Finding the Key to the Deductibility of Rental Payments Under a Gift and Leaseback

Michael R. Goldfein
Finding the Key to the Deductibility of Rental Payments Under a Gift and Leaseback

INTRODUCTION

A gift and leaseback transaction is comprised of two legally cognizable events. A taxpayer initiates the arrangement by transferring real or personal property used in his business to an irrevocable trust. The grantor's children or spouse typically are named as the income beneficiaries. Subsequent to the conveyance, the second element of the transaction is actuated through a lease of the property to the donor. The goal of the grantor-lessee is to procure a deduction on his federal income tax return for the rental payments. These amounts constitute taxable income to the beneficiaries upon distribution by the trustee. Hence, if the deduction is upheld, the grantor will have shifted to the beneficiaries taxable income in the amount of the rental payments.

This article will outline the tax ramifications of the transfer of property to the trust and the concomitant leaseback of the trust corpus. The discordant approaches utilized by the courts in determining the tax consequences to the grantor-lessee will then be ex-

1. Section 162(a)(3) of the Internal Revenue Code of 1954 [hereinafter referred to as the Internal Revenue Code or the Code] provides, in pertinent part:

(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.


analyzed. Finally, the article will consider the effect of a separate corporate entity as lessee.

**ANALYTICAL FRAMEWORK**

Section 671 of the Internal Revenue Code, commonly referred to as the Clifford Trust provision, allows a taxpayer to transfer income-producing property to a trust and designate members of his family as the beneficiaries. The trust beneficiaries are taxed on the income distributed to them. The net result of the arrangement is an assignment of income by the grantor to members of his family who are in a lower tax bracket.

However, sections 673-677 define circumstances under which the income of certain trusts is taxed to the grantor despite distribution to the beneficiaries. These conditions reflect a failure by the donor to relinquish substantial control. They include the retention by the grantor of: (1) a reversionary interest in the trust corpus, (2) the power to control the beneficial enjoyment of the corpus or income, (3) administrative controls exercisable primarily for the benefit of the grantor, (4) the power to revoke the trust and (5) the power to distribute income for the grantor's benefit or the benefit of his spouse. Nonetheless, if the reversionary interest, power to control beneficial enjoyment, and power of revocation do not take effect within ten years of the conveyance of the trust corpus, the income

---

3. Section 671 provides, in pertinent part:
   No items of a trust shall be included in computing the taxable income and credits of the grantor or of the other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart. See Treas. Reg. § 1.671-1(a), T.D. 7148, 1971-2 C.B. 251.

4. The name is based upon the case of Helvering v. Clifford, 309 U.S. 331 (1940) in which a taxpayer set up and donated property to a five-year trust naming his wife as beneficiary and recipient of the trust income. The United States Supreme Court held that the trust was invalid as a means of assigning income because the grantor continued to be owner of the trust. The decision was based upon three factors: 1) the trust was only five years in duration; 2) the grantor's wife was trust beneficiary; and 3) the grantor retained control over the trust. Sections 671-677 of the Code were enacted to give the questions raised by Clifford in the grantor trust area a statutory underpinning. See Freeland, supra note 2, at 314.

5. Freeland, supra note 2, at 393 gives the following illustration: A doctor with taxable income of $40,000 pays $10,000 rent to a Clifford Trust. The trust distributes the money to the doctor's child, resulting in $10,000 taxable income to the child. The doctor deducts the rent paid to the trust in arriving at an adjusted income of $30,000. See Cohen, supra note 1, at 33; Webster, supra note 1, at 322-24.


Deductibility of Rental Payments

derived from the trust will not be taxed to the donor. The statute does not require that the grantor have a business purpose for the creation of the trust. Thus, the Code recognizes that the dominant motive for setting up these trusts is the deflection of the taxpayer's income to members of his family.

However, sections 671-677 have no application in determining the right of a grantor to deductions for rental payments to a trust under a gift and leaseback arrangement. Hence, the grantor must rely on the Code's general provision for business rental deductions, section 162(a)(3). This section allows a deduction for rental payments on property which is used in the taxpayer's business and in which the taxpayer possesses no legal or equitable ownership interest. The failure of the Clifford Trust provisions to furnish guidance regarding deductibility has spawned the judicial development of two means of applying section 162(a)(3) to a gift and leaseback transaction.

Under one approach, the courts combine the gift and leaseback elements into an integrated transaction. This integration imposes the requirement under section 162(a)(3) of a connection with the taxpayer's business on both elements of the arrangement. Thus, deductibility is conditioned upon a business purpose for the initial conveyance of property to the trust as well as for the rental payments. However, the integrated approach presents an anomalous situation. The Clifford Trust provisions recognize that the trust will be valid for the sole purpose of assigning income. Hence, where no business purpose exists, the trust functions as a vehicle for assigning income even though it is not recognized for purposes of securing a deduction.

11. I.R.C. §§ 673, 674, 676. The Clifford Trust allows the grantor to assign income even though he may retain a reversionary interest. Thus, although the grantor in theory divests himself of control for the duration of the trust, there is not a complete abandonment of ownership by the grantor. For a discussion of whether a reversion constitutes a disqualifying equity under § 162(a)(3) see note 110 infra.
13. Treas. Reg. § 1.671-1(c), T.D. 7148, 1972-2 C.B. 251 provides in pertinent part: "These sections [671-677] have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement." See Planning Perspectives, supra note 1, at 205; Cohen, supra note 1, at 40.
14. See note 1 supra.
16. It has been suggested that the courts should not focus on whether a business purpose exists for the gift. Rather, the inquiry should center on whether a sufficient property interest has been transferred to justify shifting the incidence of taxation. Oliver, supra note 1, at 31; Tax Planning, supra note 1, at 237. The transfer of a sufficient property interest relates to the grantor's divestment of control. See text accompanying notes 37, 38 infra.
The other approach involves a two-transaction analysis. With respect to the gift element of the arrangement, this analysis presumes that the trust is valid for purposes of deductibility, notwithstanding the absence of a business motive. The search for a business purpose is focused on the leaseback portion of the transaction. Shifting the emphasis to the leaseback is realistic because it recognizes the futility of searching for a sound business purpose for a gift to the trust. If the gift and leaseback elements are integrated and a two-transaction approach is not employed, the arrangement normally will fail as a means of securing a deduction under section 162(a)(3).

**JUDICIAL ANALYSIS OF THE GIFT AND LEASEBACK**

**Discord Among the Courts**

**The Two-Transaction Approach**

The first major court decision regarding the deductibility of rent paid by a grantor to an irrevocable trust under a gift and leaseback arrangement occurred in 1948. Litigation in the thirty years that followed has produced a procession of ostensibly conflicting court decisions. In *Skemp v. Commissioner*, a physician deeded a medical building in which he had offices to a twenty year irrevocable trust. He named his wife as life beneficiary and his children as recipients of the property upon termination of the trust. Pursuant to a prearranged plan, the physician entered into a ten year lease with the corporate trustee on the same day as the creation of the trust. The doctor deducted his monthly rental payments.

The court permitted the deductions under the predecessor of section 162(a)(3). The court felt that the grantor’s divestment of con-

---

18. See note 15 supra.
19. *Skemp v. Comm’r*, 168 F.2d 598 (7th Cir. 1948).
21. 168 F.2d 598 (7th Cir. 1948).
22. *Id.* at 599.
23. *Id.* at 599-600. The Internal Revenue Code of 1939, § 23(a)(1)(A) provided:
   In computing net income there shall be allowed as deductions:
   (a) Expenses.
control over the trust corpus established the validity of the trust.\textsuperscript{24} This determination enabled the court to focus on the leaseback portion of the arrangement in applying the business purpose test of section 162(a)(3). The court viewed the lease as an arm’s length transaction under which the taxpayer was obligated to pay rent to the trustee, “just . . . as if [he] had moved across the street into the property of a third party.”\textsuperscript{25} Thus, in presuming the efficacy of the trust and focusing the search for a business purpose only on the leaseback, the court created what later became known as the two-transaction approach.\textsuperscript{26}

Two years after \textit{Skemp}, the Third Circuit in \textit{Brown v. Commissioner}\textsuperscript{27} applied the two-step analysis in a similar fact situation. Mr. and Mrs. Brown transferred to an irrevocable trust\textsuperscript{28} property used in their coal mining business. Their children were named as beneficiaries and their attorney served as trustee. The day after the execution of the trust instrument, the taxpayers leased the property from the trustee. Subsequently, they deducted the rental payments made to the trust under the predecessor to section 162(a)(3).\textsuperscript{29} The court explicitly adhered to the rationale of \textit{Skemp} and held the payments were deductible. The court emphasized that the presence of an independent trustee was critical to establishing the validity of the trust entity for purposes of deductibility.\textsuperscript{30} Hence, \textit{Brown} elucidates the determination of relinquishment of control which \textit{Skemp} viewed as significant in applying the two-transaction approach.

Although \textit{Brown} finds the presence of an independent trustee significant, the case leaves open the question of the degree of inde-

---

\textsuperscript{24} Trade or business expenses.
\textsuperscript{25} In general.
\textsuperscript{26} All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . 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.

\textsuperscript{24} 168 F.2d at 600.
\textsuperscript{25} Id.
\textsuperscript{27} 180 F.2d 926 (3rd Cir.), cert. denied, 340 U.S. 814 (1950).
\textsuperscript{28} Id. at 928. The trusts were to terminate when the first beneficiary reached 25 years of age or if the first beneficiary died before this time, the trust would terminate when the youngest of the substituted beneficiaries reached 21 years of age. Thus, the trust satisfied the ten year condition of §§ 673, 674 and 678 of the Internal Revenue Code.
\textsuperscript{29} Id. at 928. See note 23 supra.
\textsuperscript{30} Id. at 929.
pendence required. According to the trust instrument executed by Mr. and Mrs. Brown, the trustee was to function independently of the grantors in the management of the trust property. Yet, certain events occurring subsequent to the gift and leaseback indicate that the trustee was independent in name only. During the initial year of the lease, a prior owner of the taxpayer's property made use of equipment on the property. In return he paid Mr. and Mrs. Brown twenty-six dollars. This amount was then turned over by the taxpayers to the trustee. Accordingly, these transactions manifested continued management of the trust property by the grantors even after the execution of the trust instrument. Thus, Brown may obviate the need for real managerial independence on the part of the trustee in applying the two-transaction approach.

Skemp and Brown illustrate that a valid trust is requisite to employment of the two-step analysis. Relinquishment by the grantor of control is critical to a determination that the trust is valid. Nevertheless, by concluding that the grantor had relinquished control, these cases did not have an opportunity to consider the consequences of a retention of control by the grantor. Subsequent decisions in other circuits and the Tax Court, however, have focused on this issue.

The Integrated Approach: Focus on A Business Purpose for the Gift

In Van Zandt v. Commissioner, the Fifth Circuit utilized the independence of the trustee as a measure of the grantor's dominion over the trust. Dr. Van Zandt set up two irrevocable trusts for terms of ten years and two months for the benefit of his sons and daughters. The physician donated to the trust medical equipment and a building in which he had offices. He retained a reversionary interest in the trust property and named himself as trustee. Immediately thereafter, Dr. Van Zandt, in his capacity as trustee, executed a lease of the equipment and building to himself.

The court held that the taxpayer's rental payments were not deductible under section 162(a)(3). It reasoned that the absence of

31. Id. at 928-29.
32. Id. at 928.
35. 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965).
36. Id. at 441.
37. Id. at 444.
an independent trustee exhibited the retention of control by the grantor.

By virtue of the taxpayer's failure to relinquish control over the trust, he retained the ability to determine the terms of the leaseback obligation. Consequently, the leaseback and the concomitant rental payments became inextricably tied to the trust established by the taxpayer. Thus, the court believed that the leaseback and original conveyance of property creating the trust had to be viewed as a single, integrated transaction. In order to sustain a deduction under section 162(a)(3), a business purpose was required for the gift as well as the leaseback.

The court's analysis in Van Zandt indicates that the grantor's retention of control defeats the presumption of validity necessary to the application of the two-step approach. In Skemp the court presumed the validity of the trust for purposes of deductibility because the taxpayer's relinquishment of control over the trust effectively divested him of authority concerning the leaseback obligation. In Van Zandt, control over the leaseback inhered in the grantor's dominion over the trust, and it was, therefore, appropriate to scrutinize the trust itself for purposes of deductibility. In analyzing Dr. Van Zandt's arrangement, the court found that there was no business purpose for the gift to the trust. It observed that the only purpose for the grantor's conveyance was to split his taxable income among his children. Further, the court recognized certain aspects of the arrangement which corroborated the absence of a business purpose. These factors included: (1) the short duration of the trust, (2) the reversion in the grantors, and (3) the predetermined leaseback which assured the taxpayer of the right to possession of the trust res.

However, reliance on these elements in finding no business purpose disturbs the progression of analytical steps under the integrated approach. A preliminary determinant to employment of an integrated analysis is the conclusion that the grantor failed to relinquish control. These factors should lead to a finding of retention of control by the grantor. However, they do not help in determining whether there was a business reason for the grantor's conveyance.

38. Id. at 443. Aitken, supra note 1, at 47; Tax Planning, supra note 1, at 236. See Oliver, supra note 1, at 29.
39. 341 F.2d at 443. See Aitken, supra note 1, at 47; Tax Planning, supra note 1, at 236-37.
40. 341 F.2d at 443. Aitken, supra note 1, at 47. See Tax Planning, supra note 1, at 237.
41. 341 F.2d at 444.
42. Id. at 443. See Willis & Pinzur, supra note 1, at 229.
Thus, the court's use of these elements to buttress its finding of the absence of a business motive is unsound.

Subsequently, in Perry v. United States, the Fourth Circuit relied heavily on Van Zandt in applying an integrated test to the gift and leaseback arrangement.\footnote{520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976).} Dr. Perry and his medical partner each established a Clifford Trust for the benefit of his children. They named the same bank as corporate trustee. The physicians then transferred an undivided one-half interest in their medical building to the respective trusts. The durations of the trusts were fourteen and ten years, respectively. Each corporate trustee was given broad administrative powers. Reversionary interests were reserved to the grantors. A leaseback of the medical building was arranged prior to the transfer of the trust corpus. The lease was then executed simultaneously with the trust instrument. The doctors made rental payments to the requisite trusts and sought to deduct the amounts under section 162(a)(3).\footnote{Id. at 236-37.}

The court held that the payments were not deductible because there was no business purpose to the transaction as a whole.\footnote{Id. at 239.} It indicated that in Van Zandt, the Fifth Circuit had emphasized the absence of an independent trustee in finding no business purpose. Accordingly, since the Perry leases were prearranged and were of the same length as the trusts, the court concluded that there was literally no area in which the bank's broad powers of management could operate. Hence, the trustee's independence from the settlors was largely illusory.\footnote{Id.}

However, the court's reliance on Van Zandt appears misdirected. In Van Zandt, the lack of an independent trustee pointed to the grantor's retention of control. This retention was not employed in determining the existence of a business purpose. Rather, it merely led to the employment of an integrated analysis. Thus, under the reasoning of Van Zandt, Dr. Perry's failure to relinquish control should have triggered the application of an integrated approach.

Nonetheless, in Perry the court chose a different analytical route in deciding to integrate the gift and leaseback elements. It reasoned that the Fourth Circuit's judicial custom of viewing transactions from an overall perspective compelled an integrated approach.\footnote{Id.} However, the case authority upon which the court relied to establish this custom is theoretically infirm. The cases cited by the court
arose in the context of a corporate distribution and reorganization. Integration in the corporate tax area should not necessarily lead to a similar approach with respect to a gift and leaseback arrangement.

In addition, the court indicated that its holding was consistent with Skemp. Although Skemp employed a two-transaction approach, the court noted that if an integrated analysis had been applied in Skemp, the Seventh Circuit’s holding would not have been altered. Two factual distinctions were utilized to support this conclusion. First, in Skemp, more property was conveyed to the trust than was leased back to the grantor. Consequently, a proper business purpose may have been found in the taxpayer’s desire to provide for effective management of the trust property. Dr. Skemp also retained no reversionary interest in the trust res. Hence, the

48. The Fourth Circuit cited De Treville v. United States, 445 F.2d 1306 (4th Cir. 1971); J.M. Turner & Co. v. Comm’r, 247 F.2d 370 (4th Cir. 1957); Starr v. Comm’r, 82 F.2d 964 (4th Cir. 1936), cert. denied, 298 U.S. 680 (1936) to support its use of an integrated analysis. In De Treville, a subchapter S corporation and its shareholders formed a new company. The old corporation received capital stock of the new company in exchange for real estate properties. At the end of the year, the corporation made a distribution of cash to its stockholders. The distribution was tax-free because it was not paid out of the company’s earnings and profits. Less than one week later each stockholder purchased from the company shares of stock equal in value to his share of the previous cash distribution. The Fourth Circuit held that the cash distribution and subsequent sale was utilized only after the shareholders discovered that a direct property distribution would not be tax-free. As a result, the transaction was viewed as a whole and for tax purposes there was a distribution of property (stock) rather than one of cash. 445 F.2d at 1308.

In J. M. Turner & Co., a sole proprietorship transferred all of its properties to a duly organized corporation. The president and principal stockholder acquired the newly formed corporation. The court held that these two steps did not constitute a tax-free sale and purchase but an exchange of stock for properties. The incorporation procedure was thus analyzed as an integrated transaction. 247 F.2d at 376-77.

In Starr, the shareholders of an existing corporation transferred common stock to a new corporation in exchange for the new corporation’s preference stock and cash. The stockholders also transferred what the court referred to as “special” stock in the old corporation for the new corporation’s common stock. The court held that these separate steps constituted an integrated transaction in carrying out a single general reorganization plan. As such, profits realized by the taxpayers as a result of the entire reorganization arrangement were taxable. 82 F.2d at 969.

49. 520 F.2d at 239.

50. Id.

51. Id. A transfer of property to a trust, some of which is leased by a party other than the grantor, would also pertain to the issue of the grantor’s relinquishment of control. Thus, if Dr. X transferred his medical building to an irrevocable trust and leased only part of it, the trust income would not be attributable solely to the grantor’s payments. This would reflect less control by the grantor as well as increased management functions delegated to the trustee. Under this view, the emphasis is on the degree of control retained, not the amount of control the donor surrendered in making the transfer. Brooke v. United States, 468 F.2d 1155, 1160 (9th Cir. 1972) (Ely, J. dissenting).
trustee's supervision of the property would not ultimately benefit the grantor.52

However, a prominent factual similarity overlooked by the court demonstrates that Perry is inconsistent with Skemp. Both cases involved prearranged leasebacks. In Perry, the court found this factor critical to its holding of no business purpose for the gift.53 Nevertheless, in Skemp, the presence of a prearranged leaseback did not prevent the court from employing the two-transaction approach, which presumes the existence of a business purpose.54

The Fourth Circuit also distinguished the facts in Brown v. Commissioner in two respects. The court noted that since the length of the lease in Brown was shorter than the duration of the trust, the taxpayer did not control the diversion of income to the beneficiaries throughout the entire term of the trust.55 However, this distinction is questionable. The crucial consideration should be the grantor's control for the period coterminous with the leaseback.56 The court further observed that unlike Perry, the rental payment in Brown was a continuation of the historic use of the trust res to produce

---

52. 520 F.2d at 239.
53. Id. at 238.
54. It has been suggested that a prearranged leaseback is the crucial element in defeating a relinquishment of control. Willis & Pinzur, supra note 1, at 229; Oliver, supra note 1, at 46. Willis & Pinzur suggest that a prearranged lease does not necessarily serve as a benefit to the grantor. If the grantor were forced to negotiate the lease in an open market after the execution of the trust, a higher rental payment might be necessary in order to lease the premises, and the taxpayer would have an opportunity to deflect even more income.

On the other hand, if the trustee were truly independent, the grantor would have no assurance of obtaining use of the property absent a prearranged lease. If prearrangement is a crucial factor in control, the taxpayer must balance the risk that control was not relinquished against the risk that another prospective tenant will rent the property.

The Internal Revenue Service also takes the position that a prearranged lease exhibits control by the grantor:

The independence of the trustee in reality disappears under circumstances where the transaction is prearranged. The grantor of the proposed trust will merely transfer the property to the trust with control reserved, thereby retaining the use and enjoyment of the property. The business of the grantor and the property in which it is conducted will remain undisturbed; there has been no parting with a real interest in the property involved which is requisite to the passage of a gift. In substance the grantor remains the owner of the property.

55. 520 F.2d at 239.
56. If the trust is of a greater duration than the lease, it does not necessarily lead to the conclusion that the grantor has divested himself of control for the period during which the trust is coterminous with the lease. See Mathews v. Comm'r, 520 F.2d 323, 325 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976) where the Fifth Circuit held that an initial lease of one year with an option to renew and a trust of 10 years and one day did not divest the grantor of control. The court was persuaded by the potential for the grantor to retain substantial control during the coterminous period.
income. Although this observation may be valid, it does not distinguish *Brown* from any other rental situation. A leaseback will invariably continue the historic use of the property for the production of income.

Moreover, *Perry* stands for the proposition that a trustee must perform actual managerial functions before a bona fide business purpose can be established. However, the managerial control exercised by the trustee in *Brown* was unclear. Thus, *Brown* is used to corroborate the result in *Perry* even though the trustee in *Brown* failed to achieve the threshold standard established by the Fourth Circuit.

The Integrated Approach: Focus on Economic Reality

The business purpose test employed in *Van Zandt* and *Perry* was eschewed by the Fifth Circuit in *Mathews v. Commissioner*. Mr. and Mrs. Mathews owned real property on which the Mathews Funeral Home was situated. They conveyed the real property to a Clifford Trust which had been established for their children. The grantors retained a reversionary interest upon termination of the trust. The property was then leased back from the trust under a prearranged agreement with the trustee, Mr. Mathews’ attorney. The court disallowed the rental payments as deductions under section 162(a)(3).

As in *Van Zandt*, the Fifth Circuit found that the grantor’s failure to relinquish control initiated the use of an integrated analysis. The court indicated that the prearranged lease and the grantor’s retention of a reversionary interest were germane to the issue of control.

Nonetheless, the court did not use a business purpose test to analyze the gift and leaseback transaction. The court observed that the validity of the trust was not established merely by the taxpayer’s allegation of a business purpose for its creation. Instead, the court explained that the gift and leaseback arrangement must...

---

57. 520 F.2d at 239-40.
58. *Id.* at 238. Willis & Pinzur, *supra* note 1, at 228.
59. 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976). The factual situation was similar to *Van Zandt*. The presence of an independent trustee in *Mathews* was the only distinction.
60. *Id.* at 324. The duration of the trust was 10 years and one day. The trust was made irrevocable, complying with §§ 673-677 of the Code.
61. *Id.* at 325.
62. *Id.* *See* note 54 *supra* for a discussion of the significance of a prearranged lease.
63. 520 F.2d at 325.
64. *Id.* *But see* Brooke v. United States, 468 F.2d 1155, 1159 (9th Cir. 1972) where Judge Ely in dissent noted that the prior law in the Ninth Circuit, as well as in the Second and Fifth Circuits, required a business purpose test. *See also* note 86 *infra.*
possess economic reality by substantially affecting the grantor's state of affairs. Since the transaction as a whole did not alter the grantor's financial position, the deduction of rental payments to an artificial entity would not be permitted.

The Fifth Circuit in Mathews deviated in two respects from its earlier opinion in Van Zandt. First the absence of an independent trustee led the court in Van Zandt to integrate the gift and lease-back elements. In Mathews, the Fifth Circuit did not dispute the independence of the trustee, yet it applied an integrated test. Further, in employing the integrated analysis, Mathews substitutes an economic reality test for the business purpose test introduced in Van Zandt. Economic reality is not defined. However, the court implies that the standard is more stringent than the business purpose rationale. As business justifications for their conveyance to the trust, Mr. and Mrs. Mathews claimed that they sought to isolate their property from liability and to discourage their employees from aspirations of a partnership position. The court surmised that these reasons were "conjured up by the taxpayer" and did not satisfy reality.

In addition, the imposition of an economic reality standard strays further from the language of section 162(a)(3) than the test formulated in Van Zandt. The statute refers to the deduction of rental payments "for purposes of the [taxpayer's] . . . business." Accordingly, the business purpose test may more accurately depict the standard articulated in the statute.

The Tax Court in Butler v. Commissioner applied the economic reality test formulated in Mathews. Dr. Butler transferred a medical building to a trust for the benefit of his wife and daughter. He retained a reversionary interest in the trust corpus. Under a prearranged plan he leased the property back from an independent bank trustee for the duration of the trust. The Tax Court held that the rental payments were not deductible under section 162(a)(3).

65. 520 F.2d at 325.
66. See text accompanying notes 38, 39 supra.
67. Economic reality has been attacked as defying definition. "Economic reality, like pornography, seems to be something which the court cannot define but which it can recognize." Aitken, supra note 1, at 49.
68. The court stated, "The fact taxpayers can conjure up some reason why a businessman would enter into this sort of arrangement—tax consequences aside—does not foreclose inquiry. Rather there must be 'economic reality'." 520 F.2d at 325.
69. Id. at 325 n. 7.
70. I.R.C. § 162(a)(3). See note 1 supra.
71. 65 T.C. 327 (1975).
72. Id. at 332.
Deductibility of Rental Payments

The Tax Court’s decision in Butler was colored by its application of the rule established in Golsen v. Commissioner. The Golsen rule represents a formulation of policy of the Tax Court. To avoid unnecessary litigation, the Tax Court will follow a decision of a particular circuit if the decision is squarely on point, and appeal from the Tax Court’s judgment lies to that circuit. The decision in Butler was appealable to the Fifth Circuit, which in Van Zandt and Mathews had utilized an integrated analysis. Consequently, application of the Golsen rule eliminated the need to determine whether there was a failure by the taxpayer to relinquish control, thus triggering an integrated approach. The Golsen rule, rather than the merits of the case, compelled the Tax Court to integrate the gift and leaseback elements and employ the standards of the Fifth Circuit.

The Tax Court found that the taxpayer had failed to establish a business purpose under the standard articulated in Van Zandt. The court observed that the stipulated facts did not indicate that the conveyance of the medical building was motivated by a desire to obtain managerial expertise, or any other business reason. In addition, application of the Mathews economic reality test permitted the court to consider other aspects of the arrangement which would not normally be subject to scrutiny in testing for a business purpose. The taxpayers argued that the existence of an independent trustee and the failure by the grantor to retain a reversionary interest should lead to a finding of deductibility. The court dismissed these contentions. It reasoned that since the trustee had no discretion except to decide the amounts to be distributed to the taxpayer’s children, and because possession of the property remained in the grantor, the arrangement did not comply with economic reality. Further, the court observed that the absence of the reversionary interest in the grantor was devoid of economic significance, as the holder of the interest was the grantor’s wife and partner on his joint tax return.

73. 54 T.C. 742 (1970), aff’d, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971).
75. 65 T.C. at 332.
76. Id. at 330.
77. Id. at 332.
78. Id. at 331.
79. Id. at 331-32. If the grantor had not filed a joint return with his wife, the absence of a reversionary interest may have caused the arrangement to satisfy the economic reality test. This could have been significant because in cases where the grantor did not retain a reversionary interest, the lease deduction was upheld if there was an independent trustee. Oakes v. Comm’r, 44 T.C. 524 (1965); Skemp v. Comm’r, 168 F.2d 598 (7th Cir. 1948). But see Penn
An economic reality test had been used by the Ninth Circuit prior to Mathews as the standard for assessing a gift and leaseback arrangement. In Brooke v. United States, the taxpayer deeded property to his children. Following the conveyances, he had himself appointed guardian of his children by the Montana State Probate Court. As guardian, Dr. Brooke performed the functions of a trustee. He collected rent and applied it to the children's insurance, health and education.

The Ninth Circuit determined that the guardianship constituted a trust under section 677 of the Internal Revenue Code. Initially, the court focused on the validity of the trust as an independent entity for purposes of deductibility. It alluded to certain aspects of the arrangement as indicative of the trust's sufficiency. The court noted that the property was not being used for the donor's benefit because the expenditures were not the guardian's legal obligations under Montana law. Further, it found that the "trustee" was independent. One of the crucial elements of this conclusion was the stringent set of fiduciary standards which state law imposed on the guardian. Nonetheless, after concluding that these factors evidenced the viability of the trust, the court applied an economic reality analysis as a final test of the trust's validity. It concluded

80. The Tax Court also had applied an economic reality test to a gift and leaseback arrangement in Oakes v. Comm'r, 44 T.C. 524 (1965) and Felix v. Comm'r, 21 T.C. 794 (1954). 81. 468 F.2d at 1155 (9th Cir. 1972). 82. Id. at 1157. 83. Id. 84. Id. at 1158. The court does not provide substantial authority for this conclusion. In dealing with this issue the court states:

The Government further argues that even if deductions under 26 U.S.C. § 162(a) are allowable, expenditures for the children's benefit merely serve to satisfy the taxpayer's legal obligations to support them imposed by 26 U.S.C. § 677(b) and therefore are not allowable. The District Court determined that Rev.Rul. 56-484, 1956-2 C.B. at 23, establishes the applicability of local law in construing the meaning of support in Section 677(b). Montana law provides:

'The parent entitled to the custody of a child must give him support and education suitable to his circumstances.' Mont. Rev. Codes § 61-104.

The District Court held that the expenditures made were not the legal obligations of the taxpayer under Montana law. The only authority cited by the Government which suggests the contrary, ... is entirely limited to its facts.

A finding that the property was used to fulfill the grantor's support obligation may have vitiated the transaction under an economic reality test.

85. Id.

86. The court stated, "Neither substance nor impact denies this transfer professional or economic reality." 468 F.2d at 1158. Judge Ely in a strong dissent indicated that the court
that the taxpayer’s non-tax motives for the property transfer were consistent with economic reality. The non-tax motives advanced by Dr. Brooke were his desire to provide for the health and welfare of his children, avoid friction with his partners in his medical profession, withdraw his assets from the threat of malpractice suits, and diminish the ethical conflict resulting from ownership of a medical practice with an adjoining pharmacy. However, as acknowledged by Judge Ely in dissent, whether these justifications would have satisfied a business purpose test is subject to doubt.

In applying an economic reality standard the Ninth Circuit, unlike the Fifth Circuit in Mathews, did not integrate the gift and leaseback elements. Instead, the court viewed the components as two distinct transactions and required only the initial gift to possess economic reality. By satisfying this standard, the validity of the trust was established. Accordingly, leasing the property back from the trust followed as a business necessity. Hence, the grantor was entitled to a rental deduction under section 162(a)(3).

The Mathews Tax Court Test

The Tax Court in Mathews v. Commissioner formulated specific parameters to determine the deductibility of rental payments under a gift and leaseback arrangement. Although its decision was reversed by the Fifth Circuit, the standards themselves were not overturned. Moreover, the Tax Court has relied upon them in subse-

was compelled to adhere to the business purpose test as promulgated by other decisions in the Ninth Circuit. He also noted that the Second and Fifth Circuits utilized a business purpose standard in analyzing a gift and leaseback, citing as support White v. Fitzpatrick, 193 F.2d 398, 402 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952); Van Zandt v. Comm’r, 341 F.2d 440, 443 (5th Cir.), cert. denied, 382 U.S. 814 (1965). However, Ely did not mention, but the majority did note, Gilbert v. Comm’r, 248 F.2d 399 (2d Cir. 1957) in which the Second Circuit required that the transfer of the gift to a trust be grounded in substantial economic reality.

In the only gift and leaseback case heard by the Sixth Circuit, the Court of Appeals reversed the Tax Court decision allowing taxpayer’s rental deduction. Although the reversal was on other grounds, the Court of Appeals took a strict view of a gift and leaseback transaction by holding that the trust income was includable in the grantor’s gross income. The Sixth Circuit did not make it clear whether it would use a business purpose or economic reality test as a standard for assessing a gift and leaseback arrangement. Duffy v. United States, 487 F.2d 282 (6th Cir. 1973), rev’g on other grounds 343 F. Supp. 4 (S.D. Ohio 1972), cert. denied, 416 U.S. 938 (1974).

87. 468 F.2d at 1158.
88. Id.
89. In Brooke, economic reality is thus used as a less stringent standard than a business purpose test. In Mathews, the Fifth Circuit used economic reality as a more stringent standard in analyzing a gift and leaseback. See text accompanying note 68 supra.
90. 468 F.2d at 1157-58.
91. 61 T.C. 12 (1973), rev’d, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976).
sequent cases. The court held that rent paid by a grantor to a trustee in a gift and leaseback arrangement is deductible under section 162(a)(3) if four requirements are met: (1) The grantor must not retain substantially the same control over the property as he had before he made the gift. (2) The leaseback should normally be in writing and must require payment of a reasonable rental. (3) The leaseback (as distinguished from the gift) must have a bona fide business purpose. (4) The taxpayer must not possess a disqualifying equity in the property within the meaning of section 162(a)(3).

In Serbousek v. Commissioner, the Tax Court demonstrated its devotion to these guidelines absent the obligation under Golsen to apply the rationale of a specific circuit. Serbousek involved the transfer by two doctors of their medical facility to irrevocable trusts. The children of the grantors were beneficiaries of the respective trusts and the wives were remaindermen. After the transfer to the trusts, an independent bank trustee negotiated a lease of the building to the doctors at a rental of $400 per month.

The Tax Court held that the rental payments were deductible under section 162(a)(3). It adhered to the parameters which it had delineated in Mathews. The court found that the grantor had relinquished control over the trust property. It observed that the presence of an independent trustee who had actual managerial functions evidenced the grantor's relinquishment. The absence of a prearranged lease and reversion in the grantor further neutralized the grantor's influence. The second condition outlined in Mathews, that the leaseback be in writing and for a reasonable rental, was not disputed. Similarly, the grantor's failure to reserve a reversionary interest thwarted any argument that he had retained a disqualifying equity.

92. See text accompanying notes 95, 105 infra. See also Aitken, supra note 1, at 49.
93. If the first two conditions are fulfilled, it becomes a necessity for the grantor to lease his property in order to carry on business and the third condition will nearly always be met. The factual situation in Mathews might be an exception. A funeral home was located on the property to be leased. The demand for the facility would not, in all probability, be very great. Consequently, the property would not have a high rental value on the open market. This differs from the typical situation where the conveyed property houses an office building with the potential to be in considerable demand.
94. 61 T.C. at 19.
95. 36 T.C.M. (CCH) 479 (1977).
96. The Tax Court in Serbousek made it clear that its decision in Butler was mandated by the Golsen rule. 36 T.C.M. at 481 n. 7. That is the reason the Tax Court in Butler did not discuss the requirements it applied in Mathews. See text accompanying note 74 supra.
97. 36 T.C.M. at 480.
98. Id. at 483. Willis & Pinzur, supra note 1, at 229.
99. 36 T.C.M. at 482. Willis & Pinzur, supra note 1, at 229.
The court found that there was a bona fide business purpose for the leaseback element because the medical building was necessary for Dr. Serbousek to carry on his practice. In reaffirming its position in Mathews requiring a business motive solely for the leaseback, the Tax Court emphasized that in future cases it would not use an integrated approach unless the Golsen rule was applicable.

In addition, the Tax Court in Serbousek maintained that the four conditions which it had articulated in Mathews were consistent with the Fifth Circuit's economic reality test. However, the court failed to note that one of the requirements of the Mathews test contradicts the economic reality standard. The Mathews test requires a business purpose only for the leaseback. On the other hand, the economic reality rationale is used to scrutinize the entire gift and leaseback arrangement in the Fifth Circuit. Furthermore, the Fifth Circuit has stressed that a "conjured up" business purpose will not clothe the transaction with economic reality.

Subsequently, in Quinlivan v. Commissioner, the Tax Court further illustrated how fulfillment of the Mathews guidelines gives rise to a deduction under section 162(a)(3). Two attorneys transferred to separate trusts their respective interests in the building which housed their law offices. Both taxpayers named their children as beneficiaries. After the conveyance, each grantor entered into a lease with an independent bank trustee. The leaseback was for a reasonable rental and was not prearranged. The grantors retained

100. 36 T.C.M. at 483. See Willis & Pinzur, supra note 1, at 229.
101. Id. at 483. The Golsen rule requires an integrated analysis when appeal lies to the Fifth Circuit. Butler v. Comm'r, 65 T.C. 327 (1975). In Lerner v. Comm'r, 71 T.C. No. 24 (Nov. 27, 1978) appeal could be made to the Second Circuit, which had previously applied an integrated analysis approach in a case involving an outright transfer and leaseback. See White v. Fitzpatrick, 193 F.2d 398, 402 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952). See also Note, Gift and Leaseback: A Continuing Tax Controversy, 4 Loy. Cm. L. J. 371 (1973). The Golsen rule did not apply in Lerner because the case was not squarely on point due to the presence of a corporation. See text accompanying note 112, infra. However, the court, in dictum, analyzed the case as if the lessee were not a corporation, in which case Golsen conceivably would apply and an integrated test would be appropriate. Yet, the Tax Court applied the Mathews guidelines, one of which calls for only the leaseback to be scrutinized for a business purpose.
102. 36 T.C.M. at 482.
103. However, the Ninth Circuit's analysis in Brooke v. United States required only that the transfer of the gift to the trust be grounded in economic reality. 468 F.2d at 1158.
104. See text accompanying notes 67, 68 supra. The absence of a prearranged lease in Serbousek would have produced the same result whether an economic reality or business purpose standard was used. If there had been no prearranged lease in Mathews, the Fifth Circuit's opinion implies that even under an economic reality analysis, the rental deductions would have been allowed.
105. 37 T.C.M. (CCH) 346 (1978).
reversionary interests in the respective trusts.\footnote{106}

The Tax Court held that the four Mathews requirements had been met and allowed the leaseback deductions.\footnote{107} It observed that the trustee's power to periodically renegotiate the leases evidenced the trustee's independence.\footnote{108} Accordingly, it viewed this independence, along with the arrangement of the lease subsequent to the establishment of the trust, as determinative of the grantor's surrendering control. Further, the grantor's retention of a reversionary interest did not prevent the court from finding a relinquishment of control.\footnote{109}

In addition, the court concluded that the reversionary interest did not constitute a disqualifying equity under section 162(a)(3). It recognized that if the lessee's property rights are derived from the lessor or become possessory during the lease, the statute precludes a deduction. Since the grantor's reversionary interest was attributable to the trust instrument and would take effect after the lease expired, a deduction would not be foreclosed.\footnote{110}

\footnote{106. Id. at 347.} \footnote{107. Id. at 348-49.} \footnote{108. Id. at 348. But see Mathews where the Fifth Circuit, reversing the Tax Court, addressed the trustee's power to negotiate, though not to renegotiate, the lease as a factor in analyzing the economic reality of the transaction as a whole. The court stated, "[T]he fact rent negotiations produced 'reasonable' results is totally irrelevant. Any bargaining is simply not at arm's length, because any rent exceeding expenses stays in the Mathews [grantor's] family." 520 F.2d 323, 325 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976).} \footnote{109. 37 T.C.M. at 348.} \footnote{110. Id. at 349. In arriving at this conclusion the Tax Court relied on its earlier opinion in Mathews. In that discussion, the court interpreted section 162(a)(3) to mean that the property in which the grantor may not take title or have an equity is limited to the particular property rights owned by the lessor at the inception of the lease and forming the subject matter of the lease. Accordingly, in the typical gift and leaseback arrangement, the only property owned by the lessor-trust is the term of years that constituted the trust corpus. The lessee at no time during the duration of the trust acquired from the lessor any part of his reversionary interest. 61 T.C. at 20.}

The Tax Court in Mathews also analyzed the statutory language in order to buttress this conclusion. The court noted that the disjunctive "or" rather than the conjunctive "and" is used after the phrase "the taxpayer has not taken or is not taking title." According to the court, the rent would be legitimate if the taxpayer "has not taken or is not taking title without regard to whether he has an 'equity.'" Furthermore, even if title were taken, the rental for the property would not be rendered nondeductible by the taking title language unless the taxpayer had an equity. Thus, under the court's interpretation, the actual language of the statute requires the exclusion of only one of the three enumerated conditions. However, if the disjunctive "or[s]" were meant to be interpreted in the conjunctive sense, the court posits that the equity clause should be read together with the preceding language. Thus "the kind of 'equity' in the 'property' referred to must be one 'taken' (from the lessor), or at least overlapping a purported ownership interest of the lessor." 61 T.C. at 22.

On the other hand, it is equally plausible to interpret the statute in the conjunctive sense and require that the taxpayer neither have taken nor be in the process of taking title, nor have an equity in the property. The Tax Court recognized that if the equity clause stands
LEASEBACK BY A CORPORATION

A new twist to the gift and leaseback arrangement was attempted in *Lerner v. Commissioner*.

Dr. Lerner created a Clifford Trust for the benefit of his children. His attorney was named as trustee. Upon termination of the trust, the corpus and any accumulated income was to revert to the grantor. Subsequently, Dr. Lerner transferred to the trust medical equipment and other property used in his practice.

At the same time as the creation of the trust, Dr. Lerner incorporated his practice under the laws of the state of New York. He functioned as the corporation's sole shareholder, director, and president. His wife was the corporation's secretary. On the same day, Dr. Lerner executed a lease of the medical equipment from the trust. He did this in his capacity as president of the corporation. The length of the lease was coterminous with the duration of the trust. During the course of the arrangement, Dr. Lerner requested that the trustee loan him money from the trust at favorable interest rates. The trustee refused to accede to the request. Additionally, the trustee resisted several requests to purchase medical equipment, although on some occasions the trustee did acquire the equipment and lease it to the corporation.

The Tax Court held that the rental payments made by the corporation to the trust were deductible business expenses under section...
162(a)(3). supra. It observed that the property covered by the lease was used by the corporation in its business. Further it emphasized that the corporation was a separate taxable entity apart from the grantor.\textsuperscript{14}

The execution of this type of corporate leaseback is subject to question under the business purpose and economic reality tests articulated in \textit{Van Zandt} and \textit{Mathews}.\textsuperscript{15} Nonetheless, the \textit{Golsen} rule did not require the court to follow circuit court decisions employing these standards.\textsuperscript{16} Thus, the issue was not considered.

As an addendum to its analysis, the court considered the arrangement under the \textit{Mathews} guidelines. It indicated that the requirements of a written lease for a reasonable rental, a business purpose for the leaseback, and the absence of a disqualifying equity were readily met. Consequently, the court focused on whether the grantor had relinquished control.\textsuperscript{17} It explained that the trustee's independent actions evidenced the grantor's lack of control. The trustee's reliance on Dr. Lerner's advice in purchasing equipment was not found to be significant. Rather, the court was persuaded by the trustee's resistance to the grantor's efforts to purchase certain equipment and borrow funds at favorable rates.\textsuperscript{18}

\section*{Resolving the Conflict}

The procession of gift and leaseback opinions has failed to produce a uniform set of guidelines for the taxpayer to follow. The

\begin{itemize}
\item \textsuperscript{113} Id. at 3732.
\item \textsuperscript{114} Id. at 3731. For that reason, the court dismissed the holdings in \textit{Hall v. United States}, 208 F. Supp. 584 (N.D.N.Y. 1962) and \textit{Miles v. Comm'r}, 41 T.C. 165 (1963), two partnership cases. In each, the trust \textit{res} was leased to partnerships in which the grantors, or related individuals, were partners. The cases were inapposite because partnerships, unlike corporations, are not distinct taxable entities. 71 T.C. at 3731; I.R.C. § 701; A. Willis, \textit{PARTNERSHIP TAXATION} § 2.02-03 (2d. ed. 1976).
\item \textsuperscript{115} In \textit{Lerner} factors were present which heretofore had led the courts to find that the grantor had not relinquished control. These included a reversion in the grantor, the presence of a prearranged lease, a lease covering the full duration of the trust, and a lease of all of the property conveyed to the trust. Implicit in the court's holding is that the creation of the corporation is per se sufficient to divest the grantor of control. Once control by the grantor is eliminated, and the necessity of renting the property to carry on business is established, the rental deduction is allowed.
\item \textsuperscript{116} The argument that a reversionary interest in the grantor results in an equity that violates section 162(a)(3) of the Internal Revenue Code is inapplicable in \textit{Lerner}. Here, the corporation, rather than the grantor, was paying the rent and the corporation could not conceivably have any title or equity in the leased property. 71 T.C. at 3732.
\item \textsuperscript{118} This is the first requirement under the \textit{Mathews} test.
\item \textsuperscript{119} 71 T.C. at 3736.
\end{itemize}
circuits differ with respect to whether an integrated or a two-step analysis will be performed. There is also intracircuit, as well as intercircuit, disagreement as to whether a business purpose or economic reality test will be applied. Further, the circuits vary with respect to what constitutes a relinquishment of control over the trust by the grantor. The result is uncertainty by the taxpayer and the Commissioner regarding the precise characteristics the gift-leaseback must possess in order to elicit judicial approval.

The discord among the courts can best be resolved and the flood of litigation stemmed by Congressional action. One possible approach by Congress would be to adopt a two-step analysis employing a business purpose standard similar to that of the Tax Court in Mathews. Sections 671-677 of the Code establish the validity of a Clifford Trust for purposes of assigning income.\textsuperscript{119} The two-step analysis, which recognizes the validity of the trust and focuses the search for a business purpose on the leaseback,\textsuperscript{120} appears to be the approach most consistent with the Clifford Trust provisions.

Until there is specific statutory authority, the taxpayer must continue to use the courts as his guide. In structuring an arrangement to successfully procure a deduction, several points should be kept in mind. The grantor should relinquish control in every conceivable way. Toward this goal, the trustee should be an independent fiduciary exercising managerial control over the trust. The leaseback should not be prearranged and should be less than the entire term of the trust. If possible, trust income should not be exclusively derived from the grantor. This serves the dual purpose of extricating the grantor from control of the trust and enabling the trustee to exhibit management authority in areas outside of his dealings with the grantor. Finally, the grantor should not retain a reversionary interest.

**CONCLUSION**

When the gift and leaseback are viewed as two independent transactions a bona fide business purpose for the rental payments will follow as a matter of course. On the other hand, under an integrated approach, it is unlikely the court will find that the arrangement comports with a bona fide business justification or economic reality. Thus, the key question is whether the gift and leaseback elements will be viewed separately or from an overall perspective. Recent decisions of the Tax Court demonstrate that it will adhere to the

\textsuperscript{119} See text accompanying note 12 supra.
\textsuperscript{120} See text accompanying notes 17, 18 supra.
four *Mathews* parameters and apply a two-transaction approach unless *Golsen* compels otherwise.

The key to a judicially approved tax deduction remains elusive in light of the discordant approaches applied by the courts. Not until Congress legislates in the area will the controversy become quiescent.

MICHAEL R. GOLDFEIN