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It is submitted that the present rule in these cases should be altered. The adoption of a control test will work toward a desirable end, particularly if liberally applied, but as indicated above, two suits will still be required. The minority view, whereby the parent's action is derived from the child's and must fall if the child fails, would be an improvement, but it also sometimes requires two trials. It is urged that the best solution is in a statutory revision to permit joinder, giving all of the parties their day in court, while at the same time eliminating a costly second trial.

PHILIP G. CARSON

Taxation—Deductions of Rental Payments after Gift and Leaseback to Short-Term Trust—Taxation of Income

Taxpayers may use the gift and leaseback device to effect tax saving with greater confidence as a result of a recent decision of the Tax Court of the United States.1 The gift and leaseback has been popular among some taxpayers in high income brackets, chiefly physicians, as a method of reducing income taxes while boosting total family income.2 Its popularity began to decline, however, when the Tax Court held in I. L. Van Zandt3 that a noncorporate taxpayer had to show a "business purpose" for making a gift of real estate to a trust before he could validly deduct rental payments made to the trust on leaseback of the property.4

1 Alden B. Oakes, 44 T.C. No. 48 (July 6, 1965).
2 The popularity of the gift and leaseback is reflected by the amount of litigation it has generated. Notable successes include Brown v. Commissioner, 180 F.2d 926 (3d Cir.), cert. denied, 340 U.S. 814 (1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Commissioner v. Greenspun, 156 F.2d 917 (5th Cir. 1946), on remand, 7 CCH Tax Ct. Mem. 509 (1948); Alden B. Oakes, supra note 1.
4 The court said:
Since deductions are matters of legislative grace and the taxpayer has the burden of proving he is entitled to them, the petitioner here must establish that the rental payments were in fact "ordinary and necessary" expenses in his medical practice. While they may be ordinary, were they necessary under these circumstances? We think not. The petitioner owned and used the building and medical equipment in his "trade or business" before he ever created the trusts, transferred the property to the trusts, and then leased it back. Actually he continued to use the property in exactly the same manner he had before these transactions were arranged and carried out. This indicates a lack of any business purpose, which we believe is implicitly required by section 162(a).
40 T.C. at 830-31. (Emphasis added.)
The Tax Court repudiated the Van Zandt "business purpose" test in the case of Alden B. Oakes,5 decided in July 1965, and cleared the way to renewed interest in the use of the gift and leaseback. The device has frequently been used in conjunction with a short-term trust6 and was so used by taxpayers Van Zandt and Oakes. The latter used it successfully while the former did not.

An illustration of a typical situation involving a short-term trust and a gift and leaseback will be helpful in demonstrating how the device works. The taxpayer establishes an irrevocable trust with a term of at least ten years and a day7 for the benefit of his minor children, conveying real estate used in his business (the gift) to the trust as its corpus. He then leases the same property from the trust (the leaseback), being careful not to pay more than a reasonable rental,8 and deducts the rent payments as business expenses.9 Upon the termination of the trust the property reverts to the taxpayer, unless he has sold or otherwise disposed of his reversionary interest.

Assuming the taxpayer's rental deductions are larger than any depreciation deductions he might have claimed if he had kept the property,10 and assuming any gift tax on the transaction is less than the potential saving of income tax,11 the taxpayer's reward from using this device is a reduction of his taxes. In addition, he is

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5 44 T.C. No. 48 (July 6, 1965).
6 As used in this note, a short-term trust is any trust of limited duration that complies with all of the requirements of §§ 671-78 of the Internal Revenue Code of 1954, so that the income of the trust will not be taxed to the grantor.
7 The term must be longer than ten years in order to comply with § 673(a) of the Code.
8 Reasonableness of the rental is one of the factors that determines the deductibility of rent payments. See, e.g., Kirschenmann v. Westover, 225 F.2d 69, 70 (9th Cir. 1955), where the court found a yearly rental of $19,412.25 to be unreasonable when the same property had rented for $1,050 per year before the gift and leaseback, and denied the deductions on this basis.
9 Deductions are permitted by § 162(a)(3) of the Code for reasonable rental payments that must be made for purposes of a trade or business.
10 "For a leaseback to be profitable tax-wise, property must either be non-depreciable (real estate) or have a low basis, since rent deduction through a leaseback arrangement is a substitute for depreciation." Cohen, Transfers and Leasebacks to Trusts: Tax and Planning Considerations, 43 Va. L. Rev. 31 (1957).
11 Under § 2521 of the Code a donor has a $30,000 lifetime exemption from the gift tax, and under § 2503(b), he has an annual exclusion of $3,000 per donee provided such gift is not a "future interest." Moreover, the aforesaid amounts may be doubled by the donor by "splitting the gift" under § 2513 of the Code.
indirectly rewarded through the benefit that his children receive from the trust. A tax reduction for the family will result only if the income is taxed to the trust or its beneficiaries at a rate lower than that paid by the grantor on his income. The difference in the tax at the lower rate and the tax at the higher rate accrues to the benefit of the taxpayer's family as an economic unit and makes the gift and leaseback device worthwhile for high bracket taxpayers.\(^2\)

While perhaps the most important advantage to be gained by use of a gift and leaseback with a short-term trust is splitting of income between a parent in a high tax bracket and children in lower brackets, this is not the only advantage.\(^3\) The device may be useful for assuring education expenses for children,\(^4\) assuring income for aged relatives,\(^5\) providing life insurance coverage on persons other than the taxpayer,\(^6\) and for accomplishing many other purposes. Its use is limited only by the ingenuity of the planner and provisions of law.

A taxpayer must pay particular attention to two primary issues if he is to use the gift-leaseback device successfully with a short-term trust. These are (1) whether or not the rental payments to the trust are deductible to the grantor, and (2) whether the trust

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\(^2\) For an illustration of how worthwhile it can be, see Yohlin, *The Short-Term Trust—A Respectable Tax-Saving Device*, 14 TAX L. REV. 109, 110 (1958)

\(^3\) For a general idea of the many applications of the gift and leaseback device with a short-term trust, see Drew, *Paying Family Expenses and Saving Taxes*, 37 TAXES 689 (1959), and Yohlin, *op. cit. supra* note 12.

\(^4\) In setting up a trust to assure education expenses for children, the grantor must bear in mind that trust income applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain will be taxable to the grantor under authority of § 677(b). However, the measure of the parent's legal obligation is to be found in local rather than federal law, Treas. Reg. § 1.662(a)-4 (1956), and no cases have been found in which a state required a parent to furnish a college or professional education for his child. Therefore, it is doubtful that trust income used to defray a child's college expenses, other than room, board and clothing, will be taxable to the parent.

\(^5\) The principle of § 677(b) of the Code applies to support of parents as well, and if the grantor is under a legal obligation to support them under state law, trust income used for their support will be taxable to him. Still, a trust for the benefit of parents can be a useful device when the income is used only to supplement the parents' own funds.

\(^6\) Trust income used to buy insurance policies on the life of the grantor will be taxed to the grantor. Burnet v. Wells, 289 U.S. 670 (1933). See generally Durant, *Trust Income and the Payment of Premiums*, 27 TAXES 904 (1949); Smith, *Federal Taxation of Insurance Trusts*, 40 MICH. L. REV. 207 (1941). But trust income used to pay premiums on insurance covering someone other than the grantor is not taxable to the grantor.
GIFT AND LEASEBACK

income is taxable to the trust, to the beneficiary or to the grantor. The gift and leaseback device will yield no tax saving if the rental deductions are disallowed or if the trust income is found to be taxable to the grantor.

In determining the issue of deductibility of rental payments under a gift and leaseback with a short-term trust, the courts have chosen to look at several factors. Chief among these in the past have been the extent of prearrangement of the leaseback, the independence of the trustee, the revocability of the trust, and the reasonableness of the rental payments.

The Van Zandt decision was the first application by the Tax Court of a business purpose test to a gift and leaseback made by a noncorporate taxpayer. In order to understand what misled the court in applying the test, it is first necessary to examine the section of the Internal Revenue Code under which the taxpayer claimed a deduction for rental expenses. The deduction was claimed under section 162(a)(3), which says:

(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.

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17 See Helen C. Brown, 12 T.C. 1095, 1101 (1949).
18 See Brown v. Commissioner, 180 F.2d 926, 929 (3d Cir. 1950), reversing 12 T.C. 1095 (1949).
19 See Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948).
20 See Kirschenmann v. Westover, 225 F.2d 69 (9th Cir. 1955).
21 In I. L. Van Zandt, 40 T.C. 824, 830 (1963), while the court purportedly acted under the authority of a line of decisions, a study of the decisions it cited shows that a business purpose test was determinative of only one other case involving a gift and leaseback. This case, White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), was criticized by a dissenting judge as a mistaken application of the business purpose test. The test had been applied in earlier cases involving a sale and leaseback, and two of the four cases cited by the Van Zandt court were sale and leaseback rather than gift and leaseback cases. W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951), affirming 12 T.C. 539 (1940); Unger v. Campbell, 7 Am. Fed. Tax R.2d 547 (N.D. Tex. 1960). The court in the fourth case found there was no gift because of lack of showing of a clear and unequivocal intention to part with the property. Johnson v. Commissioner, 86 F.2d 710 (2d Cir. 1936), affirming 33 B.T.A. 1003 (1936).
The Van Zandt court held the rental payments in that particular gift and leaseback situation were not "necessary" within the meaning of section 162(a)(3) because the taxpayer had owned the property before the transfer, and there was no compelling business reason for him to give it to the trust; thus the rental was not "required to be made as a condition to the continued use or possession" of the property. The Oakes court said the test of business necessity required by section 162(a)(3) should be made by viewing the situation as it exists after the gift is made, not before. It is clear that if the court had not repudiated the Van Zandt test in Oakes, the gift and leaseback would have become valueless as a device for saving income taxes. To require the showing of a business purpose for giving property to the trust is tantamount to an automatic disallowance of the rental deduction. Rarely, if ever, is there a valid business reason for making such a gift to a trust.

In abandoning the "business purpose" test of Van Zandt, the Oakes court did not say why it was repudiating the earlier position. The court may have had in mind a distinction explained in a recent article by Professor Froehlich in the California Law Review. That distinction is that a rational basis exists for applying such a "business purpose" test to a gift and leaseback in the case of a corporation, but does not exist in the case of an individual. The author explained that a corporation is by nature business motivated and ordinarily does not make gifts. Therefore, where a corporation transfers property to a related entity and then leases it back, it

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23 In affirming the case on appeal, the Court of Appeals for the Fifth Circuit said:

[I]t seems to us inevitably we must look at the original conveyance of the property together with the execution of the leaseback as a single transaction. 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 443.

24 The court said:

At that point, since Alden Oakes needed a building for practicing medicine, he agreed to rent the property from the trustee for a reasonable amount. Consequently, we believe there is a sound basis for holding that the rent paid by Oakes was, in terms of section 162, both "ordinary and necessary" and "required to be made as a condition to continued use . . . of property."

44 T.C. at ——.

would appear proper to look to the business reasons for the transfer in determining deductibility of lease payments. Professor Froehlich continued:

An individual, however, is governed by many non-business influences, and it is recognized that all his transfers need not be business motivated. He may, for instance, make outright gifts of income producing assets. No one has ever challenged the right of an individual to establish a . . . [short-term] trust with stock of a corporation, for instance. Similarly, there should be no problem created by a proprietor's transferring some of his business assets to his child's trust. The fact that the transaction has no business purpose has nothing to do with its bona fides—it is not intended to have a business purpose.26

Another factor which has recently come to bear on the issue of deductibility of rental payments made to a short-term trust is the requirement in section 162 (a) (3) that the taxpayer have no "equity" in the property he is renting. The section permits deductions only for property "to which the taxpayer has not taken or is not taking title or in which he has no equity."27

A few recent cases in the gift and leaseback area have adopted a broad, literal interpretation of this phrase and, as an alternative basis for decision, have denied rental deductions because the lessee had an "equity" in the property.28 What exactly is the prohibited "equity," and what effect does it have on practical applications of the gift and leaseback device in conjunction with a short-term trust? The Commissioner of Internal Revenue has taken the position that the "equity" is any equitable interest held by the taxpayer in the rented property.29 This interpretation has a direct and adverse

26 Id. at 973.
27 See text accompanying note 22 supra. (Emphasis added.)
28 See Hall v. United States, 208 F. Supp. 584, 588 (N.D.N.Y. 1962), where the grantors retained the power to dispose of the corpus of the trust and the court said "it would seem that the grantors had an equity in the premises at least until the power of sale was exercised and for that reason also the Commissioner was right in disallowing the deduction"; Kirschenmann v. Westover, 225 F.2d 69, 71 (9th Cir. 1955), where the concurring opinion suggested that another ground for disallowance of the deduction was that the grantor had an "equity" in the property because he bought the property under a mortgage and gave it to the trust subject to the mortgage, retaining an equity of redemption.
29 In discussing the Commissioner's contention that taxpayer Oakes had retained the prohibited "equity," the Oakes court defined "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." 44 T.C. at ———.
impact on the use of a short-term trust with a gift and leaseback, as will be presently shown.

One of the primary reasons why the taxpayer chooses a short-term trust as the tax-saving vehicle is the fact that it permits him to regain control of the property after his purpose has been served;30 i.e., in giving real estate to a trust for ten years, he retains a reversionary interest in the property, and upon the termination of the trust at the end of the ten-year period the property reverts to him. Thus, he is able to effect a tax saving during a temporary period of family need—for instance, when his children need money for college tuition and expenses—and he is restored to full ownership rights in his property when the temporary need has been satisfied.

Is the reversionary interest retained by the settlor of the trust an “equity” within the meaning of the rental deduction section of the Code? If it is, then he may not deduct rental payments upon leaseback. It is true that he can avoid this consequence by either selling or giving away this reversionary interest. However, if he does either of these he will not regain control of the property upon termination of the trust, which amounts to a failure of his primary consideration for choosing a short-term trust.

The Oakes decision approved by implication the Commissioner’s contention that rental deductions should be disallowed whenever the lessee has any equitable interest in the property.31 However, neither the Oakes case nor other decisions in the gift and leaseback area that have dealt with the “equity” problem have met the issue head-on. In Oakes the court found that the taxpayer had no equity in the property because he had sold his reversionary interest to his wife.2 The court failed to consider the probability that Oakes retained effective control over the reversionary interest in his wife’s hands. In the future, the court will likely take notice of this prob-

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30 See Yohlin, op. cit. supra note 12.
31 44 T.C. at ———.
32 The court said:
One of the reasons why respondent asserts Alden Oakes did not divest himself of sufficient control and ownership over the property is that upon termination of the trust the property must be returned to the grantors. This argument disregards two pertinent facts, viz., the pre-existing and continuing interest of the wife and the transfer of the doctor’s remainder interest to his wife. Surely, after April 28, 1959, Alden Oakes had neither a present nor a remainder interest in the trust property. His wife alone was then left with the power to eventually dispose of the trust corpus.

Id. at ———.
ability and use it as a basis for denying deductions. In the other cases the "equity" issue was not the sole basis for decision.  

Insofar as they are authority for the argument that deductions should be refused whenever the taxpayer retains any type of equity in the property, however, it is submitted that the cases are in error. Such a broad interpretation of section 162(a)(3) urged upon the courts by the Commissioner is unwarranted. To follow the argument of the Commissioner to its logical conclusion would mean that no person having a future interest in real estate could rent that real estate from the holder of the present possessory interest and get the benefit of a rental deduction, for if he had a future interest in the property, he would have an equity.

The legislative history of the section offers no clue to the meaning of "equity." The only clue available is in a series of cases dealing with leases containing purchase options. Here, the courts have been concerned by the fact that the lessee has an equity in the property—the option to purchase. Instead, they have looked to the rental payments to see whether the payments are for "rent" or whether they are for the "purchase" of the property. Deductions have been allowed unless it was determined that each rental payment increased the ownership interest of the lessee-optionee. It is submitted that these cases correctly interpret "equity" in the context of this section in its colloquial usage as "ownership" rather than in its legal usage, and that the purpose behind inclusion of the phrase is to prevent persons from deducting as rental expense, money that was really being applied toward purchase of the property.

Turning now to the problem of taxation of the income of the trust, will the income be taxable to the trust, to the beneficiaries, or to the grantor? The main concern of the grantor is that the income not be taxed to him. Many of the problems connected with the

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83 In Kirschenmann v. Westover, 225 F.2d 69 (9th Cir. 1955), the court held the rent payments nondeductible because they were not paid as a condition to continued use of the property in the taxpayer's business, and in Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962), the court disallowed the deductions because the taxpayers retained control over the actions of the trustee.


85 See Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Judson Mills, 11 T.C. 25 (1948); Edward E. Haverstick, 13 B.T.A. 837 (1928).

86 Ibid.
taxation of the income of a short-term trust have been either solved or simplified by the so-called "Clifford Trust" provisions of the 1954 Code, and if the grantor will carefully comply with their requirements, he will be largely assured that the trust income will not be taxed to him.

Tax consequences of a gift and leaseback are sufficiently predictable to permit use of the device for income-splitting among family members. However, taxpayers should be wary in using the device with a short-term trust so long as the possibility exists that a reversionary interest held by the grantor in the trust corpus will be found to be a prohibited equity under section 162(a) (3). Until this issue is settled favorably, it would appear wise to make a gift of the entire fee to the trust, to sell the reversionary interest, or to give the remainder interest to another beneficiary who is not so related to the taxpayer as to raise an issue of his possible continued control over the property.

THOMAS J. BOLCH

Taxation—Strike Benefits as Income

The Internal Revenue Code excludes from gross income "the value of property acquired by gift." Although similar language was contained in the first income tax statute following enactment of the sixteenth amendment and in all subsequent revenue acts,

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87 INT. REV. CODE OF 1954, §§ 671-78. The name "Clifford" comes from Helvering v. Clifford, 309 U.S. 331 (1940), the landmark case requiring the settlor to pay tax on the income of a short-term trust where he retained substantial elements of control over the trust corpus and income. This case caused a great amount of uncertainty and resulted in the promulgation by the Treasury of the Clifford Regulations, which set up a series of clear tests defining the situations in which the income of a trust would be taxable to the grantor. These regulations were put into the Code itself in 1954.

8 Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 167, provided that gross income shall not include "the value of property acquired by gift, bequest, devise, or descent."