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Eugene L. Mahoney

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GIFT AND LEASEBACK: A CONTINUING TAX CONTROVERSY

The deductibility for federal income tax purposes of rental payments made to a related party under a gift and leaseback continues to elicit judicial scrutiny. Several circuits of the Court of Appeals have allowed tax deductions for rental payments on a leaseback of property placed in trust by concentrating on the legal relationships between the donee and the lessee. Other circuits have denied rental deductions if the gift and leaseback as an integrated transaction does not serve a sound business purpose. The better view in determining the deductibility of rental payments would seem to emphasize the legal relationships between the parties when the motive of tax avoidance does not predominate.

The federal courts generally do not allow a taxpayer to circumvent the spirit of the taxing statutes by mere compliance with the statutory formalities. This judicial position, known as the doctrine of substance over form, involves the court in a careful analysis of the statutory language in dispute between the taxpayer and the federal government. If the language contains some ambiguity, the federal courts review the congressional reports that preceded the enactment of the provisions of the Internal Revenue Code of 1954 to determine what evils Congress intended to prevent or what economic benefits Congress intended to provide by the enactment of the sections of the taxing statute under scrutiny. As a further means of implementing the doctrine of substance over form, the federal courts will also examine the totality of the taxpayer's separate business activities to see if the legal formalities of the taxpayer's activities have genuine economic substance. This inquiry, the "sound business purpose" test, applies particularly to cases of a gift and leaseback of property placed in trust. In a gift and leaseback of trust property the grantor leases the property back for a rental payment. The requirements for a federal income tax deduction of such

1. Hereinafter referred to as the INTERNAL REVENUE CODE or the CODE.
rental payments have generated a great amount of conflicting commentary among the circuits of the federal Court of Appeals and in the United States Tax Court. However, the circuits have agreed that in arriving at a decision in a gift and leaseback case, the following factors are relevant: (1) the duration of the transfer, (2) the controls retained by the donor, (3) the use of the gift property for the benefit of the donor, and (4) the independence of the trustee.

**Equity Interest**

All of the circuits have agreed that after the gift and leaseback the grantor must not have any equity in the property, but the circuits have disagreed on the definition of a continuing equity interest. The Second and the Fifth Circuits have stated that if the grantor has indirect but continuing control of the property, he has an equity interest in fact, if not in law. The Ninth Circuit, while agreeing with the Second and the Fifth Circuits, has decided that if an independent third party such as a state court has supervisory powers over the use and disposition of the property, the grantor's continued management of the property will not necessarily warrant a court's finding of a continuing equity interest in the grantor. The Third and the Seventh Circuits have concentrated on the legal rights in the property and have not imputed an equitable interest to the grantor who has continued to manage the property indirectly after a gift and leaseback.

To qualify a rental payment for an income tax deduction under section 162(a)(3) of the Internal Revenue Code the taxpayer must not take or have taken title to or any equity in the property. In _Brooke v. United States_ the grantor made a gift of real property improved by a pharmacy, a rental apartment, and the offices of his medical practice. The transfer to the grantor's minor children was absolute by an unen-
cumbered warranty deed. The grantor on a leaseback of the property made rental payments to himself as guardian of his minor children's estates. The Ninth Circuit allowed him a deduction for the rental payments partly because he did not retain the legal right to the ownership of the property at the end of his guardianship.

The federal courts have denied a deduction for rents paid on the leaseback of the property when the grantor retains the legal right to claim the property after a determinate or indeterminate period. The courts have based the denial upon the continuing proscribed equity interest of the grantor-lessee. In *Van Zandt v. Commissioner*, a case involving a physician who created irrevocable trusts for ten years and two months, the Fifth Circuit Court of Appeals denied the taxpayer's claim to a rental deduction partly because of the taxpayer's reversion in the property. In *Hall v. United States* physicians created trusts that conveyed to the beneficiaries, their minor children, the income of the trust property for an indeterminate period in excess of ten years. The district court denied rental deductions to the grantors-lessees because the corpora of the trusts under no conditions could pass to the beneficiaries or ultimately escape from the ownership and control of the grantors. Similarly some federal courts have regarded the retention by the grantor-lessee of indirect control and management of the transferred property as an equity interest and have denied a rental deduction on his subsequent lease of the property. Therefore the mere creation of legal title in the donee is insufficient to divest the grantor of an equitable interest in the property, if by formal or informal arrangement the donor retains administrative control and dominion over the property.

Despite a transfer of his entire interest in the property to the donee, any rental payments made by the grantor to the donee on a subsequent leaseback may be nondeductible if the grantor's entire interest in the

10. *Id.* at 444.
12. *Id.* at 588. The court said:
   The trustee certainly holds the legal title to the trust property but no one, other than the grantors or their estates, can ever acquire a fee interest therein. The beneficial interest always remains with the taxpayer. Even though the trustee has the power of sale, it owed such a duty to the grantors as a fiduciary as to require the protection of their interest. In any event, it would seem that the grantors had an equity in the premises at least until the power of sale was exercised and for that reason also the Commissioner was right in disallowing the deduction.
14. *Id.* at 401.
property is less than a fee simple interest. In *Kirschenmann v. Westover*\(^\text{15}\) the taxpayers entered into an agreement to purchase land and then transferred without consideration their entire interest in the mortgaged land to their minor daughter. The taxpayers paid rent for their continued use of the land to their minor daughter's legal guardian, a brother of one of the taxpayers. While claiming a federal income tax deduction for the rental payments, which the minor daughter's legal guardian used to pay the balance due under the land purchase agreement, the taxpayers exercised the same control over the property after the transfer as they had exercised over the property before the transfer. The court rested its decision on the premise that tax consequences depend upon the actual substance and not the formal aspects of a transaction.\(^\text{16}\) After concluding that the taxpayer's rental payments were excessive in amount and not ordinary and necessary expenses,\(^\text{17}\) the Ninth Circuit stated that the rental payments were not deductible.\(^\text{18}\)

The Internal Revenue Service has taken a similarly restrictive position. The Service has stated that rental payments made to a trust by the grantor will not constitute deductible business expenses if the grantor has the privilege of leasing back the property placed in trust for a determinate period such as ten years because the grantor has not parted with a sufficient interest in the property requisite to the making of a gift.\(^\text{19}\) The business of the grantor and the property in which he conducts such business remain undisturbed.\(^\text{20}\) In substance the grantor remains the owner of the property.\(^\text{21}\)

In view of the restrictive positions of the Internal Revenue Service and several of the circuits the grantor can attempt to preserve his deduction on a leaseback transaction by amending the trust agreement to divest himself of any continuing or contingent equity interest in the property. However, in considering the federal income tax consequences of a relinquishment of a reversionary interest the United States Tax

\(^{15}\) Rev. Rul. 71, 1954-1 CUM. BULL. 20, 22.

\(^{16}\) *Id.* at 70.

\(^{17}\) *Id.* at 70.

\(^{18}\) *Id.*

\(^{19}\) *Id.*
Gift and Leaseback

Court has produced conflicting precedent. In *Oakes v. Commissioner*\(^{22}\) the Tax Court sustained a deduction for a lease payment made by the grantor-lessee after the grantor conveyed his reversionary interest in the trust corpus to his wife.\(^{23}\) The Tax Court, after concluding that the grantor had no business reason for making the gift,\(^{24}\) denied the necessity of inquiring into the presence or absence of business purposes when the grantor gives property over which he retains no control to a valid irrevocable trust and then leases it back.\(^{25}\) On the other hand, in *Penn v. Commissioner*,\(^{26}\) after relinquishing his reversionary interest, the grantor-lessee of property placed in trust was still unable to secure a rental deduction because the Tax Court concluded that the taxpayer's dominion and control over the trust property did not diminish significantly by the conveyance of his reversionary interest therein within the family group.\(^{27}\)

The conflicting decisions within the Tax Court reflect the conflicting decisions within the several circuits of the Court of Appeals. The Ninth Circuit has previously decided many gift and leaseback cases against the taxpayer when tax avoidance motives have predominated. Generally the Ninth Circuit\(^{28}\) has denied a deduction for rental payments in cases in which the grantor-lessee has not relinquished the dominion and control of the property consonant with actual ownership. In the Third\(^{29}\) and Seventh Circuits\(^{30}\) taxpayers have secured an income tax deduction for rental payments on leasebacks of trust property when the rental payments were not excessive in amount and the taxpayers retained no legal interest in the leased property. The Internal Revenue Service has generally contested\(^{31}\) and not acquiesced\(^{32}\) in decisions which have stressed the legal ownership of the property. The Service prefers those decisions which have focused on the actual exercise of dominion and control by the grantor-lessee because the Service consid-

\(^{22}\) 44 T.C. 524 (1965).
\(^{23}\) *Id.* at 530.
\(^{24}\) *Id.* at 532.
\(^{25}\) *Id.*
\(^{26}\) 51 T.C. 144 (1968).
\(^{27}\) *Id.* at 154.
\(^{30}\) Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).
\(^{31}\) *Oakes v. Commissioner* arose in the Sixth Circuit Court of Appeals which on February 14, 1966 and on the government's motion dismissed the government's appeal of the Tax Court's decision in favor of the taxpayer. *p. 91,470 CCH 1972 STAND. FED. TAX REP.*
\(^{32}\) The Internal Revenue Service subsequently expressed its nonacquiescence in the Tax Court's decision in *Oakes v. Commissioner*. 1967-1 CUM. BULL. 3.
ers such decisions to accurately reflect the substance of the transaction. In this type of "integrated transaction" analysis the legal arguments most likely to remain persuasive and most likely to fit within the spirit of the statutory language of the Internal Revenue Code of 1954 have stressed substance over form, and have denied a deduction for rental payments made by a grantor-lessee on a gift and leaseback that had no other purpose than to secure a deduction and that did not divest the taxpayer of effective dominion and control of the property placed in trust. This preferred view has received the support of the Ninth Circuit in its holding in the *Brooke* case.

**TAX AVOIDANCE AND THE SOUND BUSINESS PURPOSE TEST**

Taxpayers have a legal right to avoid taxes. But an individual cannot use a gift and leaseback arrangement to secure a federal income tax deduction if the transfer of property is a sham or fraud or has no substantial economic reality. Generally courts will not recognize a transfer of property solely to avoid taxes. Although some courts require a "sound business purpose" for a gift and leaseback before the arrangement qualifies for a deduction as a business expense, other courts have expressly eschewed this test and have required only that substantial economic reality inhere in the transfer and leaseback of property. These courts have found substantial economic reality by concentrating on the legal rights and duties established after the gift and leaseback. For example, in *Brooke v. United States*, the Ninth Circuit held:

33. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935). In the lower court opinion, 69 F.2d at 810-11, Judge Learned Hand wrote:

   We agree with the Board [of Tax Appeals] and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.... Therefore, if what was done here, was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.

34. *Brooke v. United States*, 468 F.2d 1155, 1158 (9th Cir. 1972).

35. *Id.*


38. In Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948), the court said:
Circuit, which did not expressly adopt the "sound business purpose" test, noted the lack of unanimity in its application by other courts. In *Brooke* the circuit court affirmed the finding of the district court that the gift and leaseback had a professional or economic reality because of the non-tax motives: to provide for the health and education of his children, to avoid friction with partners in his medical practice, to withdraw his assets from the threat of malpractice suits, and to diminish the ethical conflict arising from ownership of a medical practice with an adjoining pharmacy.\(^8\)

The holding in *Brooke* was not unanimous. In his dissent Judge Ely stated that the prior law\(^40\) in the Ninth Circuit subjected a gift and leaseback transaction to scrutiny under the business purpose test.\(^41\) Under that test rentals are not valid deductions as business expenses unless there is a legitimate business purpose motivating the transfer of the leased property.\(^42\) He also noted that although the district court allowed a deduction for rental payments to the grantor,\(^43\) the court found as a fact that the transfer did not serve any substantial business purpose,\(^44\) but the district court did allow a tax deduction for the rental payments made by the grantor. Judge Ely conceded that early cases adopting the business purpose test for a gift and leaseback failed to recognize that usually the motive for a gift, unlike a sale, of business property is not a business purpose. In his view the distinction between a sale

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While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments. In this case we have a valid irrevocable trust, wholly divesting the taxpayer of any interest in the trust property, and an agreement by the taxpayer to pay the trustee a reasonable rental under a valid lease. . . . We have here only a question of deduction of rental from gross income. There can be no question but what rent required to be paid is properly deductible. The trustee was duty bound to exact rent of the taxpayer and the taxpayer was legally bound to pay it, just as much as if the taxpayer had moved across the street into the property of a third party. No one doubts that he would have had to pay rent then, and would have been entitled to deduct it even though he had voluntarily created that situation. We are not impressed with the argument of the Government that the taxpayer voluntarily created the present situation.

39. 468 F.2d at 1158.
41. 468 F.2d at 1159.
42. *Id.*
43. *Id.*
44. In *Brooke v. United States*, 292 F. Supp. 571, 572 (D. Mont. 1968), the district court, reiterating the dicta of *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948), wrote:

> When taxpayer used the property, he had an obligation created by law to pay rent in at least a reasonable amount. I think it artificial to hold that the rents which had to be paid as a matter of law for necessary office space, were not necessary expenses. The transaction is judged at the time the rent is paid and not when the gift is made.
and a gift is important only if the finder of fact treats the gift and subsequent leaseback as separate and independent transactions.\textsuperscript{46} The integration analysis adhered to by Judge Ely is consistent with the views of the Second\textsuperscript{46} and the Fifth Circuits.\textsuperscript{47} Moreover, in cases prior to \textit{Brooke} such as \textit{Kirschenmann v. Westover}, the Ninth Circuit had also applied an integration analysis in keeping with the "sound business purpose" test.

\textit{Brooke v. United States} may mark in the Ninth Circuit the beginning of a lessening of the need to show predominating non-tax business motives for a rental deduction in a gift and leaseback transaction. Like the \textit{Brooke} decision the Third\textsuperscript{48} and the Seventh Circuits have allowed rental deductions in cases in which the legal relationships after the gift and leaseback of property have necessitated the payment of reasonable rentals by the grantor-lessee. The payment of reasonable rentals has established the substantial economic reality of the transaction which in the courts' views has justified the tax deduction. Consistent with this approach the Seventh Circuit in \textit{Skemp v. Commissioner}\textsuperscript{50} allowed rental deductions to a settlor-lessee because the lease agreement had substantial economic reality. In \textit{Skemp} the trustee and the taxpayer entered into an apparently prearranged lease which granted the entire premises to the taxpayer for ten years. Furthermore the taxpayer as settlor of the trust provided in his trust agreement that the settlor shall have the option of renting all or any part of the real estate in this trust at a rental determined by the trustee. The court did not view these facts as sufficient to destroy the finding of substantial economic reality in this transaction. Following the holding in the \textit{Skemp} case, the Third Circuit in \textit{Brown v. Commissioner}\textsuperscript{51} allowed the taxpayers, grantors-lessors of trust property, to deduct rentals as business expenses\textsuperscript{52} in computing net taxable income notwithstanding

\begin{footnotesize}
\textsuperscript{45} Brooke v. United States, 468 F.2d 1155, 1160 (9th Cir. 1972).
\textsuperscript{46} White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), \textit{cert. denied}, 343 U.S. 928 (1952).
\textsuperscript{47} Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), \textit{cert. denied}, 382 U.S. 814 (1965).
\textsuperscript{49} Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).
\textsuperscript{50} \textit{Id.}
\textsuperscript{52} The INT. REV. CODE of 1939, § 23(a)(1)(A) provided:
In computing net income there shall be allowed as deductions:
(a) Expenses.
(1) Trade or business expenses.
(A) In general.
All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other
\end{footnotesize}
that the lease arose pursuant to a prior understanding between the taxpayers and the prospective trustee.\textsuperscript{53}

On the other hand, in \emph{Van Zandt v. Commissioner}\textsuperscript{54} the Fifth Circuit denied a federal income tax deduction for rental payments made by the taxpayer who conveyed property for ten years and two months under an irrevocable trust and shortly thereafter leased back the property.\textsuperscript{55} The court stated that in determining whether the rental payments were ordinary and necessary expenses, it must regard the conveyance and the leaseback as a whole rather than as isolated acts. Without an integrated analysis approach the court would view the taxpayer’s expenses required under the lease without reference to the simultaneous act of conveying the taxpayer’s property to the trust that necessitated such a lease.\textsuperscript{56}

The Fifth Circuit acknowledged the apparent contradiction between its holding and the Seventh Circuit’s decision in \emph{Skemp} which involved similar facts and issues. The Fifth Circuit distinguished \emph{Skemp} by stating that the Seventh Circuit had declined in that case to consider the conveyance of the property and the leaseback as a whole in determining whether the rental payments were tax deductible as ordinary and necessary expenses.\textsuperscript{57} Despite the similarity of the facts and circumstances in \emph{Van Zandt} and \emph{Skemp}, the distinction between the holdings in these circuits rests largely on the courts’ judgments of what factors control as a matter of law. The Fifth Circuit tried to minimize the differences between \emph{Van Zandt} and \emph{Skemp} on several other grounds. In \emph{Skemp v. Commissioner} the grantor did not have a reversionary interest, the trusts lasted for twenty years, and there was a bank trustee. By contrast the grantor in \emph{Van Zandt v. Commissioner} retained a reversionary interest in a shorter term trust for which he was also the trustee. In light of these substantial differences the Fifth

\begin{footnotesize}

\textsuperscript{53}This section is the predecessor to \textsection{162(a)(3)} of the Int. Rev. Code of 1954.

\textsuperscript{54}180 F.2d at 929.

\textsuperscript{55}341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965).

\textsuperscript{56}Id. at 441.

\textsuperscript{57}Id. at 442. In the dissenting opinion in Brooke v. United States, 468 F.2d 1155, 1160 (9th Cir. 1972) Circuit Judge Ely wrote:

[I] am convinced that the better approach requires an integration of the gift and leaseback transactions, at least in cases in which the donor-lessee was an occupant of the premises at the time the gift was made. When the transactions are thus integrated, it becomes obvious that the allowance of rental deductions requires satisfaction of the business purpose test at the inception of the transaction, the time when the gift was made.

\end{footnotesize}
Circuit in *Van Zandt v. Commissioner* concluded that its holding was consistent with *Skemp v. Commissioner*. Since the Supreme Court denied *certiorari* in *Van Zandt*, it declined the opportunity to resolve the differences in thinking that had then developed in the several circuits.

While a controversy has developed over the applicability of the "sound business purpose" test in cases of gift and leaseback of property placed in trust, the courts have applied the "sound business purpose" test to cases of outright transfer of property by the donor to a related donee and its subsequent leaseback by the donor. In *White v. Fitzpatrick*, the grantor after conveying a fee simple in patent rights to his wife sought a tax deduction for royalty payments to her for their use. The Second Circuit found no evidence of a potential for the exercise of control and management on the part of the donee, only acquiescence to the will of the donor. The court concluded that since the husband had retained the actual enjoyment and ownership of the property, payments to the wife did not constitute valid business deductions within the taxing statute. This holding seems to conflict implicitly with the decision of the Seventh Circuit in *Skemp* allowing a tax deduction. In *Skemp* the grantor continued to use property conveyed in trust, and made payments directly to a trustee but indirectly to his wife and children. The use of the property by the grantor after the conveyance seems substantially indistinguishable in these two cases. Their disparate holdings result from the opposing attitudes in the circuits as to the legal requirements for an arm's length transaction between the parties. Supporting the "sound business purpose" test, the Internal Revenue Service has publicly agreed with the position taken in the Fifth Circuit. In Revenue Ruling 54-9 the Service stated that if a grantor conveys property in a short term trust for the benefit of his children and retains the privilege of renting such property, he merely reallocates income within a family group. Therefore, rental payments made to the trust by the grantor will not constitute deductible business expenses for him.

The necessity for a sound business purpose and its elements are issues on which the courts and the Service are gradually forming divergent opinions. The position, exemplified by the Fifth Circuit in *Van

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58. *Id.* at 444.
60. *Id.* at 402.
61. *Id.*
62. 1954-1 CUM. BULL. 20, 22.
Zandt, rigidly emphasizes the necessity of a sound business purpose and disregards bona fide personal motives other than mere tax avoidance. This position deprives taxpayers of the fair treatment that a flexible construction, intended by the drafters of the Code, would provide.\(^6\)

The better view seems to be the one enunciated by the Seventh Circuit in *Skemp v. Commissioner*. When the principal motive for a change in legal relationships is any sound reason other than mere tax avoidance, this view recognizes the tax effects resulting from such a change.

**INDEPENDENT TRUSTEE**

Although a gift and leaseback of property placed in trust meets the “sound business purpose” test and divests the grantor-lessee of any equitable interest in the property, a lack of independence in the trustee deprives the transaction of its income tax advantages to the grantor-lessee.\(^6\) If the trustee does not exercise an unrestricted control of the trust property, the trustee is the agent or *alter ego* of the grantor, and the grantor must bear the income tax normally borne by the trust or its beneficiaries. While all the circuits have agreed that a trust requires an independent trustee to secure a rental deduction for the grantor, the Second\(^6\) and the Fifth\(^6\) Circuits have concluded that a grantor does not usually qualify as an independent trustee of the property that he has placed in trust. The Ninth Circuit\(^6\) has concluded that a grantor qualifies as an independent trustee of property that he has placed in trust when the grantor has a continuing legal obligation to account for his stewardship to a reviewing court. Since the amount and type of activity performed by a trustee and his relationship to the grantor bear heavily on the independence of a trustee, the Second and Fifth Circuits have concluded that a trustee has lost his independence if the trustee and the grantor have prearranged the gift and leaseback of the property to the grantor. However, the Third and the Seventh Circuits have allowed a rental deduction notwithstanding the leaseback of the property to the grantor by prearrangement with the trustee when

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63. § 162 refers to the “ordinary and necessary” expenses of the trade or business and not to the “sound business purpose” test. An expense may be necessary and ordinary if the transaction resulting in the expense occurs frequently for personal motives. Hence “ordinary and necessary” does not mean, but merely includes, business dealings.

64. 468 F.2d at 1157.


the leaseback required the payment of a fair rental. Although the courts have tried to minimize the appearance of inconsistencies in their holdings on these points, the resolution of these conflicts remains a problem.

In *Brooke*, after the conveyance of his property to his minor children, the taxpayer was appointed their guardian by the probate court. The Ninth Circuit noted that in Montana the term "trustee" includes guardian and then held that a guardianship establishes the necessary independence of the trustee because the probate court administers a guardianship with the same requisite independence of any court administered trust. Under the supervision of the court the guardian must meet his rental obligations and must make accountings to the court. The court must approve the sale of guardianship property. If the taxpayer should at some future date breach his fiduciary duty toward his children, the government might well renew its challenge to the validity of the gift.

Other courts and the Internal Revenue Service have taken a less liberal position than the *Brooke* court. The Service has stated that, although someone other than the grantor becomes the trustee of the donated property, the independence of the trustee in reality disappears when the grantor by prearrangement with the trustee leases back the

68. *Id.* at 1159. In *Brooke v. United States*, 292 F. Supp. 571, 572-73 (D. Mont. 1968), the district court observed:

> There are differences between a guardianship and a trust, but a guardianship may be denominated a trust, . . . and a guardian is called a trustee. . . . Illustrative of the word usage is the law in Montana. See the statutes describing the guardian's duty as a trust and fixing it by reference to the sections of the code dealing with trusts. . . . See the cases using the word 'trust' to define the guardian relationship. . . . The word 'trust' may express an intent to embrace guardianships.

69. 468 F.2d at 1158.
70. *Id.* at 1158.
71. § 91-4907, REV. CODES MONT. (1947) provides as follows:

> The guardian must, upon the expiration of a year from the time of his appointment, and as often thereafter as he may be required, present his account to the court for settlement and allowance. The court shall thereupon appoint a day for the settlement of said account and the clerk shall give notice thereof by posting notices in three public places in the county, setting forth the name of the guardianship proceeding and of the guardian and the time and place appointed for the settlement of the account. The court may order such further notice to be given as it may deem proper.

72. § 91-4518, REV. CODES MONT. (1947) provides as follows:

> The guardian of the property must keep safely the property of his ward. He must not permit any unnecessary waste or destruction of the real property, nor make any sale of such property without the order of the district court, but must, so far as it is in his power, maintain the same with its buildings and appurtenances, out of the income or other property of the ward, and deliver it to the ward at the close of his guardianship, in as good condition as he received it.

73. 468 F.2d at 1158.
property.\textsuperscript{74} In \textit{Van Zandt} the grantor was the trustee, but the court did not emphasize this fact in finding a lack of independence in the trust arrangement. The Fifth Circuit decided that an independent trust did not exist because, at the moment of the conveyance of the property to the trustee, the trustee had an obligation to convey it back under lease to the original transferor.\textsuperscript{75}

The Ninth Circuit differs from the Fifth Circuit in the emphasis that the Ninth Circuit has placed on the control of the grantor-trustee's activities by a state probate court. As long as a responsible party not subject to the grantor's control periodically reviews the stewardship of the trustee, the Ninth Circuit would not see any reason to stress the probable prearrangement of a leaseback of the trust property by the grantor. Like the Seventh Circuit, the Ninth Circuit emphasized the legally binding duty of the trustee-grantor to exact fair rentals from the lessee-grantor in denying the government's claim that the trust and leaseback arrangement was a sham. Unlike the Ninth and the Seventh Circuits, the Fifth Circuit has concentrated on the intentional interaction, by contract or otherwise, between the grantor and the trustee to find a tax avoidance motive in the creation and operation of the trust and thereby a lack of independence in the trustee.

The view advanced in the Ninth Circuit has gained ground in other circuits. For instance, in \textit{Brown v. Commissioner}\textsuperscript{76} the taxpayer designated his attorney as the trustee of two irrevocable trusts created by the taxpayer for the benefit of his children. Although the trustee leased back the property to the grantor pursuant to a prior understanding between the grantor-taxpayer and the prospective trustee, the Third Circuit did not regard this point as significant. The appearance of a new independent owner, the trustee, who was in a position to and did require the payment of the rents and royalties as a condition to the continued use and possession of the lands by the taxpayer for his business, wholly without regard to whether the business operations resulted in taxable income, was the controlling point.\textsuperscript{77} In \textit{Skemp} the grantor made a trust company sole trustee, but the grantor reserved the right to rent all or a part of the trust corpus at a rental to be determined by the trustee. The Seventh Circuit held that the trust arrangement involved substance and was not a formal sham.\textsuperscript{78} The \textit{Skemp} court did

\begin{footnotesize}
\textsuperscript{74} Rev. Rul. 9, 1954-1 Cum. Bull. 20, 22.
\textsuperscript{75} 341 F.2d 440, 443 (5th Cir.), \textit{cert. denied}, 382 U.S. 814 (1965).
\textsuperscript{76} 180 F.2d 926, 929 (3d Cir.), \textit{cert. denied}, 340 U.S. 814 (1950).
\textsuperscript{77} \textit{Id}.
\textsuperscript{78} 168 F.2d 598, 600 (7th Cir. 1948).
\end{footnotesize}
not question the independence of the trustee, and added that in these circumstances the fact that the payment of rent as trust income went to the taxpayer's wife was not material.\textsuperscript{79}

The extent of activity performed by the trustee helps to establish the separate identity and independence of the trustee from the grantor. In \textit{Audano v. United States},\textsuperscript{80} the taxpayer appointed his attorney and accountant as trustees of several trusts created by the taxpayer. The trustees signed the trust agreements, signed receipts for the conveyance of medical equipment to the trusts, and then resigned. The Fifth Circuit stated that reasonable men could not have concluded on these facts that the taxpayer's attorney and accountant exercised the duties of independent trustees in accordance with the "strict principles of a fiduciary in the management of the property."\textsuperscript{81} The \textit{Audano} court emphasized that the attorney and accountant as trustees did not exercise the ordinary duties of a trustee because they failed: (1) to determine whether the rentals paid by the grantor on the leaseback of the equipment were fair, (2) to determine whether the property could lease for higher rentals elsewhere, (3) to attempt to obtain the execution of a written lease from the lessee, (4) to determine whether the language of the conveyances fulfilled the taxpayer's intent to transfer all of the equipment to the trust, and (5) to manifest any intent to protect the beneficiaries' interest in the trust property.\textsuperscript{82}

While the activities of the trustee help to establish the trustee's control of the property, a retention of any legal interest in the property by the grantor can jeopardize the independence of a trustee in a subsequent leaseback of the property. In \textit{Hall v. United States} the grantor had a reversionary interest in the trust corpus and also a right to settle the accounts of the trustee. The district court concluded that in these circumstances the trustee did not have full freedom of action and was not wholly independent.\textsuperscript{83} The \textit{Hall} court distinguished the findings in similar cases in the Seventh and Third Circuits, which found that the trustees were independent, on the ground that the settlors of the trusts in those cases retained no reversionary interest in or no power of disposition of the corpus of the trust.\textsuperscript{84} On the other hand, in \textit{Oakes v. Commissioner}, the grantor, in the trust agreement, retained the power

\textsuperscript{79} Id.
\textsuperscript{80} 428 F.2d 251 (5th Cir. 1970).
\textsuperscript{81} Id. at 258.
\textsuperscript{82} Id.
\textsuperscript{83} 208 F. Supp. 584, 588 (N.D.N.Y. 1962).
\textsuperscript{84} Id.
to "approve and settle the account of the trustee." The agreement also gave the trustee the power to "have its account settled by a court of competent jurisdiction." Since the trustee was a commercial bank subject to the strict provisions of Ohio law with respect to approval by the probate court of the accounts of the trustee, the Tax Court concluded that the bank was an independent trustee. If the trustee is a close family member, the court will usually look at all the facts and circumstances to determine if real independence of action exists. In Potter v. Commissioner the grantor transferred the full and exclusive right, title, and interest in a patent to trusts of which the taxpayer's father, wife, and accountant were the trustees. In reviewing the tax impact of a later nonexclusive license to the grantor the Tax Court held that the trusts were not shams and that the trustees were still independent because the subsequent license had genuine economic substance.

In deciding whether a trustee is independent in any given case, the court's focus on the relevant facts and circumstances will differ from circuit to circuit. A prior lease agreement between the grantor and the prospective trustee, a reversionary interest in the grantor, a right reserved to the grantor to settle the accounts of the trustee, a close family or business relationship between the grantor and the trustee, or an identification of the grantor as trustee will often weigh heavily against determination of an independent trustee. The Ninth Circuit has shown its willingness to decide the issue of the independence of the trustee on the degree of enforceability of the legal relationships established by the trust arrangement rather than upon a subjective weighing of the tax and non-tax motives of the grantor. This disposition weakens the precedential value of the "integrated transaction" approach of the Fifth and the Second Circuits of the Court of Appeals. The Brooke holding that the supervision of a local court suffices to make a grantor-trustee independent "has widespread implications and is certain to raise eyebrows at the Treasury."

SUPPORT PAYMENTS

Although the presence of genuine economic substance and an independent trustee suffices for a rental deduction on a leaseback of trust property by the grantor, the deduction loses its tax advantage to the

85. 44 T.C. 524, 532 (1965).
86. Id.
87. Id.
88. 27 T.C. 200 (1956).
89. Id. at 213.
90. 37 J. TAXATION 315 (1972).
grantor if he has a legal obligation to maintain or support the beneficiaries of the trust. Pursuant to section 677(b) of the Code the grantor is taxable on trust income applied or distributed for the support of the beneficiaries. By requiring the grantor to pay a federal income tax on trust income used for the support of the trust beneficiaries, the deduction for rental payments by the grantor-lessee loses its tax-saving value because the rental deduction equals the additional taxable income, and the offsetting amounts result in no addition or subtraction of tax payable by the grantor-lessee. The grantor ends up in the same tax position from which he began at the time of the gift and leaseback. While most courts have not expressly dealt with this issue, the Ninth Circuit in Brook gave it extensive consideration. In addition to the arguments that the trust was a sham and that the trustee was not independent, the government also argued that the trust was the alter ego of the grantor to the extent that it distributed its income to its beneficiaries and thereby relieved the grantor of some of his legal obligations to the beneficiaries. To obviate the government's argument, the grantor must prove that the beneficiaries did not spend the trust income distributed to them for the support legally due them by the grantor. The resolution of this legal controversy depends upon the judicial definition of the term "support."

In Brook the grantor-trustee, after collecting the rent on the leased premises from himself, applied the rental payments to his minor children's insurance, health, and education. He made expenditures for private school tuition, musical instruments, and music, swimming and public speaking lessons. The grantor-trustee also purchased an automobile for his eldest son and paid travel expenses to New Mexico for his asthmatic child out of the rental collections. On an initial hearing, the district court said that the taxpayer had a legal obligation to support and educate his children suitable to his circumstances, and

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91. The INT. REV. CODE of 1954, § 677(b) provides, in pertinent part, as follows:
Obligations of Support.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. . . .
93. § 61-104, REV. CODES MONT. (1947), provides as follows:
The parent entitled to the custody of a child must give him support and education suitable to his circumstances. If the support and education which the father of a legitimate child is able to give are inadequate, the mother must assist him to the extent of her ability.
that the expenditures that he made from the rental payments were
for the support and maintenance of his children even if the law did not
legally compel the taxpayer to make such expenditures.\textsuperscript{94} Hence, the
court held that the grantor-trustee had to recognize taxable income
on these expenditures.\textsuperscript{95}

On rehearing,\textsuperscript{96} the district court held that because the Internal Rev-
ue Service publicly stated that the amount included as taxable income
in the grantor's federal income tax return should not exceed the trust
income spent for the grantor's legal obligations under local law,\textsuperscript{97} it
granted the taxpayer leave to set forth the specific amounts expended
in each year for items not legally required for the support and main-
tenance of his children.\textsuperscript{98} The district court based its original deci-
sion on the premise that the statutory language "legally obligated" mod-
ified the word beneficiary and not the word "support" in section 677
(b) of the Internal Revenue Code. The district court thought that a
different interpretation led to the unintended tax inequality of allowing
a tax deduction to a parent making payments to a trust that used the
payments to rear the parent's minor children, while denying a tax de-
duction to a parent who directly made identical payments for his minor
children.\textsuperscript{99} The court concluded that if the Treasury Department
maintains a public position, the court, as a matter of policy, should
support that position if: (1) the position favors taxpayers, (2) the
position is one on which taxpayers may alter their relations, (3) some
taxpayers have benefited from the position, and (4) the position is not
manifestly incorrect.\textsuperscript{100} The Service has stated publicly that it inter-
prets section 677(b) to mean legally obligated support and not support
of beneficiaries to whom the grantor has a legal obligation. Since the
district court did not consider the statute perfectly clear, it adopted the
position taken by the Service.\textsuperscript{101} The Ninth Circuit did not disturb
the amended holding of the district court on this point.

Since the government lost on the issue of support because of a prior
inconsistent position taken publicly in a revenue ruling, the Internal

\textsuperscript{94} 292 F. Supp. at 573.
\textsuperscript{95} Id.
\textsuperscript{97} In Rev. Rul. 484, 1956-2 CUM. BULL. 23, 24, the Internal Revenue Service
stated:

However, the amount of such income includable in the gross income of a
person obligated to support or maintain a minor is limited by the extent of
his legal obligations under local law. . . .
\textsuperscript{98} 300 F. Supp. at 467.
\textsuperscript{99} Id. at 466.
\textsuperscript{100} Id. at 467.
\textsuperscript{101} Id.
Revenue Service can revoke it or issue a new ruling to conform with the position taken by the government in *Brooke v. United States*. Thereafter the trial court could redefine the term "support" to include any payments made for the beneficiaries to maintain them in a condition consistent with the standard of living of the grantor. The court could thereby deny the tax advantages enjoyed by the grantor in a *Brooke* situation. The ultimate resolution of the wording of the support statute would then rest upon the Court of Appeals which would probably leave the definition of support to state law. The drafters of section 677(b) did not choose to define the term "support." The Constitution does not empower Congress to pass legislation regulating the legal duty of support. The states regulate the duty of support and state law should prevail on the definition of the term "support." *Brooke v. United States* will probably remain good precedent on the issue of support notwithstanding any subsequent change of position by the Internal Revenue Service.

CONCLUSION

The federal income tax consequences of a gift and leaseback of property remain an uncertain battleground for the taxpayer and the Internal Revenue Service. Various circuits of the Court of Appeals, notably the Fifth Circuit, have favored the government's position, and have denied rental deductions when tax motives seemed to predominate in the transaction. Other circuits, in sustaining the income tax deductions claimed by the grantor-lessee, have concentrated on the legal obligations created by the gift and leaseback. The independence of the trustee, the determination or necessity of a sound business purpose, and the reasonableness of the terms of the leasing agreement typify the issues on which the courts in the several circuits have taken conflicting positions.

*Brooke v. United States* reflects in many ways the judicial attitudes forming in several of the circuits. While the decision in *Brooke* broadens the tax planning horizons of many middle-class taxpayers, the rationale of the Ninth Circuit stands in sharp contrast to the position taken in other circuits in cases involving similar facts. However, the Supreme Court has not yet adopted the "integrated transaction" analysis or the "independent transactions" test. The Court continues to adhere to the doctrine of substance over form102 in deciding federal tax consequences.

income tax matters, but distinguishing mere formality from genuine substance in cases of gift and leaseback taxes even the wisdom of Solomon. To establish uniformity in the handling of these issues in all the circuits the Supreme Court will have to enter this judicial maelstrom.

Eugene L. Mahoney