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INCOME TAX ASPECTS OF GIFTS AND LEASE-BACKS OF BUSINESS PROPERTY IN TRUST

William W. Oliver†

Rental deductions for a grantor who transfers property used in his business into a short term trust and then leases it back have been at issue in three recent cases, with the deduction being denied in two of the three cases. Some of the concepts used by the courts in these cases are of doubtful help in analyzing the problems, and there is a need for further clarification before tax consequences can be predicted with a reasonable degree of assurance. There is a possibility that the income will be taxed to the trust, even though a deduction is denied the grantor. Careful planning is indicated, with an independent trustee as apparently the most crucial factor.

A decade ago there was considerable interest in the income tax treatment of intra-family gifts and leasebacks of business property.¹ Between 1948 and 1951, the deductibility of rental or royalty payments made by the donor had been litigated in three well-known cases.² Those cases showed pronounced differences of opinion between the judges;³ however, with a subsequent shift in position by a majority of the tax court⁴ and acquiescence by the Commissioner in another tax court decision, a degree of predictability appeared to have been achieved.⁵ At that time, an apparently reliable prediction could have been made that if business property were given to an independent trustee and the property then was leased back at a reasonable rent, the donor would be allowed to deduct the rent paid to the trustee.⁶ Three recent cases⁷ involving short-term trusts with a reversion in the grantor designed to satisfy the ten-year post-

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¹ Cary, "Current Tax Problems in Sale, or Gift, and Lease-Back Transactions," N.Y.U. 9th Inst. on Fed. Tax 959, 974 (1951); Cary, "Current Problems in Sale, or Gift, and Lease Back Transactions," 29 Taxes 662, 669 (1951); Smith, "Shifting Income Within the Family Group," 30 Taxes 995, 1000 (1952); Gold, "Trust and Lease Back," 40 A.B.A.J. 714 (1954); Notes, 51 Colum. L. Rev. 247 (1951), 65 Harv. L. Rev. 1250 (1952), "The Gift and Leaseback: A New Tax Avoidance Gimmick," 59 Yale L.J. 1529 (1950).

² *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951); *Brown v. Commissioner*, 180 F.2d 926 (3d Cir. 1950); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948).

³ The court of appeals in *Brown v. Commissioner*, supra note 2, and *Skemp v. Commissioner*, supra note 2, reversed the tax court. In the tax court two judges dissented in *Skemp* and six judges dissented in *Brown*. The court of appeals in *White v. Fitzpatrick*, supra note 2, affirmed the district court, but there was a strong dissent.

⁴ *Albert T. Felix*, 21 T.C. 794 (1954) (four judges dissented).

⁵ *John T. Potter*, 27 T.C. 200 (1956), acq., 1957-2 Cum. Bull. 6.

⁶ *Lasser, Tax Planning for Real Estate 132-34 (1955)*; *Olson & Gradishar, Saving Income Taxes by Short Term Trusts 68 (1956)*; *Prentice-Hall, Encyclopedia of Tax Shelter Practices 909 (1963)*; *Gold*, supra note 1.

⁷ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); *Alden B. Oakes*, 44 T.C. No. 48 (July 6, 1965). Another case which also may stimulate new Service activity in this area is *Egbert J. Miles, Jr.*, 41 T.C. 165 (1963), in which the taxpayers unsuccessfully attempted to shift income to Bermuda trusts, entities not subject to federal income taxation.

ponement requirement of section 673 of the Code, suggest that there may be an area of active litigation emerging and that the gift in trust and leaseback of business property may again become a matter of greater uncertainty for the tax planner.

BACKGROUND

A progressive income tax stimulates persons with incomes above their consumption levels to attempt to shift the excess income to other persons within the family who have lower incomes and would pay less tax on that income. Controversies over whether these attempts have succeeded in shifting the incidence of taxation have resulted in much litigation, and a significant body of tax law including many landmark cases.

We can classify cases of attempted intra-family shifting of income into those involving compensation for services, income from income-producing property, and the appreciation in value of assets.⁸ For situations in the first and third categories, apart from factual difficulties in identifying the source of the income, one can generally predict the results with confidence. If the assignor's services earned the income, the income is that of the assignor and not that of the assignee.⁹ If the potential income is from appreciation in the value of assets, the incidence of taxation may be shifted by a gift to another member of the family before realization of the gain by sale, exchange, or a taxable disposition.¹⁰ More uncertainty is encountered in the category of intra-family shifting of income from income-producing property than in the other two categories. However, even in this category we can confidently predict that the incidence of taxation has been shifted if the donor makes a complete gift (*i.e.*, with no reserved powers and the income not to be used for his benefit) in the property co-extensive in time with the maximum interest the donor has ever owned. A well-known case is *Blair v. Commissioner*¹¹ in which a trust beneficiary with certain income rights for life assigned certain amounts of that income for the rest of his lifetime to three of his children. The Supreme Court held the assignees, not the assignor, taxable upon the income received under the assignments.

In contrast to the *Blair* case is *Harrison v. Schaffner*,¹² in which an

⁸ This classification is suggested by the definition in *Eisner v. Macomber*, 252 U.S. 189 (1920).

⁹ *Helvering v. Eubank*, 311 U.S. 122 (1940); *Burnet v. Leininger*, 285 U.S. 136 (1932); *Lucas v. Earl*, 281 U.S. 111 (1930).

¹⁰ See *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954); *Visintainer v. Commissioner*, 187 F.2d 519 (10th Cir. 1951); *Elsie SoRelle*, 22 T.C. 459 (1954); *Estate of W. G. Farrier*, 15 T.C. 277 (1950); *Rev. Rul. 55-138*, 1955-1 Cum. Bull. 223; *White v. Brodrick*, 104 F. Supp. 213 (D. Kan. 1952); cf. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Helvering v. Horst*, 311 U.S. 112 (1940).

¹¹ *Blair v. Commissioner*, 300 U.S. 5 (1937).

¹² 312 U.S. 579 (1941).

assignment by an income beneficiary of the right to income from the trust for the following year did not shift the incidence of taxation. The underlying concept of the Court's decision was that income from property is taxed to the owner of that property, and the Court believed that in this case only income was given away and not a substantial interest in the property.¹³

In *Schaffner* the Supreme Court could conceivably have stated the rule that a transferor could not shift the incidence of taxation unless he transferred an interest coextensive in time with the interest he owned,¹⁴ a rule similar to the one that it later adopted for capital gains from sales of carved-out oil payments.¹⁵ That Court did not intend such a rule, however, for it spoke of future judicial decisions drawing the precise line between "gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes."¹⁶ Taken in conjunction with *Helvering v. Clifford*,¹⁷ decided one year earlier, the implication was clear that at some point the duration of a trust could be long enough (and hence the donor's reversion far enough in the future) and retained controls so minimal that the donee would be treated as owning a property interest so that the income was his and not the donor's.

The "gift of income versus gift of income-producing property" test can easily lead to confusion because of varying meanings that can be given to the word "property."¹⁸ There is a usage in which the term means broadly any right of value that a person may assert through a legal action. There is also the usage which distinguishes property rights from contractual rights as is done in many law school curricula.¹⁹ The concept of dividing ownership of both land and personal property into possessory estates and future

¹³ Id. at 583.

¹⁴ While such a rule would have avoided the considerable short-term trust litigation, the Clifford regulations, and also perhaps the ten-year reversionary rule of Int. Rev. Code of 1954, § 673, the Court should not be criticized for failure to lay down such a rule.

The brief for the government did not explicitly urge such a rule. The thrust of the government's argument was to rely upon *Helvering v. Horst*, 311 U.S. 112 (1940), and *Helvering v. Eubank*, 311 U.S. 122 (1940), while distinguishing *Blair v. Commissioner*, 300 U.S. 5 (1937). In distinguishing *Blair*, it spoke of it as an "exception to the general rule . . . where he is merely a life beneficiary and strips himself of his entire property interest in the trust." Brief for Petitioner, p. 8, *Harrison v. Schaffner*, 312 U.S. 579 (1941).

¹⁵ *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958).

¹⁶ *Harrison v. Schaffner*, supra note 14, at 583-84.

¹⁷ 309 U.S. 331 (1940).

¹⁸ The term "property" gives rise to difficulties in somewhat related contexts; the basis of successive estates in property. See, e.g., *Hort v. Commissioner*, 313 U.S. 28 (1941); Int. Rev. Code of 1954, § 273; Treas. Reg. § 1.1014-5 (1965); and the treatment as capital assets of less than fee interests in property. See, e.g., *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947).

¹⁹ Mr. Chief Justice Hughes was apparently reflecting this usage in the *Blair* case when he wrote that "the assignment of the beneficial interest is not the assignment of a chose in action but of the 'right, title, and estate in and to property.'" 300 U.S. 5, 13, 14 (1937).

estates is a fundamental one in Anglo-American property law, and apart from a particular context calling for a different answer, an American lawyer would probably call a possessory estate "property." That many lawyers prior to *Clifford* were of the opinion that the current income beneficiary of a trust owned "property" and that the income was taxed to that beneficiary is not surprising.²⁰

In the grantor-trust litigation following the *Clifford* decision, the courts pointed to the duration of the trust,²¹ the controls retained by the grantor,²² and the use of the income for the benefit of the grantor²³ as factors to aid in deciding whether the grantor would be treated as still the owner of the trust property so that the income was his. Even with these factors as guides, the planner could not precisely advise those prospective settlors of trusts who did not want completely to cut all strings between themselves and the trust. The problem was even more acute concerning trusts already in existence when the *Clifford* case was decided. In the *Clifford* case, the grantor had a substantial reversionary interest, perhaps retained in reliance upon the failure of the Treasury Department in 1934 to obtain from Congress legislation taxing the income of short-term trusts to the grantor. The Clifford regulations themselves stated that the application of the Clifford principle "to varying and diversified factual situations has led to considerable uncertainty and confusion."²⁴ When the provisions of the Clifford regulations were with some modification enacted as Sections 671-77 of the Internal Revenue Code in 1954, a welcomed degree of certainty was achieved for the tax planner. In general, under sections 671-77 if the term of the trust is at least ten years, if certain prohibited powers are not retained by the grantor, and if the income may not be used for the benefit of the grantor, then the income will not be taxed to the grantor. This article seeks to explore the problems of a trust designed to meet the tests of sections 671-77 but in which the corpus of the trust is property previously used in the grantor's business which is leased back to the grantor.²⁵

²⁰ Before *Helvering v. Clifford* many lawyers doubtlessly also interpreted the provisions then in the Revenue Acts for taxing the income of a trust to the trustee or beneficiary to preclude taxing the income to the grantor. This interpretation was reinforced by the fact that Congress had enacted the Treasury's recommendations for revocable trusts in 1934, but not those for short-term trusts. See Mr. Justice Roberts' dissenting opinion in *Helvering v. Clifford*, 309 U.S. 331, 338 (1940).

²¹ This aspect is reflected in § 673 of the 1954 Code.

²² This aspect is reflected in §§ 674-76 of the 1954 Code.

²³ This aspect is reflected in § 677 of the 1954 Code. The duration, control and benefit tests are separate under the 1954 Code, rather than a combined "bundle of rights" test as in *Helvering v. Clifford*.

²⁴ Treas. Reg. 111, §§ 29.22(a)-21(a), as amended by T.D. 5488, 1946-1 Cum. Bull. 19.

²⁵ Corporate distributions of property in kind to shareholders followed by a leaseback and family partnerships with a trustee for minor children as a partner are outside the scope of this article.

THE EARLIER GIFT AND LEASEBACK CASES

Although the landmark intra-family shifting of income cases are relevant to the issues in this area, there are five gift and leaseback cases²⁶ more directly in point, of which the earliest is *Skemp v. Commissioner*.²⁷ A physician owned a building in which he had his own office, and the remaining part was rented to third persons. He transferred this building to a corporate trustee. The duration of the trust was twenty years or until both he and his wife died. The income was to be paid to his wife and to his children; the corpus was eventually to be distributed to his children, and he had no reversionary interest. The trustee leased back the entire premises to the grantor for ten years, with an option to renew for ten years, at a rental which the tax court apparently thought was fair.²⁸ However, the tax court sustained the Commissioner's disallowance of a deduction for the rent.²⁹ In its opinion the tax court did not rely upon the *Clifford* doctrine; instead, the court concluded that there was no present gift of a property interest since under the planned leaseback there was only a promise to pay rent and the property would not pass to the trustee until the lease had expired. The Court of Appeals for the Seventh Circuit reversed.³⁰ The court indicated that payment of the rent was a condition to the continued use and possession of the property. To the argument of the Government that the taxpayer had voluntarily created that situation, the court answered that while that was so, the fact remained that the situation voluntarily created did require the payment of rent.

The next gift and leaseback case to come before the courts was *Brown v. Commissioner*.³¹ A husband and wife who were partners in a coal-mining business transferred a railroad siding for coal loading and a tract of coal-bearing land to their attorney as trustee for their two minor sons. Pursuant to a prior understanding, the siding and the coal lands were leased back for rental charges and royalties, which were found by the tax court to be reasonable in amount.³² There was no reversion in the grantors under the trust although the period of the lease was estimated to be long enough to exhaust the coal in the leased land, and the land was

²⁶ *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951); *Brown v. Commissioner*, 180 F.2d 398 (2d Cir. 1951); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948); *John T. Potter*, 27 T.C. 200 (1956); *Albert T. Felix*, 21 T.C. 794 (1954).

²⁷ *Supra* note 26.

²⁸ The majority opinion makes no statement about the reasonableness of the rent; the dissenting opinion indicates there was no controversy about the reasonableness of the rent. See *A. A. Skemp*, 8 T.C. 415, 422-23 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948).

²⁹ *A. A. Skemp*, *supra* note 28.

³⁰ *Skemp v. Commissioner*, *supra* note 26.

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

³² *Helen C. Brown*, 12 T.C. 1095, 1099 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950).

estimated to be without significant value once the coal was removed. The tax court sustained the Commissioner's disallowance of any deduction for rents and royalties paid to the trust. It characterized the situation as merely a gift of income. The Court of Appeals for the Third Circuit reversed the tax court.³³ It concluded that the trusts were valid and irrevocable and that there was a new independent owner of the trust property (*i.e.*, the trustee) who was in a position to require payment of the rents and royalties as a condition to use and possession.

The third case in the series of earlier gift and leaseback cases was *White v. Fitzpatrick*.³⁴ There a taxpayer was engaged in the business of manufacturing chokes for shot guns. A basic patent on an invention of the taxpayer was essential to this business. The business was conducted on real property leased with an option to purchase. In January 1941, the taxpayer made a gift of this patent to his wife for the full term of the patent, and on the following day the wife granted an exclusive license to manufacture back to the husband for the full term of the patent. Earlier in December of 1940, the taxpayer's wife had purchased the real property on which the business was conducted with funds given to her by her husband. Immediately she leased the property orally to her husband for the same rent he had been paying previously to the prior owner. In attempting to sustain deductions for the rent of the building and for the royalties under the license of the patent, the taxpayer relied heavily upon *Skemp* and *Brown*. However, the Court of Appeals for the Second Circuit, after commenting that those two cases went "to the verge of the law,"³⁵ distinguished them as involving independent trustees. The court of appeals affirmed the district court which had dismissed a suit for refund.³⁶ It observed that the formal gift to the wife did not interfere with the practical and effective control that the taxpayer had of the property. The wife was not equipped and had never evinced any inclinations to try to exploit the patent and the building which were only useful as an integral part of the husband's business. Characterizing the transaction as a mere transfer of the single right to receive income, the court said that no deduction should be allowed.

Although the Second Circuit distinguished *Skemp* and *Brown* as involving independent trustees, it gave no rationale in its opinion of why an

³³ *Brown v. Commissioner*, 180 F.2d 926 (3d Cir.), cert. denied, 340 U.S. 814 (1950).

³⁴ 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952).

³⁵ 193 F.2d 398, 401 (2d Cir. 1951).

³⁶ 43 Am. Fed. Tax R. 1169 (D. Conn.), aff'd, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952).

indirect gift to a beneficiary through an independent trustee presents a stronger case for a deduction than a direct gift to the donee.³⁷

In 1954 the tax court in *Albert T. Felix*³⁸ followed the *Skemp* and *Brown* decisions of the Seventh and Third Circuits, thus abandoning its earlier position in those cases in which it had been reversed by those circuits. In the *Felix* case the parents gave cash to a corporate trustee for the benefit of a minor child. The parents were partners in a coal-stripping business and the trustee bought machinery from this partnership and leased it back at rentals equal to the OPA maximums. Arguments made by the government included (1) that this was a mere device to assign income and (2) that no business purpose was served by the sale and lease-back. In following *Skemp* and *Brown*, the tax court distinguished the *White* case by stating that the court there "found that the taxpayer had in fact remained the real owner of the property."³⁹

In *John T. Potter*⁴⁰ the tax court again followed *Skemp* and *Brown*. In *Potter*, a husband as a sole proprietor was manufacturing various items of which one of the most profitable was a chronograph. The husband had invented this chronograph and had pending an application for a patent on it. He assigned this patent application to his father, his wife, and his tax advisor as trustees for his wife and two minor children. The trustees licensed back to him at a royalty which had been agreed upon before the transfer into trust. Finding the royalties not to be excessive, the tax court held them deductible as a business expense by the husband. Although the gift of patent rights followed by a license back is quite similar to that aspect of the *White* case and venue for a petition to review the tax court decision was with the same court of appeals, the Service acquiesced⁴¹ and did not seek review of the tax court decision.

THE RECENT GIFT AND LEASEBACK CASES

The first of the three recent cases involving a gift of business property to ten year trusts with a leaseback was *Hall v. United States*.⁴² There, each of three doctors practicing as a partnership owned, together with their respective wives, an undivided one-third interest in the building in which

³⁷ A possible rationale is that an individual donee is more likely to be a party to a pretended gift or agree to return the property than would an independent trustee. Cases such as *Unger v. Campbell*, 7 Am. Fed. Tax R.2d 547 (N.D. Tex. 1960), and *Hilda M. Royce*, 18 T.C. 761 (1952), may involve pretended gifts.

³⁸ 21 T.C. 794 (1954).

³⁹ *Id.* at 803.

⁴⁰ 27 T.C. 200 (1956).

⁴¹ 1957-2 Cum. Bull. 6. The nonacquiescence in *Albert T. Felix*, 1956-2 Cum. Bull. 10, apparently has not been withdrawn.

⁴² 208 F. Supp. 584 (N.D.N.Y. 1962).

they had their offices. Part of the space in the building was rented to third persons. Each doctor and his wife conveyed their undivided one-third interest in the building to a corporate trustee. Two days later the trustee leased back to the partnership for a term of two years the space used by it. The rental was admittedly reasonable, for it was at the same amount per square foot as the rent being received from third persons.

The provisions of the three trust instruments were similar. In each trust, children of the grantors were the beneficiaries. The court stated that it was apparent from the terms of the trusts that the trusts looked toward providing for the education of the children. Each trust was to last until the death of a child of grantors, or either of the grantors. At that time the property would revert to the surviving grantor or pass under the will of the last surviving grantor. The grantors reserved a power to revoke, amend, or modify the trust after ten years.

Upon audit, the rent paid by the partnership to the trustee was disallowed as a deduction. The taxpayers paid the resulting deficiencies and brought an action for refund in the federal district court. The court dismissed the actions, and the taxpayers did not take an appeal. The court in stating its conclusion adopted the language of the *White* case that "in essence the assignment in the present case was effective only to the extent of transferring the single right to receive income."⁴³ The *Brown* and *Skemp* cases were distinguished as involving an independent trustee and not reversionary interests. The court believed that the trustee lacked independence because the grantors reserved the right to settle the accounts of the trustee. This the court thought would tend to make the trustee subservient to the grantors.

Although the transfer to the trustee had occurred in 1956, there is no reference in the opinion of the court to any possible application of Sections 671-77 of the 1954 Internal Revenue Code to the issues in the case. All cases cited and relied upon by the court were decided under the 1939 Code.

The second of the recent cases involving a ten-year trust of business property with a leaseback is *Van Zandt v. Commissioner*.⁴⁴ The taxpayer in that case was also a physician. He owned the building and the equipment which he used in his practice. In April, 1957, he created two irrevocable trusts for the respective benefit of his two minor children. The corpus of each trust was to be returned to the grantor at the expiration of ten years and two months or at the prior death of the beneficiary.

⁴³ *White v. Fitzpatrick*, 193 F.2d 398, 402 (2d Cir. 1951), paraphrased by *Hall v. United States*, 208 F. Supp. 584, 588 (N.D.N.Y. 1962).

⁴⁴ 341 F.2d 440 (5th Cir. 1965).

The sum of \$100.00 in cash was the initial corpus of each of the two trusts. The settlor, Van Zandt, was named trustee. One month later Dr. Van Zandt and his wife (she had a community interest in the property) transferred to Dr. Van Zandt as trustee the building and equipment used in his medical practice. On the same date the property was leased back to Dr. Van Zandt in his individual capacity. The tax court found as a fact that the rent required by the lease did not exceed a reasonable amount.

Upon audit of Dr. Van Zandt's returns for 1958 and 1959, the rental was disallowed as a deduction, but a depreciation deduction was allowed. The tax court sustained the determination of a deficiency as a result of the disallowance of the rental deduction, and this was affirmed by the Fifth Circuit.⁴⁵

In its opinion, the tax court indicated that it had a narrow question of a rental deduction, and not a question of to whom trust income is taxable. Accordingly, it did not analyze the possible application of sections 671-77 of the 1954 Code. Although the court thought that the rental payments might be ordinary, it concluded that they were not necessary because the taxpayer had owned the property before he transferred it to the trust. Furthermore, the court thought the transfer lacked a business purpose, which it felt to be an implicit requirement of section 162(a). The court also referred to the net effect of the transaction as being a shift of family income which subverted statutory intent, and it indicated that economic reality rather than the validity of the documents would determine whether a deduction should be allowed. *Skemp*, *Brown*, and *Felix* were also distinguished as involving independent trustees, while in the *Van Zandt* case itself the grantor himself was the trustee.

The Fifth Circuit, in affirming the tax court in *Van Zandt*, emphasized the importance of the factual evaluation of the particular case. The "short term of the trust, reversion to the settlors, predetermination of the right to possession of the property, and the like"⁴⁶ were mentioned as factors bearing on "business purpose." The obligation to pay rent was incurred not as an "ordinary and necessary incident in the conduct of the business," but to divide the taxpayer's income tax. The court also stated that it regarded its holding as consistent with *Skemp*.

The most recent case involving a gift in trust and leaseback of business property is *Alden B. Oakes*.⁴⁷ It involved (as did the other two recent

⁴⁵ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133).

⁴⁶ *Id.* at 444.

⁴⁷ 44 T.C. No. 48 (July 6, 1965).

cases) a physician and the building in which he had his office. He and his wife on December 31, 1956, conveyed this building which they owned jointly to a corporate trustee. The trust was for a term of eleven years, after which the property would revert to the two grantors. The beneficiaries of the trust were the four children of the grantors. Two days later, the trustee leased the building to the husband for eleven years at a rental found reasonable by the tax court. On April 28, 1959, the husband gave his interest in the reversion to his wife so that she thereafter was the sole owner of the reversion. The Service disallowed the rental deductions for 1959, 1960, and 1961 "since the trust and lease back agreement are merely a means of assigning income to family members."⁴⁸

Judge Dawson wrote the opinion for the tax court, just as he had done in *Van Zandt*, and neither case was reviewed by the full tax court. The *Oakes* case, unlike *Van Zandt*, was decided for the taxpayer on the authority of *Skemp*, *Brown*, and *Felix*. The court acknowledged that the distinction between *Skemp*, *Brown*, and *Felix* on the one side and *Van Zandt* on the other might be thin, but referred to the "actual independence" of the trustee as a "pivotal factor."⁴⁹ The opinion in *Oakes* appears to restrict somewhat the language in *Van Zandt* about business purpose, for the court says the fact that there was no business purpose for the gift is not controlling. Business necessity, the court said, should be judged by the situation after the gift is made, a position similar to that stated by Judge Minton in *Skemp*.⁵⁰

CRITICISM OF SOME CONCEPTS USED BY THE COURTS

There are a number of concepts in the *Hall* and *Van Zandt* cases which are relied upon by one or more courts and which are of doubtful help in analyzing the problems posed by a gift of business property in trust followed by a leaseback. One concept is that the deduction should be disallowed because the transfer did not serve a business purpose. To say that there is no business purpose for an intra-family gift almost invariably states the obvious. Among the motives for a gift-leaseback between family members, two of the most prominent are to provide for a natural object of the donor's bounty and to put the income into the hands of a person who is in a lower income-tax bracket than the donor. If a business purpose for the gift itself is necessary for a deduction for rent under a leaseback of business property, then neither a long-term

⁴⁸ *Ibid.*

⁴⁹ *Ibid.*

⁵⁰ "While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments." *Skemp v. Commissioner*, 168 F.2d 598, 600 (7th Cir. 1948).

duration of the donee's interest in the property, nor his intention and ability to protect that interest can salvage the deduction. Thus the "business purpose" test proves too rigorous, since the existing case law clearly indicates that in at least some cases the donee does own an interest that justifies a deduction for the donor for reasonable rental under a leaseback. The crux of the inquiry should be whether a sufficient property interest has been transferred to justify shifting the incidence of taxation and not whether a business purpose for the transfer exists.

Even though a business purpose for the gift might not be considered essential for deduction of the rent, the expense must have been "paid or incurred . . . in carrying on . . . a trade or business" to qualify for a deduction under section 162. While this requirement of section 162 in a sense might be considered a "business purpose," there is nothing to gain by duplicating the existing terminology of an expense incurred in carrying on a business with a business-purpose doctrine. There is, however, a possibility of confusion in extending the business-purpose doctrine outside the areas where it is conventionally used.⁵¹

Both the tax court in *Van Zandt* and the district court in *Hall* believed that the deduction for rent should be disallowed once it was decided that there was nothing more than a shift of income. Thus the tax court thought its task was to "aim our inquiry at seeing if the *net effect* has been a shift of family income."⁵² The district court in *Hall* stated its ultimate conclusion by adopting language from *White v. Fitzpatrick*: "in essence the assignment in [this] case [were] [sic] effective only to the extent of transferring the single right to receive income."⁵³ While the "gift of income versus gift of property" was the prevailing test used by the courts before the Clifford Regulations and the enactment of sections 671-78,⁵⁴ it is doubtful if it should be the test for transfers in trust to which sections 671-78 are relevant. The net effect of any ten-year trust is to shift income for ten years, but, when applicable, the controlling test for such trusts is provided by section 673 rather than by the "gift of income versus gift of property" test. It is, however, the position of the service,⁵⁵ supported by language

⁵¹ The leading case on the "business purpose" doctrine is *Gregory v. Helvering*, 293 U.S. 465 (1935), a corporate reorganization case. Admittedly the term is used widely outside the reorganization cases, for example in partial liquidation cases. See, e.g., *United States v. Carey*, 289 F.2d 531 (8th Cir. 1961), where "business purpose" was used in reaching a result difficult to defend upon analysis.

⁵² *I. L. Van Zandt*, 40 T.C. 824, 830 (1963), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133).

⁵³ *Hall v. United States*, 208 F. Supp. 584, 588 (N.D.N.Y. 1962), paraphrasing *White v. Fitzpatrick*, 193 F.2d 398, 402 (2d Cir. 1951).

⁵⁴ See, e.g., *Harrison v. Schaffner*, 312 U.S. 579 (1941).

⁵⁵ "[T]hese sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement." *Treas. Reg.* § 1.671-1(c) (1954).

in the committee reports,⁵⁶ that sections 671-78 do not apply to assignments of income to a trust. Thus the Service has ruled that if a transfer to a ten-year trust takes the form of an assignment of income from property, the income continues to be that of the assignor;⁵⁷ however, if the grantor had instead transferred title to the property and provided that it revert to him at the end of ten years, then the income for ten years is not that of the grantor.⁵⁸ This is patently a case of the form of words used rather than the substance of the facts controlling the result. While the Commissioner can support his position by language in the committee reports, a court which is deeply concerned about providing similar taxation for situations which are economic equivalents may not follow this language in the committee reports, which results in formalistic distinctions. A court in so doing could still give some meaning to the language in the committee reports, for an assignment to a trust of the right to compensation from services still could be held not to be within the scope of sections 671-78.

There may be valid policy considerations why a short-term trust of property which is an integral part of the grantor's business and through a leaseback will continue to be so should not be governed by the same rules as short-term trusts of investment property, which are clearly governed by sections 671-78. These considerations, however, are not called to mind by a "mere shift of income" formula. Furthermore, confusion can arise under a "shift of income" test, for every ten-year trust under section 673 realistically can be called a temporary shifting of income. The Clifford Regulations and sections 671-78 were intended to avoid the inadequacies of the "gift of income versus gift of property" test.⁵⁹ Therefore, the courts, whenever possible, should find more meaningful guides to judgment, rather than resorting to the "shift of income" test found inadequate in the past.

Another statement sometimes made by a court⁶⁰ in denying a deduction of rent in a leaseback of business property is that economic reality rather than the validity of the trust instrument is the standard for a deduction. This statement can result in glossing over some facts, for a valid trust instrument creating rights in the beneficiaries is certainly an economic reality. The problem should be analyzed by looking not only at what the

⁵⁶ H.R. Rep. No. 1337, 83d Cong., 2d Sess. A212 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954).

⁵⁷ Rev. Rul. 58-64, 1958-1 Cum. Bull. 13.

⁵⁸ Int. Rev. Code of 1954, § 673. The sentence in the text assumes that the trust otherwise complies with the provisions of §§ 671-77.

⁵⁹ Treas. Reg. 111, § 29.22(a)-21(a), as amended by T.D. 5488, 1946-1 Cum. Bull. 19. See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. A211 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 364 (1954).

⁶⁰ I. L. Van Zandt, 40 T.C. 824, 830 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133).

grantor retains, but also at the rights of the beneficiaries. If the lease contains the typical provision for a right to enter upon non-payment of rent,⁶¹ economic reality is that the grantor has to pay the rent or face eviction, especially if there is an independent trustee. References to "economic reality" can be used to state a conclusion reached by downgrading or ignoring the implications of some of the economic realities in the entire situation. While there is an element of classifying various factors as more and less important in all decision making, stating a conclusion in terms of reality is suspect if no explanation is given for the conclusion that a valid trust instrument is not a reality.

One difficulty in the use of the words "economic reality," as well as kindred terms such as "bona fide," "substance, not form," and "sham," is that an ambiguity lurks because of two possible meanings: one, that there is pretense, *i.e.*, the parties have agreed to act contrary to their intentions as stated for the ears of the Internal Revenue Service and two, that even though everyone expects to comply fully with all expressed and reasonably implied duties and enforce all expressed and reasonably implied rights under state law, nevertheless, the rule of federal tax law which would appear to apply if labels under both state law and the federal income tax are literally interpreted is meant to apply to other situations and not the one before the court.⁶² Courts holding for the taxpayer tend to emphasize the honesty of the parties; courts holding for the government are, perhaps despite their protestations, against tax avoidance as not the highest standard of citizenship.

Another concept stated in these leaseback cases is that the income is that of the grantor because he has dominion and control over the trust property. Sections 674-76 list the powers possessed by a grantor or another which will cause the grantor still to be treated as owner of the property. Until the threshold question, that those sections do not apply to the deductibility of rent by a grantor under a leaseback, has been resolved, there is no occasion to consider powers retained by the grantor unless they are covered by sections 674-76.

Even when a court is considering powers retained by the grantor other than those stated in sections 674-76, it is important to differentiate between static control in the sense that the grantor's intention establishes the

⁶¹ It will help establish the independence of the trustee if in addition to the right to enter for non-payment of rent, the lease contains other security provisions for the trustee as lessor such as a security deposit or advance payment of the last year's rent. See 2 Powell, Real Property § 229 (1950).

⁶² See, e.g., *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958); *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Hort v. Commissioner*, 313 U.S. 28 (1941); *Gregory v. Helvering*, 293 U.S. 465 (1935).

terms of the trust, and continuing control in which the grantor's volition from day to day determines various matters about trust administration and benefits under the trust.⁶³ Continuing control is inconsistent with a genuine gift, for it involves, in whole or in part, the power to nullify the gift, which is thus more illusory than real.

A stipulation at the time of creation of the trust that the property is to be leased back to the grantor at a reasonable rent does not involve any power to nullify the gift; it is more analogous to a clause on the type of investment and thus provides the specific means by which income is to be earned for the trust beneficiaries.⁶⁴

The occupancy of the premises under the leaseback does, of course, involve "control" of the premises; however, that control is paid for currently by a reasonable rent which is the economic equivalent of the right to possession as lessee. To use occupancy adequately paid for as a reason for disallowing a deduction for the adequate payment for occupancy is circuitous reasoning.

An argument typically made by the government in gift-leaseback cases is that no deduction should be permitted because the grantor continues to occupy the property after the gift just as he did before. Although the argument has been rejected in some cases,⁶⁵ it apparently carried great weight with the tax court in the *Van Zandt* case.⁶⁶ This argument does have some appeal and might be compared to the mathematical concept that things equal to the same thing are equal to each other. Thus, occupancy-after-the-same-as-before should lead to the same tax consequences before and after, so that no deduction for rent is permitted after since none was permitted before. This analysis emphasizes physical occupancy and by omitting any reference to the difference, namely the obligation to pay rent, assumes *sub silentio* that the obligation to pay rent is of no significance. But for the argument to be intellectually satisfying, we need a reason why the obligation to pay rent for business property does not, as it usually does, lead to a rental deduction.

Apart from the intra-family and short-term trust aspect, the rent is analogous to rent paid by other businessmen for business property when looked at from the tenant's position once the trust is executed. If we

⁶³ See *Commissioner v. Sunnen*, 333 U.S. 591 (1948), for an example of continuing control which caused the income to be taxed to the donor after an assignment.

⁶⁴ A proscribed type power is one over investments in a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control, § 675(4)(B), which is an example of potential continuing control indirectly by voting the stock.

⁶⁵ *Brown v. Commissioner*, 180 F.2d 926 (3d Cir. 1950); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948).

⁶⁶ 40 T.C. 824, 831 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133).

concede the grantor's premise that sections 671-78 should apply to business property as well as investment property so that he is not considered the owner, he has an impressive syllogistic argument for a deduction. The basic inquiry then needs to be whether sections 671-78 should apply to business property or, more specifically, to such property leased back to the grantor.

From the trustee's and beneficiary's viewpoint, the duty of the trustee and the right of the beneficiary is to have the trust corpus invested to yield a reasonable income.⁶⁷ Once it is established that a reasonable rent is being paid, this basic goal has been achieved. In fact, the return is probably at a higher rate than that now prevailing on listed securities. A reasonable rent received from the grantor is, on the market, the economic equivalent of the right to lease to some third party rather than the grantor. An immediate leaseback to the grantor, rather than to some third person, avoids any loss of income through a vacancy in the premises while seeking a suitable tenant. The grantor is suitable as a tenant since he is established as one able to do business profitably at that location. Furthermore, a family relationship to the beneficiary reinforces the normal economic reasons for paying the rent. These factors show that from the trustee's or beneficiary's viewpoint, leasing back to the grantor at a reasonable rent is likely to be preferable to leasing to any other person.

Another indication that the occupancy-after-same-as-before argument does not come to grips with the fundamental issue is that this argument would not be given serious consideration in the case of a sale and leaseback of business property,⁶⁸ although physical occupancy there is the same as before the sale. This suggests that this argument should be rejected and the inquiry turned to a search for fundamental reasons why sections 671-78 should or should not apply to business property even though those sections admittedly apply to investment property.

Although the trustee receives the economic equivalent of occupancy rights to the property in the form of a reasonable rental, the grantor under the leaseback may receive various intangible benefits which a hypothetical willing renter would not receive when paying the same reasonable rent. These include continued location at the same place of business and the attendant avoidance of the inconvenience of dislocation. Continuation of place of business is also assured at the termination of the lease and trust. These benefits result from the pre-arranged leaseback.

⁶⁷ It is the duty of the trustee to make the trust property productive. See Bogert, *Trust and Trustees* § 611 (2d ed. 1960); Scott, *Trusts* § 181 (2d ed. 1956).

⁶⁸ This sentence in the text assumes an arm's-length transaction. There may be doubt about the deductibility of the rent in a sale and leaseback with a charity. See Cary,

A retained benefit to the grantor, and especially one that thereby diminished the benefits to the trustee and beneficiary, is a conventional ground for defeating an attempted intra-family shifting of income.⁶⁹ These intangible benefits to the grantor under a leaseback, however, are not detrimental to the trustee or beneficiary. It would be difficult to assign any fair market value to these benefits which could be fairly called the intangible value of this particular location for this particular business—a value which has no cost basis. This is a factor which as such would normally have no tax consequences. To the grantor the particular location in which he is established probably has a greater value than to another who would pay a reasonable rent and move in. Such added benefit to the grantor is comparable to occupancy rights which are ignored as imputed income to an owner. Failure to pay for these intangible benefits to the grantor minimizes the amount of income which would be shifted if a deduction is allowed. The Service would in fact complain if a higher rent than the reasonable market place rent were paid.

The government argued in *Hall*, *Van Zandt*, and *Oakes* that the deduction of rent could not be permitted because of language in section 162(a)(3) requiring not only that the payment be made as a condition to the continued use of the property, but also that it be for the use of "property to which the taxpayer has not taken or is not taking title or in which he has no equity." The district court in *Hall* gave this as a second ground for its decision, while this argument was not reached by the tax court or the court of appeals in *Van Zandt*. In *Oakes* the tax court did not believe the argument in point since the husband had given his interest in the reversion to his wife so that the actual tenant did not have a reversionary interest.

This argument is made in a context dissimilar to that in which the words "in which he has no equity" have historically served. This language was initially added to the Code to make it clear that a mortgagor could not deduct payments on the principal of a mortgage.⁷⁰ This language has also played an important role in the cases involving a lease with an option to purchase.⁷¹ The underlying problem in those situations was whether a payment was basically a capital item. Thus an excessive rental payment may be part of the cost of buying the property by inducing the "lessor" to grant an option price to the "lessee" below the fair market value of the

"Current Problems in Sale, or Gift, and Lease-Back Transactions," 29 *Taxes* 662, 666 (1951). See also Paul W. Frenzel, 32 *P-H Tax Ct. Mem.* ¶ 63,276 (1963).

⁶⁹ Mertens, *Law of Federal Income Taxation* §§ 18.02, 37.09 (1961); *Int. Rev. Code of 1954*, § 677.

⁷⁰ Mertens, *supra* note 69, § 25.108.

⁷¹ *Id.* § 25.109.

property. The word "equity" in section 162(a)(3) might as a matter of statutory interpretation be restricted to a present interest such as that connoted by an "equity of redemption," rather than a future interest. Whatever the solution to this issue of interpretation, the government's argument extends this "equity" provision beyond its historically conventional coverage. There is some similarity, however, between the mortgage payment cases and the case of the grantor with a reversion after a short-term trust. The mortgagor increases his equity in property by payments on the principal of the mortgage indebtedness, while the grantor of the short-term trust has an increase in the value of his reversionary interest through the passage of time. If an eight-per-cent interest rate is found to be appropriate in valuing the rental property given, the value of the grantor's reversion immediately after the creation of a ten-year trust would be 46.32 per cent of the value of the trust property,⁷² but rises to 50.02 per cent at the end of the one year when the reversion is only nine years away. Of course, 100 per cent of the value of the property belongs to the grantor as a possessory interest at the end of the ten-year term of the trust. This factor of an increase in the value of the grantor's interest is, of course, not present in the case of the gift of a fee interest. Normally the increase in value of a remainder or reversionary interest due to the lapse of time is not treated as an item of realized income by the owner of the remainder or reversionary interest.⁷² However, a distinction might well be drawn between a vested reversionary interest created voluntarily and intentionally by the grantor and a remainder received by either gift or bequest.

The beneficiary of trust income for a ten-year period has an interest which would have a present value. This value at the time the trust was first created would be arrived at by a prospective purchaser by discounting the prospective income for ten years at an interest rate which he thought correctly reflected the risks involved. Thus, in a sense, it may be said that the donee of income for ten years from a trust will receive both principal and income. We could call the present value when the trust was first created, the principal, and the "rent" received over the years in excess of that present value we could call income.⁷³ Since the reasonable rental is a fair return on an investment representing ownership of the fee simple

⁷² The entire basis for the fee interest is assigned to the future interest once it becomes possessory as the fee interest. See Treas. Reg. §§ 1.1014-5, 1.1015-1(b) (1954). The clear inference is that the owner of the future interest is treated as receiving the entire fee, not merely the future interest in the fee, by gift or inheritance. See also Int. Rev. Code of 1954, § 102(b).

⁷³ This is a problem in allocation between principal and income similar to that upon the sale of unproductive property or a mortgage salvage operation by a trustee. See Bogert, *supra* note 67, §§ 324-25.

and not a ten-year interest, the grantor by the deduction is shifting an amount of income in excess of a fair return on the present value of the beneficial interest given to the beneficiary.

If this analysis were applied to short-term trust-leaseback cases, the approach would be to permit the deduction of rent paid for the year reduced by the increase of the actuarial value of the reversion during the year. In computing this increase in the value of the reversion, one question would be whether to use the historical cost or the fair-market value of the trust property.⁷⁴ It can be argued that fair-market value of the property should not be used since that in effect would be attributing to the original owner of the property realization of part of any appreciation in value of the property. On the other hand, it can be argued that if the allowable deduction for rent is the currently reasonable rent, which would tend to parallel current market values of property, then to be consistent we should also measure the accrued increase in the value of the reversion by fair-market values.

The above analysis can be illustrated by use of Table II, Regulation 21.2031-7. Assume (1) a gift of business property worth \$100,000 to a ten-year trust with reversion to the grantor, (2) a leaseback of the property to the grantor, and (3) a net 3.5 per cent return so that the rent paid exceeds the depreciation and any other expenses shifted from the grantor to the trustee by \$3,500 a year. While one of the grantor's goals would be to shift \$35,000 of taxable income over a ten-year period to the trustee or beneficiaries, his economic sacrifice is \$35,000 only if we compare the situation as it developed with that before the creation of the trust—*i.e.*, as if no trust were created. The grantor seeking a deduction under the leaseback, however, asks us to decide the deductibility of the rental expense by the situation after the creation of the trust, for he says that he is then not owner via sections 671-78 and that as non-owner he must pay rent as a condition to use of the property. If we accept his frame of reference and consider the situation immediately after creation of the trust, he will pay a net of \$35,000.00 as rent over the ten-year period; however, assuming constant values, the value of his reversion will increase \$29,108.10 over the same ten-year period. This \$29,108.10 is essentially analogous to the interest element on a discount bond. The sum of \$29,108.10 also, assuming a 3.5 per cent interest discount factor, is equal to the present "value" of the liability immediately after the trust is created to pay a net rent of \$3,500.00 ($8.3166 \times \$3,500.00$) for ten years.

⁷⁴ When property is received which is an item of gross income, its fair market value is the measure of the amount of income. See Treas. Reg. § 1.61-2(d) (1954), as amended, T.D. 6416, 1959-2 Cum. Bull. 126, T.D. 6696, 1963-2 Cum. Bull. 23.

The above illustration also demonstrates that the initial present value of a possessory interest carved from a fee or other more extensive property interest will, if the relevant values stay constant, equal the increase in value of the reversion which will accrue over the years and become possessory when the trust terminates. In effect, the out-of-pocket net cost to the grantor, using as a reference point the situation immediately after creation of the trust is the interest factor on the present value at that time of the possessory interest he carved from his larger interest.

Since the annual increase in value of the reversion substantially offsets the annual expense of the rental payments, a sound argument appears to have been against deducting any rental payments, except those exceeding the increase in value of the reversion. However, this argument proves too much—it undermines section 673 and the entire present statutory treatment of ten-year trusts. Realistically, when investment property has been transferred into a ten-year trust with a reversion to the grantor, the approach of reversion day mitigates substantially the forbearance of current income. Since no adjustment is made in the income of the grantor of investment property to a ten-year trust for the annual increase in the value of the reversion, the grantor of business property to a ten-year trust will argue that the same increase in value should be ignored in his case.

SOME FACETS OF THE GIFT AND LEASEBACK PROBLEM

Permitting a Deduction Will Raise Valuation Problems

If the rental deduction is allowed, the net effect will be to decrease the taxable income of the donor. Normally the amount of rent on business property is established by arm's-length negotiations between lessor and lessee, and no question as to its reasonableness would be raised.⁷⁵ In the gift and leaseback situation, arm's-length negotiation may be lacking even if there is an independent trustee, for the donor may be willing to agree to a high rent so that his taxable income will be decreased more and that of the lower bracket donee correspondingly increased. This is objectionable from the standpoint of the Service, for more income is being shifted than a fair return on the income-producing property transferred to the trustee. For the rent to be lower than a reasonable amount is also objectionable. This situation suggests a subservient trustee or donee and the genuineness of the gift itself is put in doubt; there may even be a secret or implied understanding that the trustee and donee will not insist upon their apparent rights or that the donee will return the rent to the apparent donor.

Thus to be unobjectionable the rent should be neither higher nor lower

⁷⁵ Mertens, *supra* note 69, § 25.110.

than a reasonable amount. This means that recurrently in gift and lease-back cases valuation questions will arise. Valuation issues are notoriously troublesome, and could be especially difficult when unique business property such as the patent rights in *White v. Fitzpatrick*⁷⁶ are licensed back for royalties. Business property given and leased back will typically be used in a going business, and the donor has no intention of terminating its physical use in the business. Its valuation by a hypothetical willing-lessor-willing-lessee standard rather than the present business use may be quite artificial; valuation as part of the business of the donor raises questions of severability.⁷⁷ An overly generous appraisal of the rental value of a particular asset in the business may result from attributing too large a portion of the total income of the business to the property instead of to the services of the donor. Although this hazard has been sanctioned by Congress in other places,⁷⁸ it would serve administrative convenience to minimize such valuation problems. If policing such valuation issues would involve undue amounts of time by Service personnel, then either this and/or other areas will tend to be neglected in auditing returns. When securities or property rented to third persons is the corpus of a ten-year trust, the market place validates the amount of income shifted. Hence, as a legislative matter it would not be difficult to justify excluding property used in the grantor's business from the application of sections 671-77. Whether those sections as now enacted should be so interpreted, and the problems raised by such an interpretation, will be discussed below.

Interpretation of the Statutory Language

If a ten-year trust is so created that the grantor is not the owner under sections 671-77 but the trust corpus is business property leased back to the grantor at a reasonable rental, should the grantor also not be treated as owner under section 162(a)(3) so that he may deduct the rental payments? Both the tax court and the Fifth Circuit have approached the income of the trust and the deduction for the grantor as separate and apparently unrelated questions.⁷⁹ In fact, the Fifth Circuit while holding in *Van Zandt* that no rental deduction was to be allowed the grantor, in

⁷⁶ 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952).

⁷⁷ This is a recurring problem whenever the donee receives an interest in the donor's business. In the family partnership cases this took the form of evaluating the significance of services and capital in the business. See Clifford R. Allen, Jr., 12 T.C. 227 (1949), where the gift was the pinball and jukebox concession in the donor's restaurant.

⁷⁸ Int. Rev. Code of 1954, §§ 704(e)(2), 1375(c). It is likely that gifts of minority blocks of stock in family corporations to children have the effect of shifting income from the father's services, but this is an area that has never been opened up. The reason may be the administrative difficulties this concept would pose.

⁷⁹ I. L. Van Zandt, 40 T.C. 824 (1963), aff'd, 341 F.2d 440 (5th Cir. 1965), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133).

strong dicta said that the same rental payments were income of the trust, a question it noted was not before it.⁸⁰

The language in sections 673-77 is that the grantor shall or shall not be "treated as owner"; there is no language in those sections expressly limiting the operation of the rules to those sections. Section 671 supports an inference that the rules concerning the ownership or non-ownership by the grantor under subpart E of subchapter J (sections 671-78) are to apply in other parts of the Code. Thus, if the grantor is treated as owner of the trust, not only the income but also the deductions and credits are taken into account by the grantor. Also under section 671, general concepts of dominion and control "under section 61" or "any other provision of this title [title 26, U.S.C., *i.e.*, the Internal Revenue Code]" are not to be used in including any items of the trust in computing the taxable income and credits of the grantor. Add to this the canon of statutory construction that all parts of a statute are to be read together,⁸¹ and a persuasive argument appears to have been made that a grantor not the owner under sections 671-77 is also not the owner under section 162(a)(3) and may deduct reasonable rental payments.

The report of the Senate Finance Committee, however, states in a single sentence that the rules of sections 671-77 do not apply to a gift in trust and a leaseback.⁸² This same statement, apparently in reliance on this committee report, appears in the regulations.⁸³ In neither the report of the Senate Finance Committee nor in the regulations is there amplification of the consequences of not applying sections 671-77 to trusts involving leasebacks to the grantor.

Two major questions arise if the rules under sections 671-77 do not make the trustee sufficiently the owner to permit a deduction by the grantor of rent paid under a leaseback: first, is the trustee still owner under sections 671-77 so that the rent is income to him although not deductible by the grantor, and second, what rules determine the deductibility of rent paid by the grantor?

To treat the rent as income to the trust while denying a deduction to the grantor is patently taxing the same income twice; the practice when an

⁸⁰ 341 F.2d 440, 443 (5th Cir. 1965).

⁸¹ Sutherland, *Statutory Construction* § 4703 (3d ed. Horack 1943); Mertens, *supra* note 69, § 3.13.

⁸² S. Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954). This same sentence does not appear in the Ways and Means Committee Report H.R. Rep. No. 1337, 83d Cong., 2d Sess. A212 (1954).

⁸³ Treas. Reg. § 1.671-1(c) (1954). The typical individual taxpayer has no influence upon single sentences in Congressional committee reports and in the regulations, while the Treasury Department does. When such a sentence states a result inconsistent with the statutory scheme as a whole, the canon *contra proferentem*, used so often against insurance companies, might be used against the Treasury.

attempted intra-family shift of income fails has been to treat the income as that of the assignor only, and to treat the receipt by the assignee as not being income⁸⁴—a result which can be explained by saying the assignee takes by gift.

Even in the *Hall* and *Van Zandt* cases the Commissioner's action in whole or in part was consistent with the premise that the rent could not be income to the trust if it were not deductible by the grantor. In *Hall* the income of the trust was reduced by the rent paid by the grantors which was disallowed as a deduction, but the rent paid by third persons to the trust remained its income. Also, a portion of the depreciation and other expenses was allocated back from the trustee to the grantors, so that in effect the grantors were treated as still owners of the portion of the building they were renting.⁸⁵ In *Van Zandt* the depreciation and other expenses were attributed back to the grantors so that they were in effect treated as still owners of the property.⁸⁶ However, the income tax treatment of the trust is still an open matter under a protective claim for refund filed by the trustee on which the Service will presumably act after the decision in *Van Zandt* becomes final.⁸⁷

Even though it be conceded as a matter of policy that if the rent is not deductible by the grantor it should not be considered income of the trust in order to avoid double taxation, there is difficulty in finding language in the Code itself to justify not treating the rent as income to the trust. The leaseback, at a reasonable rent, even by prearrangement, is hardly one of the powers described under sections 674-76 that leaves the grantor taxable on the income. If the grantor pays a reasonable rent, the trustee and the beneficiaries have not been deprived of beneficial enjoyment—the rent received in effect is the mode of enjoyment of the income-producing property. The fact that adequate rent is being paid supports the conclusion that there are in fact no powers to deal with the property for less than adequate consideration—powers which, if present, would under section 675(1) cause the grantor to be treated as owner of the trust property. While leasing the trust property is somewhat analogous to borrowing trust funds, section 675(3) should not apply if there is an

⁸⁴ This is an example of a rule so self evident that it is rarely stated. It is implicit in the rule that the grantor receives the deductions and credit of the trust when he is treated as owner, see Int. Rev. Code of 1954, § 671, and the reallocation of partnership income to reflect the value of services, see Int. Rev. Code of 1954, § 704(e)(2).

⁸⁵ Statement to the author by counsel for the taxpayer as to the final disposition of the case.

⁸⁶ 40 T.C. 824, 829 (1963), aff'd, 341 F.2d 440 (5th Cir. 1965), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133).

⁸⁷ Letter from taxpayer's counsel to the author, dated June 17, 1965.

independent trustee, reasonable rent, and a right to enter for nonpayment of rent.⁸⁸

The sentence in the regulations which states that sections 671-78 do not apply to the right of a grantor to deduct rent paid under a leaseback says nothing about whether the rent is still the income of the trust. There are, however, other provisions in the regulations under sections 671-78 which clearly imply that in certain other situations the income is not to be considered that of the trust but rather that of the grantor. One of these provisions is that sections 671-78 do not apply to "an assignment of future income to a trust,"⁸⁹ a provision supported by a sentence found in both the House Ways and Means⁹⁰ and Senate Finance Committee⁹¹ reports. As confirmed by a ruling, the Commissioner's position is that the assignment of income from property to a trust, even if for ten years, without any powers proscribed by sections 674-76 and even though the income is not to be used for the benefit of the grantor, does not cause the income to be that of the trust rather than the grantor.⁹² If a deduction is denied on the ground the rent under the leaseback is merely an assignment of income (as was done in *Van Zandt*) then double taxation can be avoided by relying upon the regulations so that the income is not that of the trust and deductions such as those for depreciation can then under section 671 be attributed back to the grantor.

While the "assignment of income" concept would thus achieve a desirable goal, the avoidance of double taxation, the distinction between assigning income to a trust for ten years and conveying income-producing property to a trust for ten years is hardly one to justify a difference in tax result. It is a formal difference and not one of substance. It is a test that apparently can be circumvented by using a form of words that vests fee title to the trust corpus in the trustee, subject to a reversion after ten years.⁹³ Another objection to the "assignment of income" concept in the regulations is that it in effect restates the "gift of income versus gift of property" test which prevailed before the promulgation of the Clifford regulations and the enactment of sections 671-78. If the congressional purpose is to be stated in a fundamental, easy to apply manner, we can

⁸⁸ A power to borrow is not within § 675(3) if there is adequate interest and adequate security. Reasonable rent and a right to enter for nonpayment of rent are analogous to adequate interest and adequate security.

⁸⁹ Treas. Reg. § 1.671-1(c) (1954).

⁹⁰ H.R. Rep. No. 1337, 83d Cong., 2d Sess. A212 (1954).

⁹¹ S. Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954).

⁹² Rev. Rul. 337, 1958-1 Cum. Bull. 13. See also Rev. Rul. 9, 1958 Cum. Bull. 20. Rev. Rul. 9 also states that there is a gift year by year rather than initially under the gift tax, a position which appears to conflict with *Galt v. Commissioner*, 216 F.2d 41 (7th Cir. 1954).

⁹³ See *Bogert*, supra note 67, § 144. The settlor's intention, within the limits of the property interest he owns, is controlling as to the title taken by the trustee.

state that one can shift the incidence of taxation if he is willing to have the trust last at least ten years, avoid certain prohibited powers, and not have the income used for his benefit.

All conversant with tax planning know that a ten-year trust is merely to shift income for ten years; a rule that an "assignment of income" to a trust for ten years does not bring into play the rules of sections 671-78 can create confusion and ambiguity for it says those sections do not permit the very thing that in substance they do permit. The "assignment of income" exception to the grantor-trust rules stated in the regulations rests upon language in the committee reports and can thus be said to reflect Congressional intent. However, that apparent "intent" can be said to be ambiguous and the courts may thus feel free to ignore that concept in working out a satisfactory resolution of this problem.

The equitable appeal of the grantor who wants a deduction of rent paid under a leaseback of business property from a ten-year trust is that he has relied upon sections 671-78 as permitting a shift of an amount of income equal to the reasonable rental value of property to a trust for ten years. He can argue the reliance was not unreasonable since commentators have agreed with this analysis.⁹⁴ However, it can be argued that there could be no reasonable reliance since both the report of the Senate Finance Committee and the regulations state that sections 671-78 have no application to a deduction under a leaseback to the grantor. While this would appear to be a reasonable notice, the recent cases show a startling fact. In none of the opinions in *Hall*, *Van Zandt*, and *Oakes* was any reference made to this provision in the regulations that sections 671-78 do not apply to deductions under a leaseback! An examination of the brief for the Commissioner before the Fifth Circuit in the *Van Zandt* case and of the memorandum in opposition to the petition for certiorari before the Supreme Court reveals no reference to this provision in the regulations. Perhaps the attorneys for the government overlooked it in their research. If this is so, then it is somewhat unrealistic to view this as a reasonable notice to taxpayers that compliance with sections 671-78 does not insure a deduction for reasonable rent paid under a leaseback. If the government attorneys failed to locate the statement about deductions under leasebacks in the committee report and in the regulations, it is perhaps indicative of a fundamental problem in the actual process of applying our tax laws. It may be that it is difficult to have elaborate statutory language and regulations read carefully by lawyers even when engaged in litigation.

⁹⁴ Lasser, *Tax Planning for Real Estate* 132-34 (1955); Olson & Gradishar, *Saving Income Taxes by Short Term Trusts* 68 (1956); Prentice-Hall, *Encyclopedia of Tax Shelter Practices* 909; Gold, 40 A.B.A.J. 714 (1954).

Also it may indicate that a tendency toward a common-law approach prevails in this area despite the existence of subpart E of subchapter J and the regulations thereunder.

A grantor who relied upon the premise that a trustee who is the owner for purposes of sections 671-77 is also the owner for purposes of section 162(a)(3) can use *White v. Fitzpatrick*⁹⁵ to support an argument that his reliance was reasonable. There the court, when faced with the issue of a deduction by the grantor of rent and royalties paid for the use of business property he had given away, stated that the line should be drawn the same whether the issue arose under section 23(a) of the 1939 Code (now section 162 of the 1954 Code) or section 22(a) of the 1939 Code (supplanted in this context by sections 671-77 of the 1954 Code). Once having concluded the tests are the same, that court then used *Helvering v. Clifford*⁹⁶ and other income-shifting cases as controlling authority as to a deduction which, if allowed, would have the effect of shifting income. The grantor under a short-term, leaseback trust applies the same premise as the Second Circuit in *White, i.e.*, that the tests as to income shifting should be the same whether or not it involves the mechanics of creating a deduction.

Another argument which can be made for a grantor who gives business property to a trust and then leases it back is that to disallow a deduction is discrimination against the man whose only wealth is in property used in his business as compared to the man who has wealth in investment property. It is significant that many of these trust-leaseback cases have involved physicians. They are likely to arrive at a high-bracket income level while they still have minor children and before they have accumulated a relatively large amount of wealth apart from their office equipment and building (if not leasing); the traditional rule against incorporation by a professional person precludes a shifting of income through a gift of corporate stock;⁹⁷ and the fact that capital is probably not a material income-producing factor⁹⁸ as well as the problems of a partnership with a non-professional person preclude the family partnership as a means of shifting income to the children.

PLANNING ASPECTS

The implication in the Fifth Circuit's opinion in *Van Zandt* that the rent could be income to the trust although not deductible by the grantor

⁹⁵ 193 F.2d 398 (2d Cir. 1951).

⁹⁶ 309 U.S. 331 (1940).

⁹⁷ It is this traditional rule that forms the background for the current tax problems about professional corporations. See Bittker, "Professional Associations and Federal Income Taxation: Some Questions and Comments," 17 Tax L. Rev. 1 (1961).

⁹⁸ See Int. Rev. Code of 1954, § 704(c)(1).

will tend to discourage the use of ten-year trusts involving leasebacks. The specter of double taxation makes it prudent to plan conservatively to maximize the chances of achieving a deduction. If minor children without income are to be the beneficiaries, the degree of possible double taxation can also be minimized by having the rent distributed by the trustee to savings accounts where the funds can be accumulated in the names of the children.⁹⁹ Under the present Code, there would be no tax on the first \$900 of income and the parent can still take the dependency deduction.¹⁰⁰

At present it appears that the risk of failing to achieve a deduction is high unless the trustee is independent. This is a factor emphasized in all three recent cases¹⁰¹ which have either distinguished or followed *Skemp, Brown*, and similar earlier cases. Thus, unless an independent trustee, preferably a corporate trustee, is to be used, the rent paid under the leaseback will probably be held not deductible, and this in turn leads to at least some possibility of double taxation of the economic rental value of the property. Thus, unless an independent trustee is used, it appears inadvisable to use business property as the corpus of a ten-year trust.

The "independence" of a trustee under a leaseback by the trustee to the grantor can be questioned because of the mere fact of leaseback. Realistically, we should assume in all such cases that the leaseback, if not contractually prearranged, was at least a reasonable expectation. Furthermore, the family relationship of the beneficiaries to the grantor, the banking connection (if any) between the grantor and trustee, and a possibility of reimbursement of the trustee by the grantor for any surcharge, all tend to make the relationship with the trustee a friendly one. Despite this, a corporate trustee, especially for minor children who can repudiate consent upon reaching majority, will be independent in many respects. A corporate trustee would be unlikely to return rent received to a grantor who wants to be an "indian giver," and thus risk surcharge in an action brought by the children upon reaching majority.

Nevertheless, the prearrangement factor is an important consideration. It is the crux of the "assignment of income" argument accepted by the tax court and the Fifth Circuit in *Van Zandt*. A technique for somewhat blunting this argument for the Government is to make the term of the

⁹⁹ This technique was used in Alden B. Oakes, 44 T.C. No. 48 (July 6, 1965). Another planning advantage is that income earned subsequently on such accounts is clearly not the income of the grantor. This would be true even if the rental payments were accumulated and invested by the trustee. See Jack Smith, 32 T.C. 1261 (1959); Loretto McKenna Richards, 19 T.C. 366 (1952).

¹⁰⁰ Int. Rev. Code of 1954, §§ 3, 151(e)(1)(B), 152.

¹⁰¹ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965), petition for cert. filed, 33 U.S.L. Week 3380 (U.S. May 25, 1965) (No. 1133); *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); Alden B. Oakes, 44 T.C. No. 48 (July 6, 1965).

leaseback for only a fraction of the term of the trust. This would also give both the trustee and grantor greater flexibility if changes in the neighborhood during the term of the trust indicate a higher and better use for the property so that the grantor would want to change his place of doing business.

Another technique for minimizing the risks that the deduction will be disallowed is to make the term of the trust substantially longer than the minimum ten-year period permitted by section 673. If the rules of sections 671-78 are not a guide as to when rent under a leaseback is deductible, then apparently we must go back to general concepts of duration, control, relationship of beneficiaries to grantor, and benefit to grantor in determining whether a deduction is to be allowed. Prior to the enactment of those sections, it was accepted that the longer the duration of the trust, the greater the degree of control permitted to the grantor without the income being taxed back to the grantor. The optimum, of course, would be for there to be no reversionary interest at all in the grantor. Thus, in *Oakes*, the fact that the husband, who was cograntor and sole lessee, transferred his interest in the reversion to his wife was an apparent factor in his success before the tax court. *Oakes* also suggests that if a grantor finds that he is being denied a deduction while the same rent is also treated as income to the trust, giving away the reversion is a way to secure relief from double taxation.

Another method to minimize the risks of a lease of business property from a trustee is to arrange for the lessee never to have title to the trust property. If, for instance, there is a gift of cash to the wife or another who thereafter buys the property and establishes the trust, there is a distinctly greater tendency for the courts to allow a deduction for rental payments for the property.¹⁰² In such cases, the lessee is not the grantor and has no reversion.

Since there is little difficulty in using investment property, in contrast to business property, in a ten-year trust to shift the incidence of taxation, efforts should be made to use property other than business property for a short-term trust. Thus, if the grantor has a portfolio of listed stocks, such property, rather than business property, should be used for the ten-year trust. Even if the grantor has listed stocks as to which he intends to pursue an aggressive policy of speculative investment for growth potential, he can still retain a power over investment policy and divert income, although not capital gains unless considered income under the state law or the trust instrument, for ten years to a trust. Another possibility

¹⁰² Consolidated Apparel Co. v. Commissioner, 207 F.2d 580 (7th Cir. 1953); Albert T. Felix, 21 T.C. 794. But see White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951).

is to mortgage the business property and use the borrowed funds to buy securities, which could then become the corpus of the ten-year trust.

CONCLUSION

Pending clarification (or confusion if the courts continue to use inadequate tools for analysis) by further litigation or legislation, there is considerable uncertainty about the income-tax treatment of a short-term trust of business property which is leased back to the grantor. The greatest hazard is that the grantor may be denied a deduction for the rent while the rent will still be considered income of the trust, so that double taxation results. The minimum in planning for such a trust is to use an independent trustee; a preferable course, however, would be to use investment property as the corpus of the short-term trust since Congress has there provided clear guides for a short-term shift of tax liability.