811, 812-25 (1966).

¹⁹ 281 U.S. 111 (1930). Strong, *Selected Income Tax Considerations for Professionals*, 15 PRAC. LAW., Jan., 1969, at 20.

²⁰ Simmons, *Gift and Leaseback Arrangements Involving Property Used in a Professional Practice*, 48 L.A. BAR ASS'N BULL. 62-65 (1972).

²¹ CODE §167(a). See also Note GEO., *supra* note 2, at 210 n. 8. If the trust instrument requires a depreciation reserve, then the entire deduction is allowed; otherwise, it must be apportioned on the basis of trust income to each beneficiary, §§ 167(h),

value but still retain a large fair market rental value. At this point, where the rental value far exceeds the depreciation, taxes, interest and maintenance expenses, the benefits of the gift and leaseback as an income shifting and tax-minimization measure become evident. As noted above, the grantor-lessee (at a higher tax rate) gets a full deduction of the rent and the lessors (at a lower tax rate) pay tax on the difference between the rent and the above-enumerated expenses. If the asset is a building with land, this allows the high-bracket taxpayer to effectively write off the land with rental payments where he otherwise could not have done so since land is not depreciable.²²

II. BACKGROUND²³

Sale and leaseback transfers became popular in 1944, although their origin can be traced to as early as 1882.²⁴ The gift and leaseback followed closely as an early post-World War II tax saving transaction. Notwithstanding this common origin the two devices differ significantly in their function and purpose. For example, while the sale and leaseback usually involves two unrelated businesses bargaining at arms-length for their individual benefit,²⁵ the gift and leaseback²⁶ is often between two related parties calculating for the benefit of the total economic unit. Because of these diverse purposes, the sale and leaseback²⁷ is not within the scope of this comment and will be discussed only peripherally. Likewise, neither net leases,²⁸ the

642(e). A trust cannot take additional first year depreciation. §179(d)(4). Brausing, *The Trust Leaseback as a Tax Saving Device*, 14 PRAC. LAW., Oct., 1968, at 75 [hereinafter cited as Brausing].

²² Brausing, *supra* note 21, at 74.

²³ For two excellent treatments of the introductory and historical portions of a gift and leaseback analysis, see Cohen, *supra* note 2 and Oliver, *supra* note 2. For a varied approach see Note LOYOLA, *supra* note 2 and Note GEO., *supra* note 2.

²⁴ Yorkshire Ry. Wagon Co. v. Maclure, 21 Ch.D. 309 (1882), cited in Cary, *Corporate Financing Through the Sale and Leaseback of Property*, 62 HARV. L. REV. 1 (1948) [hereinafter cited as Cary I].

²⁵ Cary, *Current Tax Problems in Sale, or Gift, and Leaseback Transactions*, N.Y.U. 9TH INST. ON FED. TAX 959, 959-60 (1951) [hereinafter cited as Cary II].

²⁶ *Id.* at 974-78.

²⁷ For a history of sale and leaseback see Cary II, *supra* note 25. See also Cary I, *supra* note 24; Mickey, *Some Considerations of Sale or Gift and Lease-back*, N.Y.U. 9TH INST. ON FED. TAX., 979, 979-984(1951) [hereinafter cited as Mickey].

²⁸ Howard, *The Essential Elements of a Net Lease*, 8 PRAC. LAW., Feb., 1962, at 15.

intricacies of lease planning,²⁹ the problems of purchases denominated as lease,³⁰ nor the use of leasebacks with exempt organizations will be covered.³¹

The first leading case involving the gift and leaseback, *Skemp v. Commissioner*,³² was decided in 1948. Therein, the grantor, a doctor, transferred his office to an independent trustee for the benefit of his children and his wife. The duration of the trust was 20 years, after which the corpus was to be distributed to the children. The trustee immediately leased the office back to the grantor doctor for 10 years at \$500 a month for the first two years, after which the rent was to be renegotiated, with an arbiter to be used if an impasse resulted. In considering this transfer, the tax court stated as fact that the “[p]etitioner has not exercised any dominion or control over the trust property, except to occupy. . . .”³³ Nevertheless, later in the opinion it concluded that because the gift and leaseback was prearranged and consummated on the same day, it could not “see in the circumstances before [it] a passing to the trust of that degree of dominion and control, *in praesenti*, as to the leasehold estate which is requisite to passage of a gift.”³⁴ The court of appeals, however, reversed the decision, declaring that while the situation was voluntarily undertaken, it created a valid, enforceable requirement to make rental payments and thus was an “ordinary and necessary” expense.

A. Valid Gift and Complete Transfer

The tax court opinion in *Skemp* highlights the first prerequisite to allowing the ultimate rent deduction, a valid gift.³⁵ Obviously, the formalities of state gift law must be followed in

²⁹ Baskes, *Tax Planning for Lease Transactions*, 1972 ILL. L.F. 482. See also Rev. Rul. 540, 1955-2 CUM. BULL. 39.

³⁰ *Oesterreich v. Commissioner*, 226 F.2d 798 (9th Cir. 1955); Rev. Rul. 122, 1960-1 CUM. BULL. 56.

³¹ Note, *Criticized Uses of Federal Tax Exemption Privileges by Charitable Foundations and Educational Institutions*, 98 U. PA. L. REV. 696, 698-700 (1950). See Mickey, *supra* note 27, at 84-85.

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

³³ 8 T.C. 415, 419 (1947).

³⁴ *Id.* at 421.

³⁵ See Rev. Rul. 315, 1957-2 CUM. BULL. 624; Yohlin, *Assignment and Deflection of Income*, N.Y.U. 20TH INST. ON FED. TAX 147, 147-49 (1962).

order to initiate the gift and leaseback. The courts have split in their decisions as to the deductibility of payments required under other voluntarily created obligations,³⁶ and the pivotal question may be whether a transaction is in reality what it is in form.³⁷

Implicit in the phrase "valid gift" is the necessity of a *complete transfer*. As will be seen, it is upon this requirement that most of the gift and leaseback cases turn.

B. *Orientation of the Courts*

It is an established maxim of tax law, reiterated often by Judge Learned Hand,³⁸ that one may use every legitimate means to avoid taxes.³⁹ Equally well-founded, however, are the principles that: (1) deductions are not a right but rather a matter of legislative grace; and (2) the Commissioner of Internal Revenue is presumed correct in his determination that a particular deduction claimed lies outside the bounds of this privilege.⁴⁰ The Commissioner casts a jaundiced eye toward transactions which are entered into solely for purposes of tax avoidance, and it is up to the courts to decide if this motive will invalidate the deduction.

The taxpayers' success in obtaining such a deduction, according to one author,⁴¹ may depend upon whether the court's orientation is that where "the parties deal fairly with one another, it matters not whether their aim be . . . to avoid taxes or to regenerate the world,"⁴² or instead is that one cannot

³⁶ Notes established gratuitously have been valid for interest deductions where the obligation is enforceable at law. *Preston v. Commissioner*, 132 F.2d 763 (2d Cir. 1942); *Commissioner v. Park*, 113 F.2d 352 (3d Cir. 1940). However, many courts have rejected interest deductions paid on voluntarily-incurred indebtedness.

³⁷ *Johnson v. Commissioner*, 86 F.2d 710 (2d Cir. 1936), *aff'd* 33 B.T.A. 1003 (1936).

³⁸ Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 *YALE L.J.* 440, 447 (1968) [hereinafter cited as Chirelstein].

³⁹ *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

⁴⁰ *Intrastate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943):

And we examine the argument in the light of the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440.

⁴¹ Webster, *Transfers to Trusts with Leasebacks—Drafting and Other Suggestions for the Trust and Lease Agreements*, U. SO. CAL. 1956 *TAX INST.* 319, 358 (1956).

⁴² *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849, 852 (7th Cir. 1954),

“divide single tax earnings into two tax units by the simple expedient of drawing up papers.”⁴³ Within the intra-family gift and leaseback field, both views have been espoused.⁴⁴ For example, in 1951 the United States Court of Appeals for the Second Circuit, in a decision followed by other courts, held that a gift and leaseback rent deduction should be disallowed since it would “hide business reality behind paper pretense.”⁴⁵ In contrast, the tax court has since taken the position that the rent deduction will not be disallowed solely because of a tax avoidance motive.⁴⁶

C. Congressional Inaction

Each post-*Skemp* gift and leaseback decision has brought a flood of analysis from legal scholars.⁴⁷ Typically, these commentators report the determination of the facts, the court's interpretation of prior case law and the case's impact on future tax planning. Likewise, one feature of nearly all such works is a warning of the risks of gift and leaseback tax planning due to the uncertainty in this area of the law; the warning is invariably followed by a call for appropriate legislation.⁴⁸

Such commentary is largely precipitated by the fact that the Code does not have a provision dealing with the intra-family gift and leaseback. The only mention of such transfers in committee reports comes from the Senate report which, while speaking of grantor trusts, states: “This sub-part also has no application in determining the right of a grantor to deduc-

quoting *Chilsom v. Commissioner*, 79 F.2d 14, 15 (2d Cir. 1932). Learned Hand wrote the *Chilsom* opinion; see Chirelstein, *supra* note 38.

⁴³ Paul G. Greene, 7 T.C. 142, 151 (1946).

⁴⁴ *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849 (7th Cir. 1954).

⁴⁵ *White v. Fitzpatrick*, 193 F.2d 398, 400 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952). See also *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); *White* is discussed in GRISWOLD, *FEDERAL TAXATION* 312-18 (1960); Smith, *supra* note 18, at 1000-01; 65 HARV. L. REV. 1250 (1952).

⁴⁶ Alden B. Oakes, 44 T.C. 524 (1965). This case is discussed in Beausang, *Tax Court in Oakes Gives New Life to Trust Leaseback as a Tax Saving Device*, 23 J. TAX. 156 (1965); Kornfield, *A New Look at Family Trust-Leaseback Arrangements*, 104 TRUSTS AND ESTATES 1121, 1186 (1965).

⁴⁷ See, e.g., those articles cited *supra* note 2.

⁴⁸ Some examples of such scholarly warnings may be found among the articles cited *supra* note 2.

tions for payments to a trust under a transfer and leaseback agreement.”⁴⁹ The House report does not even contain this sentence,⁵⁰ though the treasury regulations have adopted it.⁵¹ It has been suggested that since there is no legislation in this area, the parties to an intra-family gift and leaseback should be held to the same standard as unrelated parties;⁵² that although intra-family transactions may be fertile ground for tax abuse, and the dealing should be scrutinized to see if the parties do what they say they will do, the Commissioner should not apply a different standard without legislation to that effect. Certainly, there is a sound basis for this approach; the Commissioner has procured section 267 which disallows losses in sales between related parties. In the absence of analogous legislation in the intra-family gift and leaseback field, the Commissioner perhaps ought to look closer at these transactions, but should not judge them more harshly than if they were between unrelated participants.

In the absence of a statute or consistent case law, tax planning in this area is precarious at best. Many have attempted to analogize the trust and leaseback to the *Clifford* trust,⁵³ but Treasury Regulation §1.671-1(c), alluded to above, explicitly states that these are conceptually different. The *Clifford* provisions deal with control of the trust for income attribution purposes, while the trust and leaseback concerns control of the trust as it affects the deductibility of an “ordinary and necessary expense.” Still, the two concepts do overlap in their concurrent desire to divest the grantor of control of the asset; as stated earlier, a complete transfer⁵⁴ is necessary for effective use of gift and leaseback. If the transfer is not complete, the rent is not a deductible expense (not “necessary”) and may be a gift, thus incurring a greater tax liability. Moreover, some feel that in the absence of any other guidelines,

⁴⁹ S. REP. No. 1622, 83d Cong., 2d Sess. 365 (1954).

⁵⁰ H.R. 1337, 83d Cong., 2d Sess. A212 (1954).

⁵¹ Treas. Reg. §1.671-1(c) (1956).

⁵² Lyon & Eustice, *supra* note 2, at 340.

⁵³ *Helvering v. Clifford*, 293 U.S. 465 (1935). Intrafamily transactions are subject to closer scrutiny than others are; nonetheless, they should not necessarily be subject to a higher standard of deductibility. The statutes passed subsequent to this opinion are aimed at regulating grantor control and income division of the trust. CODE §§ 671-77. Numerous regulations and rulings interpret these sections.

⁵⁴ Material cited *supra* notes 35-37 and accompanying text.

establishing a *Clifford* trust should be held to be a complete transfer for purposes of rent deduction.⁵⁵ In any event, such attempts to shed light on the gift and leaseback by analogy serve only to further demonstrate the need for specific, decisive legislation in this area of tax law.

III. RECENT DECISIONS

Pursuant to the Internal Revenue Service "prime issue" directive,⁵⁶ gift and leaseback cases are being vigorously litigated. The most recent tax court decision is *C. James Mathews*,⁵⁷ which originated when the Mathews transferred a funeral home used by Mr. Mathews in his business to their attorney as the trustee of four ten-year trusts for their minor children. The reversion initially was retained by the grantors, but was later transferred to another trust for the children. The Commissioner disallowed the petitioner's rental deductions for the time prior to the reversion relinquishment. It should be noted that the Commissioner did not challenge the deduction after the reversion was transferred; as will be developed more fully later, this may indicate that he is now willing to concede trust and leaseback rental deductions where the grantor transfers the property to an independent trustee and does not retain a reversion.⁵⁸

In the early years of gift and leaseback litigation, the tax court took a hard line against allowing the rental deduction, but its views have liberalized since then.⁵⁹ In the *Mathews*

⁵⁵ Cary II, *supra* note 25, at 977-78. At 974, Cary opines that "gift and leaseback might be classified as a collateral relative of the Clifford trust and the family partnership." Price, *supra* note 2, at 176 states that the difference is between reallocation of income and the validity of a deduction.

⁵⁶ The "prime issue" directive is discussed *supra* note 5.

⁵⁷ 61 T.C. 12, 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3 (1973). See also 4 RIA TAXATION COORDINATOR ¶ 4810.1, at 35,826A-B (Recent Developments, Aug. 29, 1974).

⁵⁸ Josephs & Glicker, *supra* note 9, at 40.

⁵⁹ In its first two gift and leaseback cases, the tax court denied the deductions, but was reversed on appeal. *Brown v. Commissioner*, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 349 U.S. 814 (1950); *Skemp v. Commissioner*, 8 T.C. 415 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948). The facts of *Skemp* are given *supra* in the text; the *Brown* facts are similar. The results of these appeals drew fire from the Commissioner: Rev. Rul. 9, 1954-1 CUM. BULL. 20, *modified by*, Rev. Rul. 315, 1957-2 CUM. BULL. 624. *Brown* is discussed in Cary II, *supra* note 25, at 974; Note, *The Gift and Leaseback: A New Tax Avoidance Gimmick*, 59 YALE L.J. 1529 (1951); 51 COLUM. L. REV. 247 (1951).

opinion, Judge Hall synthesized from the diverse and disparate decisions of the various jurisdictions a three-prong test for allowing the rental deductions:

(1) The grantor must not retain "substantially the same control over the property that he had before." . . .

(2) The leaseback should normally be in writing and must require payment of a reasonable rental.

(3) The leaseback (as distinguished from the gift) must have a *bona fide* business purpose [citations omitted].⁶⁰

Finding that the petitioner had satisfied each of these requirements, the court then looked to §162(a)(3) of the Code, which allows the taxpayer's rent deduction only for "property . . . in which he has no equity." The Commissioner argued that this excluded the petitioner's deduction since he had retained an equitable interest, the reversion. The court, however, concluded that the language was directed at a sale purported to be a lease and that the rental payments should not be lost merely because the taxpayer owned a property interest that became possessory upon the expiration of a term of years.

The *Mathews* decision is now on appeal to the Fifth Circuit, which has ruled against the rental deduction when a reversion is retained in all three gift and leaseback cases it has decided. The tax court distinguished *Mathews* from those three—*Chace v. United States*,⁶¹ *Van Zandt v. United States*⁶² and *Furman v. United States*⁶³—saying that in each of them the deduction was disallowed because there was no independent trustee, a factor not present in *Mathews*, in which an attorney served as trustee. An affirmance by the Fifth Circuit would not only further clarify the law, but it would also signal a change from the hostility with which this court initially viewed gift and leaseback transactions.

In the meantime, judicial formulations like the tax court's three-pronged test, analyzed below, may provide the tax plan-

The Tax Court began to favor the taxpayer in the cases of *Albert T. Felix*, 21 T.C. 794 (1954), *not acquiesced in*, 1956-2 CUM. BULL. 10 and *Alden B. Oakes*, 44 T.C. 524 (1965). See also note 46 *supra*.

⁶⁰ 61 T.C. 12, —; 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-10, 61-11 (1973).

⁶¹ 422 F.2d 292 (5th Cir. 1970), *aff'g per curiam* 303 F. Supp. 513 (M.D. Fla. 1969).

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

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

ner with his only guidance in attacking the difficult problems of the gift and leaseback.

A. *Independent Trustee*

The tax court's requirement that the grantor must not continue to maintain "substantially the same control"⁶⁴ over the transferred property is satisfied by a transfer to an independent trustee with real powers of corpus control, rental negotiation, and lease enforcement. It is unrealistic to think that the leaseback element of "trust and leaseback" transactions is not prearranged, but the tax court in *Mathews* was not disturbed by this since the trustee owed a fiduciary duty to the beneficiaries. Indeed, the courts have generally assumed that this fiduciary duty provides sufficient impetus for the trustee not to allow the grantor-lessee an inordinate amount of control over the property.⁶⁵ Although there will nearly always be some collaboration between the trustee and the grantor, the possibility of a suit by the beneficiaries will usually keep such activities within tolerable limits. Thus, while the Commissioner may argue that the grantor has retained substantially the same control after the transfer as before it (especially where the terms of the leaseback are negotiated prior to the transfer to the trust), he will not be successful if an independent trustee with substantial powers is chosen. This is also true where the taxpayer transfers cash in trust and the trustee buys assets previously specified by the grantor.⁶⁶

The existence of an independent trustee is taken by some courts to be *prima facie* proof that the grantor has relinquished management control. Who qualifies as an independent trustee, however, is a matter of controversy. Corporate trustees, banks,

⁶⁴ 61 T.C. 12, ____; 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3, at 61-10.

⁶⁵ *Brown v. Commissioner*, 180 F.2d 926 (3d Cir. 1950), *cert. denied*, 340 U.S. 814 (1950), *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948), and *Alden B. Oakes*, 44 T.C. 524 (1965) all had independent trustees and prearranged leasebacks and were all granted the deduction. The cases with prearranged leasebacks where the deduction was denied have never used this as an independent justification for the denial. *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir.) *cert. denied*, 382 U.S. 814 (1965), (whole transaction had only a salutary effect); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied* 343 U.S. 928 (1952) (grantor retained control); *Sidney W. Penn*, 51 T.C. 144 (1968) (unreasonable rent).

⁶⁶ *Albert T. Felix*, 21 T.C. 794 (1954), *not acquiesced in*, 1956-2 CUM. BULL. 10. *Felix* is discussed in *Gold, Trust and Leaseback*, 40 A.B.A.J. 714 (1954).

savings and loan associations, and trust companies generally qualify, unless the terms of the trust so gird the trustee that he has no power. The court will not look beyond the trust instrument with a corporate trustee, assuming that the trustee is actually independent and will do everything for the beneficiaries that the trust agreement permits.⁶⁷

On the other hand, where the taxpayer's spouse acts as trustee,⁶⁸ the court's scrutiny goes beyond the trust agreement into the workings of the arrangement itself.⁶⁹ In such cases, the transfer of control must be real and not merely apparent.⁷⁰ Thus, the wife, in conjunction with the taxpayer's father, an accountant, can qualify as independent.⁷¹ Where the taxpayer himself is the trustee,⁷² he will not be allowed a deduction, since the roles of lessor and lessee which he must occupy simultaneously, are adverse. However, where the taxpayer or the spouse is appointed legal guardian for the eventual beneficiaries before becoming the trustee, the result may be different.⁷³ Since the guardian's actions must be judicially approved, the courts generally allow the deductions unless the appointment is found to be part of a bad faith tax avoidance scheme, in which case no such allowance will be granted.⁷⁴ Accountants and attorneys are generally considered independent where the trust documents provide them with sufficient powers to main-

⁶⁷ See, e.g., *Perry v. United States*, 33 Am. Fed. Tax R. 2d 74-725 (E.D.N.C. 1974); *Albert T. Felix*, 21 T.C. 794 (1954), *not acquiesced in*, 1956-2 CUM. BULL. 10.

⁶⁸ Brothers will also undergo additional scrutiny. It has been held where two brothers execute cross-guardianship agreements for the benefit of their respective nephews and neices, who own the fields that their own fathers farm, then there is no substance to the transactions and the deductions taken will be denied. *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955).

⁶⁹ *Irvine K. Furman*, 45 T.C. 360 (1966), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967). This case is noted in B. BITTKER & L. STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION*, 392-95 (4th ed. 1972).

⁷⁰ In *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962), the reversion kept the lessors from exercising full control. See also text *infra* on retention of the reversion.

⁷¹ *John T. Potter*, 27 T.C. 200 (1956), *acquiesced in*, 1957-2 CUM. BULL. 6.

⁷² *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); *Jack Wiles*, 59 T.C. 289 (1972) *aff'd per curiam*, 33 Am. Fed. Tax R.2d ¶ 74-571 (1974); *Sidney W. Penn*, 51 T.C. 144 (1968).

⁷³ *Brooke v. Commissioner*, 468 F.2d 1155 (9th Cir. 1972); *Alden B. Oakes*, 44 T.C. 524 (1965).

⁷⁴ *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955). The facts of the case are given in note 68 *supra*.

tain that status and they perform their duties.⁷⁵ Where an attorney or accountant is a mere figurehead trustee and does not actively carry out his duties, however, the deduction will not be allowed.⁷⁶

The courts look at positive action by the trustee as an indication of independence. Enforcing default payment,⁷⁷ exercising the ability to rent or sell the corpus to others and to invest the proceeds,⁷⁸ and actively negotiating rentals serve to demonstrate the relinquishment of taxpayer control.⁷⁹ Conversely, if the trustee is stripped of certain powers such as the ability to sell⁸⁰ or the ability to negotiate rent,⁸¹ he is not considered independent. The length of the lease as compared with the duration of the trust also may reflect on trustee independence. If the lease provisions severely restrict the trustee and the initial term plus options runs to the end of the trust, the trustee is not independent because he has no power other than mere rent collection.⁸² On the other hand, if there is arms length bargaining, the negotiation of a long-term lease will not necessarily be construed as negating trustee control, because it may reflect sound business judgment and it is within the scope of the exercise of the fiduciary duty.

The general rule is that the trustee cannot be considered independent if the grantor continues to act as the owner or if the grantor retains too many powers: e.g., if the taxpayer must consent to a sale⁸³ or could settle the accounts.⁸⁴ An apparent exception to this principle is presented by the *Skemp*⁸⁵ case, cited above, where, although the taxpayer retained the right to

⁷⁵ Consolidated Apparel Co. v. Commissioner, 207 F.2d 580 (7th Cir. 1953); Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); C. James Mathews, 61 T.C. 12, 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3 (1973).

⁷⁶ Audano v. United States, 428 F.2d 251 (5th Cir. 1970).

⁷⁷ Albert T. Felix, 21 T.C. 794 (1954), *not acquiesced in*, 1956-2 CUM. BULL. 10.

⁷⁸ *Id.*; Perry v. United States, 33 Am. Fed. Tax R.2d 74-725 (E.D.N.C. 1974).

⁷⁹ Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); C. James Mathews, 61 T.C. 12, 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3 (1973).

⁸⁰ Furman v. Commissioner, 381 F.2d 22 (5th Cir. 1967), *aff'g per curiam* 45 T.C. 360 (1966). The grantor had to consent to any sale initiated by the trustee.

⁸¹ Robert F. Zumstein, 42 P-H T.C. MEM. ¶ 73,045 (1973).

⁸² Chace v. United States, 303 F. Supp. 513 (M.D. Fla. 1969), *aff'd per curiam*, 442 F.2d 292 (5th Cir. 1970).

⁸³ See note 80, and accompanying text *supra*.

⁸⁴ Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962).

⁸⁵ 168 F.2d 598 (7th Cir. 1948).

mortgage or exchange⁸⁶ the property, the court voiced no concern as to the corporate trustee's independence. Still, since these were the only retained powers and the rest of the facts indicate actual independence, the deduction would probably be upheld today. Nonetheless, the reservation of any controls by the grantor creates a serious risk of a challenge by the IRS.

Most of the decisions concerning retention of management control are issued after an *ad hoc* overview of the essence of the transaction. The gift and leaseback of an office occupied by the taxpayer both before and after the gift militates against the rental deduction.⁸⁷ Continuity of occupancy, and identical use and operations⁸⁸ are merely two factors (not determinative in themselves) that the court can use in a balancing test to judge whether or not the grantor has retained control of the asset.

The foregoing discussion is perhaps best summarized by the statement of the court in *Alden B. Oakes*⁸⁹ that the actual independence of the trustee may be the "pivotal factor" in the allowance of the deduction. As noted above, corporate trustees will be assumed to be "actually independent", and attorneys and accountants can generally pass a *de facto* "actually independent" test. Because trustee independence can be pivotal, a corporate trustee, an attorney, or an accountant is suggested. Direct transfers to the children, without an intervening trust, are discouraged. In a direct transfer, the Commissioner can allege, and often show, that the grantor exercised the same incidents of ownership⁹⁰ before and after the transfer or that there was no gift because there was no relinquishment of

⁸⁶ On the other hand, the trustee determined the rent, the lease was only half as long as the trust, and the trustee was an independent trust company.

⁸⁷ *Chace v. United States*, 442 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. 1965); *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); *Jefferson Black & Supply Co.*, 59 T.C. 625 (1973); *Sidney W. Penn*, 51 T.C. 144 (1968); *Burroughs Corp.*, 33 T.C. 389 (1959); *Raymond Cassidy*, 20 P-H TAX CT. MEM. ¶ 51,182 (1951). *Contra*, *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948); *C. James Mathews*, 61 T.C. 12, 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3 (1973); *Alden B. Oakes*, 44 T.C. 524 (1965).

⁸⁸ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), noted in 8 ARIZ. L. REV. 394 (1967).

⁸⁹ 44 T.C. 524, 529 (1965).

⁹⁰ *Ernest v. Berry*, 33 P-H TAX CT. MEM. ¶ 64,181 (1964).

ownership.⁹¹ Moreover, with a direct transfer, the taxpayer cannot rely upon the presumption of independence available in many situations. Nor can he point to a written list of relinquished powers, as he can with a trust agreement. Unless the children are of majority and can exercise an active role, the taxpayer will have difficulty showing he did not keep the same control over the property that he had before making the gift. This is also true where the donee is the taxpayer's spouse.⁹² Notwithstanding all of this, one case has held that where all the other gifts and leaseback requirements are met and a direct transfer is made to the taxpayer's children, the children can exercise their discretion to appoint the father as "manager" of the asset without affecting his standing to claim the deduction.⁹³

B. Reasonable Rent and Written Lease

The second requirement of the tripartite test enunciated in *Mathews* is that "[t]he leaseback should normally be in writing and must require payment of a reasonable rental."⁹⁴ Unfortunately, the *Mathews* court did little to illuminate the criterion thus established; its only effort in that respect was to summarily state that the lease in question was written and that the rent was in fact reasonable.⁹⁵ "Reasonable rent", like "independent trustee", is a phrase whose definition is elusive.⁹⁶ The statutory standard for rent is that it be "required to be made as a condition to the continued use or possession"⁹⁷ of the property; of course, as with all other business expenses, it must also be "ordinary and necessary"⁹⁸ in order to be deductible.

⁹¹ *Burroughs Corp.*, 33 T.C. 389 (1959).

⁹² *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952); *Raymond M. Cassidy*, 20 P-H TAX CT. MEM. ¶ 51,182 (1951).

⁹³ *A.N. McQuown*, 22 P-H TAX CT. MEM. ¶ 53,204 (1953). This is also true where the grantor is the legally appointed guardian; see note 73 and accompanying text *supra*. But see notes 68 and 74 and accompanying text *supra*.

⁹⁴ 61 T.C. 12, _____, 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3 at 61-11 (1973). See also 4 RIA TAXATION COORDINATOR ¶ 4810.1, at 35,826A-B (Recent Developments, Aug. 29, 1974).

⁹⁵ *Id.*

⁹⁶ See generally 4A J. MERTENS, FEDERAL INCOME TAXATION §25.110 (Revision 1972).

⁹⁷ CODE §162(a)(3).

⁹⁸ *Id.* §162(a).

Ironically, the term "reasonable" is not explicitly applied to rentals in the Code, although it is used in the contiguous subsection of section 162 regulating deductions for "reasonable allowance for salaries or compensation."⁹⁹ This judge-made doctrine,¹⁰⁰ that rent must be reasonable to be deductible, rests on the hypothesis that all rent is reasonable;¹⁰¹ any portion of a payment denominated as rent which the court disallows is, therefore, not unreasonable, but rather is something other than rent.¹⁰² This is seen most frequently where the court determines that a lease with a purchase option is actually a sale; rental payments have also been construed as disguised dividends.¹⁰³ The excess over a reasonable amount of rent may likewise be called a gift.

Many leases will set the amount of the rent as a percentage of profits or asset value. The maximum percentage allowable as "reasonable" in such instances has never been explicitly determined and depends upon many circumstances. In one case,¹⁰⁴ a leaseback calling for 10% of the royalties earned from a patent was considered reasonable.

Where there is a sale and leaseback, the arms-length quality of the transaction is analyzed.¹⁰⁵ If the purchase price is below fair market value¹⁰⁶ and the rent is greater than 50% of the purchase price,¹⁰⁷ a sham will be concluded. On the other hand, one court has stated that in a sale and leaseback, a rental of 17% of the sale price is reasonable.¹⁰⁸ Additionally, if the rental expense is only accrued and not actually paid,¹⁰⁹ no de-

⁹⁹ *Id.* §162(a)(1).

¹⁰⁰ *Commissioner v. Lincoln Elec. Co.*, 176 F.2d 815, 817-18 (6th Cir. 1949); *Limericks Inc. v. Commissioner*, 165 F.2d 483 (5th Cir. 1948).

¹⁰¹ *Stanley Imerman*, 7 T.C. 1030 (1946).

¹⁰² *Potter Elec. Signal Corp. v. Commissioner*, 286 F.2d 200 (8th Cir. 1961).

¹⁰³ *Shaffer Terminals Inc.*, 16 T.C. 356 (1951), *aff'd per curiam*, 194 F.2d 539 (9th Cir. 1952); *Catherine G. Armston*, 12 T.C. 539 (1949), *aff'd sub nom.*, *Armston Co. v. Commissioner*, 188 F.2d 531 (1951).

¹⁰⁴ *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849 (7th Cir. 1954).

¹⁰⁵ *Southeastern Canteen Co.*, 36 P-H TAX CT. MEM. ¶ 67,183 (1967), *aff'd on this issue*, 410 F.2d 615 (6th Cir. 1969).

¹⁰⁶ *Shaffer Terminals, Inc.*, 194 F.2d 539 (9th Cir. 1952, *aff'g per curiam* 16 T.C. 356 (1951).

¹⁰⁷ *Riverpoint Lace Works, Inc.*, 23 P-H TAX CT. MEM. ¶ 54,143 (1954).

¹⁰⁸ *Jefferson Block & Supply Co.*, 59 T.C. 625 (1973).

¹⁰⁹ *Marvin & Lorraine May*, 41 P-H TAX CT. MEM. ¶ 72,070 (1972); *Riverpoint Lace Works, Inc.*, 23 P-H TAX CT. MEM. ¶ 54,143 (1954).

duction will be allowed. Nor will any gratuitous increase above that legally obligated be treated as a deductible expense.¹¹⁰ In short, to be deductible, the rent *must* be paid and may neither be too high nor too low.¹¹¹

In *Van Zandt v. Commissioner*,¹¹² the Tax Court said that the excessive portions of rental deductions should be excluded because they are not "necessary". Shifting the deductibility standard from "reasonable" to "necessary" does not vary the amount of deductible rent, because the real test still is: what would a third party pay? When the grantor pays the same rate as unrelated tenants, the reasonableness of the rental deduction has never been questioned.¹¹³ The burden is always on the taxpayer to controvert the Commissioner's assessment, and the difficulty of establishing an objective standard for "ordinary and necessary" was accurately described by Justice Cardozo in *Welch v. Helvering*:

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations, at times with border line conclusions.¹¹⁴

As stated above, the *Mathews* test also requires the lease to be reduced to writing; while this is generally true, the writing and/or recordation of the transfer or leaseback is not mandatory in all cases. However, the Commissioner may allege that

¹¹⁰ *Commissioner v. Greenspun*, 156 F.2d 917 (5th Cir. 1946) (the excess over a "reasonable" rent was to be excised on remand); *Roland P. Place*, 17 T.C. 199 (1951) *aff'd per curiam*, 199 F.2d 373 (6th Cir. 1952), *cert. denied*, 344 U.S. 927 (1953) (the taxpayer voluntarily increased the rent to his wife). However, in *J. A. Riggs Tractor Co.*, 32 Am. Fed. Tax R.2d 73-5805 (E.D. Ark. 1973), additional rent between family members was sustained when commensurate value was added in services.

¹¹¹ *58th Street Plaza Theater, Inc. v. Commissioner*, 195 F.2d 724 (2d Cir. 1952) (subletting to stockholder's wife at less than fair market value distorted the income).

¹¹² 40 T.C. 824, 830-31 (1965).

¹¹³ *Consolidated Apparel Co. v. Commissioner*, 207 F.2d 580 (7th Cir. 1953); *John T. Potter*, 27 T.C. 200 (1956), *acquiesced in*, 1957-2 CUM. BULL. 6; *A.N. McQuown* 22 P-H T.C. MEM. ¶ 53,204 (1953). Two cases involving other tenants have denied the deduction, but both were on other grounds. *Shaffer Terminals, Inc. v. Commissioner*, 194 F.2d 539 (9th Cir. 1952), *aff'g per curiam* 16 T.C. 356 (1951) (in a sale and leaseback, the rent was a substitute for dividends and the "sale" was at less than fair market value and not at arm's length); *Millard F. Machen*, 35 P-H TAX CT. MEM. ¶ 66,193 (1966) (the grantor retained complete control over the asset).

¹¹⁴ 290 U.S. 111, 116 (1933).

the lack of a writing is one of several elements showing that the total transaction is a sham and that control did not pass to the donees. Even where the trust is valid under state law, the failure to record it weighs against allowance of the deduction.¹¹⁵ Moreover, if the IRS is informed of the transfer but the mortgage of the property is not, the Commissioner may find the transfer ineffective for tax purposes.¹¹⁶ Since the Commissioner will *expect* the transfer to be recorded, generally no affirmative significance will be attached to its being written.¹¹⁷ An oral transfer, however, may raise the negative inference of continued grantor control. On the other hand, in at least one case, the court used the fact that the transfer was recorded to support the deduction.¹¹⁸ If the recordation is inordinately tardy, though, it will not have an affirmative effect.¹¹⁹

C. *Business Purpose*

The "business purpose" doctrine was first enunciated in *Gregory v. Helvering*.¹²⁰ Its basic dictate is that while all legitimate means may be used to avoid income taxes, transactions giving rise to a business deduction must have an ulterior business purpose: artifice must not be exalted above reality.¹²¹ This holding was interpreted in *Higgins v. Smith*¹²² to mean that "transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration."¹²³ The court explained that the rationale for excluding such transactions springs from the essence of taxation:

The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is

¹¹⁵ *Furman v. Commissioner*, 381 F.2d (5th Cir. 1967), *aff'g per curiam* 45 T.C. 360 (1966) (neither the trust nor the lease was recorded).

¹¹⁶ *Id.*

¹¹⁷ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), *cert. denied*, 382 U.S. 814 (1965); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952).

¹¹⁸ *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849 (7th Cir. 1954).

¹¹⁹ *Sidney W. Penn*, 51 T.C. 144 (1968). The recordation of the trust was given no effect, because it was seven months after the transaction had purportedly occurred. *Id.*, at 151 n.1.

¹²⁰ 293 U.S. 465 (1935).

¹²¹ *Id.* at 470.

¹²² 308 U.S. 473 (1940).

¹²³ *Id.* at 476.

unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group.¹²⁴

The finding of a business purpose in gift and leaseback cases turns solely upon whether the court views the venture as one integrated transaction or as two separate ones. If the court sees only one transaction, it will not allow the deduction, since there is no business purpose in giving the property away and putting oneself in the position of making a "necessary" rental payment.¹²⁵ It will be treated as a camouflaged assignment of income.¹²⁶ The alternative line of attack views the transaction after the gift was completed and questions only whether there was a legitimate purpose in the grantor renting the asset in question. In the *Mathews* case, the Tax Court used the latter approach and asked if there was a "business purpose" in an undertaker renting a funeral home. Obviously, the answer was affirmative. By viewing the transaction after the gift had been completed, the court did not have to question the business motives of the undertaker who gave away a funeral home that he would then have to rent.

To meet the business purpose requirement, the dealings must have furthered a valid business aim. A legitimate non-business purpose, such as avoidance of a divorce settlement increase will not pass the test.¹²⁷ Even a sale and leaseback must have a legitimate business motive,¹²⁸ although it is subject to a less stringent standard than is the gift and leaseback.

The courts sometimes hold that a deduction will be denied if the transaction lacks "economic reality"¹²⁹ (i.e., futhers no

¹²⁴ *Id.* at 477, citing in footnote, *Stone v. White*, 301 U.S. 532, 537 (1937).

¹²⁵ *Furman v. Commissioner*, 381 F.2d 22 (5th Cir. 1967), *aff'd per curiam* 45 T.C. 360 (1966); *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); *Unger v. Campbell*, 7 Am. Fed. Tax R.2d 547 (N.D. Tex. 1960); *Southeastern Canteen Co.*, 36 P-H T.C. MEM. ¶ 67,183 (1967).

¹²⁶ *Van Zandt v. Commissioner*, 341 F.2d 440 (1965).

¹²⁷ *Ernest V. Berry*, 33 P-H T.C. MEM. ¶ 64,181 (1964). Petitioner purchased equipment in his girl friend's name to avoid its inclusion in his assets subject to a divorce settlement.

¹²⁸ *Century Elec. Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), discussed in *Cary II*, *supra* note 25 at 961-972.

¹²⁹ *Audano v. United States*, 428 F.2d 251 (5th Cir. 1970); *Irvin K. Furman*, 45 T.C. 360 (1966), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967); *I. E. Van Zandt*, 40 T.C.

economic objective). This test is related to "business purpose", but is rarely used because its standards are even less clearly defined than those of the "business purpose" doctrine. "Lacking economic reality" is a court's shorthand for a blanket disapproval of the objectives of the transaction and of the means used to reach those objectives. Its use is tantamount to a determination that the transaction is merely a "sham".

One author has suggested that instead of seeking a "business purpose", courts should simply ascertain whether "a sufficient property interest has been transferred to justify shifting the incidence of taxation."¹³⁰ This has conceptual consistency with the *Higgins* test, *supra*, and although somewhat vague, it is a more equitable criterion than the "business purpose" doctrine.

IV. DISQUALIFYING EQUITY

The most recent attack by the IRS has been upon grantors who retain a reversion in the transferred property. Section 162(a)(3) of the Code allows rental deductions only for property "in which the taxpayer has no equity," and the Commissioner has ruled that the deduction will be denied where the lessee retains a reversionary interest.

The *Mathews* decision is one of the few to interpret this clause of Section 162. In *Mathews* there was a valid *Clifford* trust¹³¹ with the reversion to the taxpayer at its termination. The Tax Court reasoned that the "equity" referred to above must mean something other than a right enforceable in a court of equity; since specific performance is always available to a lessee, no deduction would ever be allowed if the literal meaning was applied. The court therefore decided to drop a strict reading of the statute; it was then free to follow the probable intent of Congress.¹³² In that regard, the court concluded that Congress desired to disqualify those interests in the property

824 (1963), *aff'd*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965). The tax court in *A. N. McQuown* stated that since there was a valid gift, there was economic reality. 22 P-H TAX CT. MEM. ¶ 53,204 (1953). See also Note *Geo.*, *supra* note 2, at 238, n.219.

¹³⁰ Oliver, *supra* note 2, at 31.

¹³¹ It conformed to the provisions of §§ 671-77 of the CODE.

¹³² 61 T.C. 12, 61 P-H TAX CT. REP. & MEM. DEC. ¶ 61.3 (1973).

taken from the lessor and not interests which the lessee had possessed from independent sources. Thus, since the trust was only a transfer for a term of years, the taxpayer never "took" anything from the lessor, but merely had a future interest left after the lessor's interest was carved from the full fee.¹³³ The court held that where the rental payments do not enlarge the petitioner's ownership, the rent deduction should be allowed:

We are therefore of the view that section 162(a)(3) should not be read to cause rental payments to become nondeductible merely by virtue of a lessee's property rights in an asset, which rights are not derived from the lessor or under the lease, and which will become possessory only after the lease expires.¹³⁴

In other words, since the rental was merely for use of the property, it should be deductible just as it would be for an unrelated third party. The fact that the lessor had a future right to permanent possession should have no effect, since the rent did not enlarge his interest nor did it hasten the time that the reversion would become possessory.

Prior to the *Mathews* case, only four cases had considered the "disqualifying equity" argument;¹³⁵ one has addressed it since.¹³⁶ This argument has been advanced by the IRS (and rejected by the courts), in the three most recent gift and leaseback cases and seems to be the newest weapon in the Commissioner's arsenal. Still, since no appellate court has explicitly ruled on this point yet, the weight of cases should be judged accordingly.

In *Hall v. United States*,¹³⁷ decided in 1962, the taxpayer's rent deduction was denied because he retained too much control over the asset. In addition, the court seized upon the "disqualifying equity" argument as a second, independent ground

¹³³ *Id.* ¶ 61.3, at 61-12.

¹³⁴ *Id.* ¶ 61.3, at 61-13 (1973). This passage is quoted in *Perry v. United States*, 33 Am. Fed. Tax R.2d 74-725, 74-728. (E.D.N.C. 1974).

¹³⁵ *Duffy v. United States*, 343 F. Supp. 4 (S.D. Ohio 1972), *rev'd on other grounds*, 487 F.2d 282 (6th Cir. 1973); *Gibbons v. United States*, 25 Am. Fed. Tax. R.2d 70-1332 (D.N. Mex. 1970); *Chace v. United States*, 303 F. Supp. 513 (M.D. Fla. 1969), *aff'd per curiam*, 422 F.2d 292 (5th Cir. 1970); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962).

¹³⁶ *Perry v. United States*, 33 Am. Fed. Tax R.2d 74-725 (E.D.N.C. 1974).

¹³⁷ 208 F. Supp. 584 (N.D.N.Y. 1962).

for the denial of the deduction.¹³⁸ In a 1969 Florida federal district court case, the court pointed to the retention of the reversion as one of a number of factors which caused the deduction to be denied. This case, *Chace v. United States*,¹³⁹ was affirmed per curiam without a definitive holding on the "disqualifying equity" reasoning of the Internal Revenue Service. The court in *Gibbons v. United States*¹⁴⁰ followed the literal language of the statute and the strict interpretation urged by the Commissioner: section 162(a)(3) does not allow rental deductions if the taxpayer has an equity in property; a reversion is an equity; therefore, since the taxpayer retained a reversion, the deduction must be disallowed. This case was decided in 1970.

The three cases since *Gibbons* have all held for the taxpayer on this point. One of these, *Mathews*, has already been extensively discussed. The most recent case is *Perry v. United States*,¹⁴¹ where a doctor transferred his office building to a valid *Clifford* trust, paying reasonable rent and retaining a reversion. A corporate trustee with broad powers was appointed, and the leaseback was for the life of the trust. The IRS interposed only two contentions: (1) the whole transaction was a sham and (2) the taxpayer retained a prohibited equitable interest. The court dismissed the first argument since there was a corporate trustee and the grantor retained no control. Likewise, it rejected the second contention and allowed the deduction, explaining that:

[t]raditionally the words "in which he has no equity" as used in this statute have been construed to preclude a business expense deduction for payments made by a mortgagor or conditional vendee to acquire property as distinguished from payments made for the use of the property. In this case the rental payments being made by the taxpayers do not enlarge their ownership but are simply for the use of the property during the term of the trust.¹⁴²

¹³⁸ *Id.* at 588.

¹³⁹ 303 F. Supp. 513 (M.D. Fla. 1969), *aff'd per curiam* 422 F.2d 292 (5th Cir. 1970).

¹⁴⁰ 25 Am. Fed. Tax R.2d 70-1332 (D.N. Mex. 1970).

¹⁴¹ 33 Am. Fed. Tax. R.2d 74-725 (E.D.N.C. 1974).

¹⁴² *Id.* at 74-728. The Court cites *Duffy v. United States*, 343 F. Supp. 4 (S.D. Ohio 1972), *rev'd on other grounds*, 487 F.2d 282 (6th Cir. 1973) as authority for this statement.

The *Perry* (1974) court relied on the reasoning of the decisions of *Mathews*¹⁴³ and *Duffy v. United States*.¹⁴⁴ *Duffy* was the first case to embrace the above quoted logic in a discussion of disqualifying equity and, thus, the first case to hold for the taxpayer. However, *Duffy* was reversed on other grounds and the appellate court (the United States Court of Appeals for the Sixth Circuit) did not decide the validity of the rental deduction. The Sixth Circuit had not previously reviewed a gift and leaseback case.

Whether the court accepts or rejects the deduction because of a disqualifying equity will normally depend on whether it applies a strict or liberal interpretation of the section 162(a)(3) language: "in which the taxpayer has no equity." In any event, the important point to remember is that this problem can easily be avoided by the taxpayer transferring the reversion to his children or his wife.¹⁴⁵ In *Mathews*, for example, the IRS did not challenge the rental deduction after the grantor transferred the reversion to his wife. This seems to indicate that the Commissioner will allow the deduction when the grantor does not retain the reversion, provided the other formalities are followed.¹⁴⁶ By transferring the reversion simultaneously with the estate for years,¹⁴⁷ the grantor not only increases his chances of being upheld on his income tax rental deduction,¹⁴⁸ but also

¹⁴³ 33 Am. Fed. Tax. R.2d at 74-728. The court stated that it was persuaded by the tax court opinion in *Mathews*.

¹⁴⁴ 343 F. Supp. 4 (S.D. Ohio 1972), *rev'd on other grounds*, 487 F.2d 282 (6th Cir. 1973). See, note 142 *supra*.

¹⁴⁵ See Josephs & Glicker, *supra* note 9, at 40.

¹⁴⁶ *Id.*

¹⁴⁷ Simmons, *New Developments in the "Gift and Leaseback" in Tax Planning for the Professional*, 51 TAXES 654, 658 (1973). This author, who has several excellent articles in this area, suggests it would be foolish not to transfer the reversion in light of the IRS' placing gift and leaseback cases on the Prime Issue List where a *Clifford* trust is used.

¹⁴⁸ See note 147 *supra*. The following figures indicate how the taxpayer has fared in court. They are intended only for informational purposes and are *not* to be used as a guide for gift and leaseback planning. The reader is left to attach the significance to them that he desires after considering: the types of issues that come before each court; the fact that the taxpayer must pay the assessment to get into district court; the right to demand a jury trial in district court; and the fact that tax court judges are specialists in the field of taxation.

rids himself of the estate tax consequences¹⁴⁹ arising from retaining the reversion. Of course, a gift tax¹⁵⁰ must be paid on the gift of the reversion and if it goes to someone other than the owner of the current interest, the transferor will not get the benefit of the \$3000 exclusion (which applies only to present interests).¹⁵¹ Moreover, although a transfer of the reversion requires the grantor to give up all formal control over the corpus, the grantor still has informal familial control; additionally, the children will often ultimately receive the assets or the proceeds from the asset. Thus, an early transfer of the reversion simply represents the acceleration of an eventuality rather than a change in the final result.

V. DISCHARGE OF OBLIGATIONS

The purpose of the transfer and leaseback is to shift income, but that income can be re-attributed to the grantor in two different situations. If the grantor uses the trust to discharge his legal obligations of support it will be taxable to him.¹⁵² In *Brooke v. United States*,¹⁵³ the Ninth Circuit deter-

Here are the latest box scores for fiscal 1973:

	Taxpayer Wins	Taxpayer Losses	Split Decisions
Tax Court-Regular Cases	15.8%	49.1%	35.1%
Tax Court-Small Tax Cases	12.1	52.2	35.4
District Court	30.5	58.0	11.5
Court of Appeals	21.9	71.9	6.2
Court of Claims	23.7	68.4	7.9
Supreme Court	88.9	11.1	-0-

Back at the administrative level, about 75% of the taxpayers who went to the IRS Appellate Division settled their cases there. The average settlement was for about 40% of the claimed deficiencies and penalties. In the previous two years, the settlement percentage was only about 30%.

How Taxpayers Fared, 7 PRAC. ACCT. May/June, 1974, at 32.

¹⁴⁹ CODE §2037(a)(2). If the value of the reversionary interest exceeds 5% immediately before death, the entire value of the asset is includible in the gross estate; if the value is equal to or less than 5%, then only that value is includible under CODE §2033.

¹⁵⁰ CODE §2501(1)(a)(1).

¹⁵¹ CODE §2503(b).

¹⁵² CODE §677(b).

¹⁵³ 468 F.2d 1155 (9th Cir. 1972), discussed in *Gift and leaseback technique given a shot in the arm by CA-9*, 37 J. TAX. 315 (1972); *D.C. reverses itself: income of guardian follows support*, 31 J. TAX. 102 (1969); Rev. Rul. 484, 1956-2 CUM. BULL. 23, 24.

mined that only the money actually expended for items of support was attributable to the grantor. If the income is used to form another business or to purchase luxury items,¹⁵⁴ it is not attributable to the grantor. Items of support are prescribed by state law.

Trust income that fulfills the taxpayer's obligation on a mortgage of the trust corpus also is taxable to him.¹⁵⁵ This may have special significance where the parent retains primary liability on the mortgage. If a father transfers to his minor children a building encumbered by a mortgage and, further, if under state law or by agreement with the mortgagee he remains primarily liable, the Commissioner may attribute the mortgage payments to the father-grantor. This is usually an inconsequential problem, however, since the children ordinarily will be primarily liable and the trust income will be used to discharge *their* legal obligation, with the father merely a surety.¹⁵⁶

VI. EFFECTS OF RENT DEDUCTION DENIAL

The courts have not often ventured outside the narrow, primary issue of the deductibility of the rent payments, but in those instances where the rent deduction is denied, some very important secondary questions arise. As stated above, the tax-savings in a gift and leaseback transaction derives from taking the rent deduction instead of the business expenses of depreciation, maintenance, insurance, interest and taxes [hereinafter referred to as ownership deductions]. If the rent deduction is disallowed, can the grantor-lessee deduct these ownership deductions, or should they go to the lessor, who has legal title? The answer, of course, will depend upon the line of reasoning

¹⁵⁴ *Plath v. United States*, 48 Am. Fed. Tax R. 1285 (E.D. Wash. 1954). See also Erlich, *The Effective Use of Support Trusts: Trusts for Minors, Custodian Statutes, Gifts of Future Interests*, N.Y.U. 19TH INST. ON FED. TAX 729, 737-38 (1961).

¹⁵⁵ *Jenn v. United States*, 25 Am. Fed. Tax R.2d 70-756 (S.D. Ind. 1970), discussed in Price, *supra* note 2, at 183. Where the mortgage exceeds the adjusted tax basis, then the transfer is a realization of income. One author argues if the transferor is to continue the mortgage payments, "the rule should be otherwise." Price, *supra* note 2, at 186.

¹⁵⁶ For discussions of the mortgage question see *supra* note 155; see also, Jack Wiles, 59 T.C. 289, 300-302 (1972); Irvine K. Furman, 45 T.C. 360, 366 (1966). The *Furman* opinion points out this can be a very thorny problem. The best solution is for a written and recorded assumption of the mortgage by the grantees at the same time as the gift of the asset.

adopted by the court in each case. If the court disallows the rent deduction because the grantor retained the same management or control over the asset that he had prior to the transfer, then he should be granted the ownership deductions. This would place the parties in the same position as if they had never entered into the transaction.¹⁵⁷ On the other hand, if the rent deduction is disallowed because of a disqualifying equity, then the donee-lessor should keep the ownership deductions. This would increase the grantor's income taxes by the amount of the rent times his marginal tax rate.¹⁵⁸ In short, the reason that the Court denies the deduction may have a significant effect on the additional tax liability incurred.

If the rent deduction is denied, the rental payments must

¹⁵⁷ Froelich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956, 967-77 (1964). Two cases have used this reasoning with direct transfers and leasebacks. Millard F. Machen, 35 P-H TAX CT. MEM. ¶ 66,193 (1966). Raymond M. Cassidy, 20 P-H TAX CT. MEM. ¶ 51,182 (1951).

¹⁵⁸ If the grantor had taxable income of \$55,000 before a \$15,000 rental deduction, then his net taxable income would be \$40,000. If the depreciation and other deductible expenses were \$10,000, then the trust or grantee would have net taxable income of \$5000 (15,000 - 10,000). If the deduction is denied, but the grantor gets the operating expenses, then the grantor pays tax on \$45,000 (55,000 - 10,000). (The status of the \$15,000 payment to the trust will be handled later in the text.) Thus the difference in tax liability is the difference between the tax on \$45,000 and the tax on \$40,000; if the professional had not entered into gift and leaseback, he would be in the same position as if the deduction were denied and he got the operating deductions.

Where the deduction is denied but the operating expenses are not allowed to the grantor, he must pay tax on \$55,000. This is an increase in tax liability of the incremental tax on the \$15,000 rental deduction, (i.e., difference in tax between the tax on \$40,000 and on \$55,000). Noteworthy is the further observation that if the taxpayer had not entered into the trust and leaseback, he would have to pay on \$45,000. Without the rent deduction or the operating expenses, he now has to pay tax on \$55,000; thus, he is worse off by the amount of the tax on the operating expenses at the prevailing marginal tax rate than if he had not entered into the gift and leaseback; he is worse off by the tax on the amount of the rent at the prevailing marginal tax rate than if the deduction had been allowed.

Both the discussion in the footnotes and the text treat the "operating expenses" as the same type of deductions, which the courts would determine were all deductible by either the grantor or grantee. There seems to be no problem with allowing the grantor to take the depreciation expense if the Court holds there was too much control by the grantor. However, the expenses of maintenance, taxes, interests, and insurance all require a cash flow. In order for these to be deductible, it would seem an agency or constructive trust logic would have to be employed—in other words, if the lessors receive money in their own names and expend it in order to fulfill a lease obligation or to maintain the asset, then *even if* a court decides that the lessee still controls the asset, it would seem that the lessee can not take over a deduction for an expenditure which the lessor made with his own funds, without the use of an agency theory.

also be characterized from the lessor's viewpoint. Presumably, they are either income or gifts, and there are arguments for both characterizations. Since by denying the deduction, the court has ruled the payments were not necessary and not a condition of occupancy, it would seem that they would be gratuitous and thus taxed to the lessee as gifts to the lessors¹⁵⁹ with the \$3000 annual exclusion applicable.¹⁶⁰ On the other hand, if the lessee made the payments believing them to be necessary, then there is no donative character to the transaction and thus no gift; therefore the payments would be income¹⁶¹ to the lessors.¹⁶²

It will generally be more advantageous to the taxpayer and his family for these "rent" payments to be labeled gifts to the lessors.¹⁶³ At least one "better view"¹⁶⁴ permits just such a result. This view is conceptually sound since the Commissioner contends that there is no business purpose in gift and leaseback transactions and that their sole consequence is a gratuitous assignment of income; to negate this assignment, he desires that the transaction be a "nullity". If the trust and leaseback were not used, the grantor would get a deduction for his operating expenses; in order to get money to his children, he would be required to give gifts from his taxable income. Where the rental deduction has been denied, this result can best be duplicated by classifying the rent payments as gifts to the lessors.

¹⁵⁹ Note GEO., *supra* note 2, at 239, n. 226. This is also the official IRS stand. Rev. Rul. 315, 1957-2 CUM. BULL. 624. In this ruling the Commissioner cited *Lockard v. Commissioner*, 166 F.2d 409 (1st Cir. 1948); See also notes following *Lockard* in B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION, 1013-1014 (4th ed. 1972).

¹⁶⁰ CODE §§ 2501(a)(1), 2503(b). In many cases, this provision alone will be sufficient to exclude the entire annual rent from gift taxation. This is especially true where the grantor is able to employ the split gift approach.

¹⁶¹ CODE §§ 61, 102. Donative intent is not required for a transfer to be taxed as a gift, but it does play a large part. The transaction must at least be donative in character. *Bradford v. Commissioner*, 34 T.C. 1059, 1063-64 (1960).

¹⁶² *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965). The Court explicitly stated the question was not before it, so this is merely dictum.

¹⁶³ This of course depends upon the amount of gifts given within the year and the total accumulated. It also depends on whether the beneficiaries have other income against which they offset the trust deductions, if the grantees are to receive them. A fuller discussion is beyond the scope of this comment.

¹⁶⁴ Note GEO., *supra* note 2, at 239-40.

The revenue rulings seem to support this reasoning.¹⁶⁵

Notwithstanding such authority, a cogent argument can be made to the contrary. The Supreme Court has ruled that where there is some dispute as to whether money received is gift or income, then the controlling factor is the intention of the transferor:¹⁶⁶ whether the "constraining force of any moral or legal duty"¹⁶⁷ impels the transfer or whether the transfer "proceeds from a 'detached and disinterested generosity'¹⁶⁸ . . . 'out of affection, respect, admiration, charity or like impulses' ".¹⁶⁹ With gift and leaseback the primary motive is donative, but the immediate intention is to discharge the legal duty to pay rent. Therefore, a decision refusing to construe the rent payments as gifts would not be totally without foundation.

One additional, particularly disturbing development in the law with respect to the gift and leaseback deserves further comment here. If a trust is set up with the donated asset as its corpus, its income will be the rent paid by the grantor and its deductions the ownership expenses delineated above. If the income from this trust is attributable to the grantor, and the rental deduction is allowed, the taxpayer would be in the same position as if he had not entered into the transaction (i.e., the position in which the Commissioner is desirous of putting him).¹⁷⁰ However, two cases have arisen where the grantor has had the trust's income attributed to him and has *not* been allowed to take the rental deduction.¹⁷¹ Such decisions are

¹⁶⁵ Rev. Rul. 315, 1957-2 CUM. BULL. 624, *modifying* Rev. Rul. 9, 1954-1 CUM. BULL. 20.

¹⁶⁶ Commissioner v. Duberstein, 363 U.S. 278, 285-86 (1960), *citing* Bogardis v. Commissioner, 302 U.S. 34, 43 (1937).

¹⁶⁷ *Id.* at 285, *citing* Bogardis v. Commissioner, 302 U.S. 34, 41 (1937).

¹⁶⁸ *Id.* at 285, *citing* Commissioner v. Lobue, 351 U.S. 243, 246 (1956).

¹⁶⁹ *Id.* at 285, *citing* Robertson v. United States, 343 U.S. 711, 714 (1951).

¹⁷⁰ Duffy v. United States, 487 F.2d 282 (6th Cir. 1973). The court ruled the trust did not divorce control from the grantor. The rental deduction question was not reached by the appellate court.

¹⁷¹ Audano v. United States, 428 F.2d 251 (5th Cir. 1970); Jack Wiles, 59 T.C. 289 (1972). The first invalidated the trust as controlled by the grantor; the latter attributed as income mortgage payments made by the trust.

The denial of the rent deduction coupled with the attribution of the income to the grantor can be a devastating instance of double taxation. Suppose the grantor has sufficient other income to put himself at the 70% marginal tax rate on unearned income. Assume further than the rent paid is \$30,000 and the deductible expenses by the trust (depreciation, insurance, interest, taxes and maintenance) are \$12,000. Thus,

grossly unfair to the taxpayer and emphasize the need for the courts, and Congress, to look more closely at the effect of rent deduction denials.

CONCLUSION

The gift and leaseback transaction is one about which few definitive statements can be made with certainty.¹⁷² Nevertheless, current case law has produced a number of tentative guidelines which can be outlined¹⁷³ as follows: (1) the transfer and lease should both be in writing; (2) there should generally be a trust established with a corporate trustee, unless the donees in a direct transfer situation are sufficiently capable of exercising real management and control; (3) the trustee should

by taking the rental deduction, the taxpayer saves (70%) (\$30,000) = \$21,000 in taxes. If he had not entered into the gift and leaseback, he would have saved *only* (70%) (\$12,000) = \$8,400 in taxes. If the court rules that the income should be attributed to the taxpayer, then the tax liability will be the marginal tax rate times the net income to the trust: (70%) (\$30,000 - \$12,000) = \$12,600 in taxes. Thus, if the rent deduction is allowed and the income attributed, then the taxpayer comes out exactly where he was if he hadn't entered into the trust and leaseback: he has saved \$8,400 (\$21,000 - \$12,600).

However, in *Audano*, the rent deduction was denied *and* the income was attributed to the grantor. In this example, the deficiency would be the loss of the rental deduction's tax savings (\$21,000) plus the tax on the attributed income (\$12,600) or \$33,600—more tax is owed than the deduction itself. This ludicrous result can be the outcome where the tests of rent deductibility and adherence to the *Clifford* standards are not meshed.

The characterization of the payments as to the lessor's tax status will not be discussed, other than to note that support payments are not taxable either as income or as a gift to the lessor.

¹⁷² The only statement one can make with some assurance is that the transaction will be scrutinized closely, just as all intra-family transactions are. Beyond that there are the conflicting views: the IRS will challenge every gift and leaseback rental deduction since this is a "prime issue", *supra* note 5; on the other hand, the treatise writers say that the "[m]ere existence of a leaseback arrangement between related parties does not of itself create such an atmosphere as to warrant automatic disallowance of rental payments. In each case there must be an ad hoc examination of all the facts and circumstances." 4A J. MERTENS, *FEDERAL INCOME TAXATION* §25.111, at 511 (Revision 1972).

This "ad hoc examination" will likely end up in the courts, because "Prime Issues are ones which, if raised, cannot, as a matter of IRS policy, be 'settled' by closing agreement or compromise and therefore *must* be litigated." Simmons, *New Developments in the "Gift and Leaseback" in Tax Planning for the Professional*, 51 *TAXES* 654, 658 (1973).

¹⁷³ See also Kornfield, *A New Look at Family Trust Leaseback Arrangements*, 104 *TRUSTS AND ESTATES* 1121, 1187 (1965).

have broad discretion and extensive powers; (4) the rent paid should be that which an unrelated tenant might pay; and (5) the grantor should not retain the reversion though under recent decisions it appears that the deduction may be allowed even if the grantor-lessee does retain the reversion.

The planning perspectives from which to view gift and leaseback transactions have been discussed at length above. Recommendations for each facet of the transaction have been delineated and the courts' views on deviations from those recommendations have been illustrated. It remains only for this author to appeal to Congress to legislate concerning this 25-year old tax-minimization tactic, for, clearly, the only answer to the problems it presents is congressional action. The words of the tax court in *Estelle Morris Trusts*¹⁷⁴ concerning multiple trusts are equally applicable to the gift and leaseback:

We do not intend to imply that we believe congressional inaction here means complete sanction of tax avoidance through multiple accumulation trusts. Rather, we believe the lesson to be learned is that courts should be wary of broad-scale incorporation of the doctrine of "tax avoidance" or "business purpose" or "sham" in an area so fraught with its own particular 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.¹⁷⁵

Until Congress voices its intent, taxpayers and the IRS will continue to flail at each other in attempting to thrash out common law guidelines. This could be effort better spent if a statute were available to avert such skirmishes.

Charles J. Lavelle

¹⁷⁴ *Estelle Morris Trusts*, 51 T.C. 20 (1968).

¹⁷⁵ *Id.* at 43.