Notre Dame Law Review

Volume 59 | Issue 4 Article 4

1-1-1984

Evolving Gift-Leaseback Analysis in Light of May and Rosenfeld

Karen W. Kiley

The Evolving Gift-Leaseback Analysis in Light of *May* and *Rosenfeld*

In a typical gift-leaseback situation, a taxpayer gratuitously transfers property to an irrevocable trust for the benefit of his minor children.[1] Upon executing the trust instrument, the taxpayer leases the property back for use as his professional office.[2] The taxpayer's rental payments constitute gross income to the trust and will generally be taxed in a lower income bracket.[3] The taxpayer, as lessee, then deducts the rental payments as ordinary and necessary business expenses under section 162(a)(3) of the Internal Revenue Code ("I.R.C."), which provides:

> (a) In general
>
> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> . . . .
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession of property to which the taxpayer has not taken or is not taking title or in which he has no equity.[4]

Thus, if the income is properly attributable to the trust[5] and the taxpayer is allowed to deduct the rental payments, the net effect is an attractive intra-family income-splitting, tax-saving device.

The rental deductions, however, are not uniformly allowed. The Internal Revenue Service ("IRS") continues to oppose the gift-

---

1 The taxpayer may transfer business realty, such as an office building, or he may transfer the funds to be used to purchase business property and equipment. Generally, transfers to a trust are more prudent than direct gifts to family members. *See* R. WESTIN, MIDDLE INCOME TAX PLANNING AND SHELTERS § 3.20 (1982).

2 *Id.* § 3.18.

3 A high earnings taxpayer can redirect family income for a substantial tax savings. The trust or the beneficiaries will be taxed on the income but at a lower marginal rate and after depreciation and maintenance deductions.

4 I.R.C. § 162(a)(3) (1976).

5 An effective transfer of income from the grantor to a short-term trust requires compliance with I.R.C. §§ 671-677, enacted by Congress after Helvering v. Clifford, 309 U.S. 331 (1940), which held the grantor/trustee of a five-year trust taxable on the trust income. The terms of the trust and the grantor's retained control caused him to be treated as the owner for tax purposes. *Id.* at 335. Thus the term "Clifford" trust connotes a trust satisfying §§ 671-677 whereby the grantor avoids taxation on the trust income. The taxability of income in the gift-leaseback context will not be treated in this Note.

leaseback transaction by denying the rental deductions under section 162(a)(3).[6] Likewise, the Fourth[7] and Fifth Circuits[8] disallow the rental deductions. Nevertheless, a growing majority of courts of appeals, including the Second,[9] Third,[10] Seventh,[11] Eighth[12] and Ninth Circuits,[13] as well as the Tax Court,[14] favor the taxpayer and allow the deductions if certain requirements are met.

A growing body of case law has augmented the statutory requirements of I.R.C. section 162(a)(3), but no consensus seems to have been reached on the proper criteria to determine whether rental deductions will be allowed.[15] Furthermore, Congress has yet to intervene to specify the requirements to deduct rent in the gift-leaseback situation.[16] In two recent cases, *May v. Commissioner*[17] and *Rosenfeld v.*

6 *See generally* Rev. Rul. 54-9, 1954-1 C.B. 20, as modified by Rev. Rul. 57-315, 1957-2 C.B. 624 (rental payments to a trust by a grantor are not deductible business expenses where grantor transfers property to a ten-year trust for his children then leases it back).

7 *See, e.g.*, Perry v. United States, 520 F.2d 235 (4th Cir. 1975) (no real business purpose shown for transaction as a whole therefore rentals not deductible as ordinary and necessary business expenses), *cert. denied*, 423 U.S. 1052 (1976).

8 *See, e.g.*, Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975) (no deduction of rental payments where transaction lacked economic reality), *cert. denied*, 424 U.S. 967 (1976); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.) (obligation to pay rent not the result of a real business purpose), *cert. denied*, 382 U.S. 814 (1965).

9 *See, e.g.*, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983) (upholding deduction of rental payments where gift-leaseback arrangement substantially altered grantor's legal rights and interests); *see also* notes 150-81 *infra* and accompanying text.

10 *See, e.g.*, Brown v. Commissioner, 180 F.2d 926 (3d Cir.) (rental deductions allowed where required as a condition to the continued use or possession of the gift-leaseback property), *cert. denied*, 340 U.S. 814 (1950); *see also* notes 31-34 *infra* and accompanying text.

11 *See, e.g.*, Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948) (taxpayer required to pay rentals even though he voluntarily created the situation and therefore rentals properly deductible); *see also* notes 26-30 *infra* and accompanying text.

12 *See, e.g.*, Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.) (upholding rental deductions where law firm met statutory requirements of § 162(a)(3)), *cert. denied*, 444 U.S. 996 (1979).

13 *See, e.g.*, May v. Commissioner, 723 F.2d 1434 (9th Cir. 1984) (rental deductions allowed where transfer had economic reality and leaseback required for business); Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (transfer of sufficient property interest justified rental deductions).

14 *See, e.g.*, Lerner v. Commissioner, 71 T.C. 290 (1978) (reasonable rentals paid by professional corporation to trust were ordinary and necessary business expenses); Oakes v. Commissioner, 44 T.C. 524 (1965) (allowing rental deductions where business necessity for leaseback shown); Serbousek v. Commissioner, 1977 T.C.M. (P-H) ¶ 77,105 (upholding rental deductions which met four-prong Tax Court test).

15 *See, e.g.*, May v. Commissioner, 76 T.C. 7, 17 n.1 (1981)(Coffe, J., concurring) (noting the confusion and frequent litigation with gift-leasebacks).

16 The only congressional manifestation appears in a Senate Finance Committee Report prior to the legislative enactment of the Clifford provisions. It states:

> [T]his provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the

Commissioner,[18] the Ninth and Second Circuits, respectively, allowed the taxpayers to deduct rental payments in a gift-leaseback transaction. *Rosenfeld* and *May* raise questions as to the viability of the factors which courts have traditionally regarded as important when determining if rental deductions should be allowed under section 162(a)(3).

Part I of this Note examines the development of case law in the gift-leaseback situation. Part II analyzes the opinions of *May* and *Rosenfeld*. Part III suggests the appropriate test to be applied when examining the gift-leaseback transaction for tax purposes, and Part IV concludes that success in a gift-leaseback transaction depends upon the state of the evolving jurisprudence.

I. Development of Case Law in Gift-Leaseback Transactions

At a minimum, a taxpayer desiring to deduct rental payments as an ordinary and necessary business expense must satisfy the statutory requirements of section 162(a)(3).[19] First, the rent payment must be required as a condition to the continued use or possession of property.[20] Second, the property must be used in a trade or business.[21] Third, the taxpayer must not have nor take title to the property.[22] Finally, the taxpayer must not have an equity in the property.[23]

A. *Rent as a Condition to the Continued Use or Possession of the Property*

The first statutory prerequisite to a section 162(a)(3) deduction

---

> trust. . . . This subpart also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.

S. REP. NO. 1622, 83d Cong., 2d Sess. 365, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5006; *see also* Treas. Reg. § 1.671-1(c) (1956). Nonetheless, many commentators have suggested that the "Clifford" provisions should logically be applied to the rental deduction issue also. *See, e.g.*, Froehlich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956, 971 (1964); Note, *Clifford Trusts: A New View Towards Leaseback Deductions*, 43 ALB. L. REV. 585, 594 (1979); Comment, *Gift-Leaseback Transactions: An Unpredictable Tax Savings Tool*, 53 TEMPLE L.Q. 569, 587 (1980); Note, *Gifts and Leasebacks: Is Judicial Consensus Impossible?*, 49 U. CIN. L. REV. 379, 394 (1980).

17 723 F.2d 1434 (9th Cir. 1984); *see also* notes 130-49 *infra* and accompanying text.

18 706 F.2d 1277 (2d Cir. 1983); *see also* notes 150-81 *infra* and accompanying text.

19 *See* text accompanying note 4 *supra*.

20 *Id.*; *see also* Quinlivan v. Commissioner, 599 F.2d 269, 272 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

21 599 F.2d at 272.

22 *Id.*

23 *Id.*

of rental payments is that the payment be required as a condition to the continued use or possession of the property. This prerequisite, in turn, involves at least three inquiries: whether the obligation to pay is mandatory; whether the payment is reasonable; and whether an independent trustee is used.

1. Obligation to Pay

Like other business expenses, the taxpayer must incur or pay a genuine obligation in order to deduct the rental payments.[24] Rental payments "[imply] a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property."[25]

Quite early in judicial interpretation of section 162(a)(3), the Seventh Circuit, in *Skemp v. Commissioner*,[26] determined that rentals were "required" despite the fact that the grantor/lessee voluntarily entered into the transaction.[27] In *Skemp*, a physician deeded his office building to an irrevocable, twenty-year trust to benefit his wife and minor child. An independent trust company, as trustee, simultaneously entered into a ten-year lease with the physician, charging a $500 monthly rental.[28] The Seventh Circuit upheld the business expense deductions because the taxpayer had a legal obligation to pay the fixed rental, and the trustee had a continuing fiduciary obligation to collect it.[29] Furthermore, the transaction involved a bona fide change in the taxpayer's economic status.[30]

Similarly, the Third Circuit, in *Brown v. Commissioner*,[31] upheld the taxpayers' deductions of rents and royalties paid to a trust benefiting the taxpayers' children. The taxpayers, engaged in mining operations, conveyed property to an independent trustee who, pursuant to a prior understanding, leased the land back to the taxpayers.[32] The court found it significant that the trustee, a "new independent owner,"[33] created the legal obligation to pay rent as a prerequisite to the continued use of the property, whether or not the taxpayers' min-

24 *See, e.g.*, 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25.108 (rev. ed. 1979).

25 Duffy v. Central R.R., 268 U.S. 55, 63 (1925).

26 168 F.2d 598 (7th Cir. 1948).

27 *Id.* at 600.

28 *Id.* at 599.

29 *Id.* at 600.

30 *Id.*

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

32 *Id.* at 927.

33 *Id.* at 929.

ing business generated income.[34]

2. Reasonable Rental

Deductions are allowed for reasonable rental payments only, since amounts in excess of a reasonable rent are not "required" within the meaning of section 162(a)(3).[35] Reasonable rentals are the product of an arm's length negotiation.[36] In a gift-leaseback case, however, the bargaining may occur among family members. Therefore, it is necessary to determine if the rentals exceed that amount which would result if the parties bargained as total strangers.[37] Consequently, courts have historically judged intra-family income-splitting devices with strict scrutiny.[38]

In *Kirschenmann v. Westover*,[39] a taxpayer who engaged in farming operations purchased the land he previously had leased and conveyed it to his minor daughter; the taxpayer's brother was appointed guardian of the daughter's estate.[40] In a subsequent leaseback, the taxpayer paid $19,412.54 in rent, compared to the $1050.00 payment required under the original lease.[41] The Court of Appeals for the Ninth Circuit, finding the rents unreasonably excessive, denied the deduction since such rentals were not for the continued use of the business property.[42]

Similarly, if the taxpayer fails to prove the reasonableness of the rental payments, by independent appraisals, expert testimony, or other evidence, the deduction will be denied.[43] Failure to produce

---

34 *Id.*

35 "[P]ayments in excess of reasonable rent made pursuant to an agreement between closely related parties which was not the product of arm's length negotiation are not deemed 'required' and thus are not deductible under Section 162(a)(3)." Sparks Nugget, Inc. v. Commissioner, 458 F.2d 631, 634 (9th Cir. 1972); *see, e.g.*, 4A J. MERTENS, *supra* note 24, § 25.110 at 493.

36 4A J. MERTENS, *supra* note 24, § 25.110, at 493.

37 *Id.*

38 *See* Commissioner v. Tower, 327 U.S. 280, 291 (1946) (transactions between husband and wife subject to special scrutiny); Helvering v. Clifford, 309 U.S. 331, 335 (1940) (strict scrutiny necessary where grantor is trustee and his family members are beneficiaries).

39 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955).

40 *Id.* at 70.

41 *Id.*

42 *Id.* at 70-71.

43 In Audano v. United States, 428 F.2d 251 (5th Cir. 1970), a medical partnership leased equipment, furniture, and supplies which one of the partners had conveyed to three trusts. The Fifth Circuit denied the deduction of rental payments, which were based on a percentage of the partnership's gross receipts, when the taxpayers failed to prove that the percentage was the going rate for similar equipment. *Id.* at 257.

such evidence suggests the lack of an arm's length transaction.[44] It is not unusual, however, in gift-leaseback litigation for the parties to stipulate that reasonable rental has been paid, thus foreclosing the court's inquiry into this requirement.[45]

3. Independent Trustee

To determine whether rent is reasonable and whether the taxpayer has a genuine legal obligation to pay it, courts focus on the independence of the trustee.[46] The independent trustee also becomes relevant in another context. Courts inquire into a trustee's independence to ensure that the gift-leaseback transaction has substance and that the grantor has not retained control over the property.[47] Since both *Skemp* and *Brown* upheld a gift-leaseback arrangement with independent trustees, subsequent cases recognized this distinction as "strongly indicative of the *bona fides* of the transfer."[48]

In terms of the first statutory prerequisite,[49] the arguments in favor of requiring an independent trustee are several. If a trustee lacked independence, he could not be expected to deal with the grantor at arm's length.[50] Where a grantor appoints himself trustee, he might be inclined to exact a payment which exceeded the fair market rental, thus diverting more income to the trust.[51] But a lessee negotiating as a hard-headed businessman would want the lowest rentals possible. In addition, a grantor/lessee, acting in a dual capacity as trustee/lessor, may treat the rental requirement casually, paying sporadically and without genuine obligation to do so.[52]

B. *The Property is Used in a Trade or Business*

That the property must be used in a trade or business requires that the taxpayer have a valid business purpose when he attempts to

---

44 *Id.* at 256.

45 *Cf.* Ryegate Paper Co., 1961 T.C.M. (P-H) ¶ 61,193 (unnecessary to question reasonableness of rental payments if required for the continued use or possession of property resulting from an arm's length transaction).

46 *See* May v. Commissioner, 76 T.C. 7, 14 (1981).

47 *See* notes 99-114 *infra* and accompanying text.

48 Oakes v. Commissioner, 44 T.C. 524, 529 (1965).

49 *See* text accompanying note 20 *supra*.

50 *See* 76 T.C. at 19 (Coffe, J., concurring).

51 Brief for Appellant at 24 n.16, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).

52 *See* Wiles v. Commissioner, 59 T.C. 289, 298-99 (1972) (payments not labeled rent and paid sporadically out of the taxpayer's personal, rather than business, account), *aff'd per curiam without opinion*, 491 F.2d 1406 (5th Cir. 1974).

deduct rental payments.[53] A disagreement exists as to the application of the business purpose test to the gift-leaseback arrangement.[54] The IRS, as well as the Fourth and Fifth Circuits, take an integrated approach, requiring a business purpose for the entire gift-leaseback transaction.[55] Other circuits, and the Tax Court, have adopted a bifurcated approach, first determining whether the gift was a valid transfer and then ascertaining whether the subsequent leaseback served a legitimate business purpose.[56] This latter view appears to be the majority position after *Rosenfeld* and *May*.

The Fifth Circuit first used the integrated approach in *Van Zandt v. Commissioner*.[57] Van Zandt established two Clifford trusts[58] for his children, naming himself as trustee.[59] Van Zandt deeded his medical facilities to the trusts for ten years and two months,[60] retaining a reversionary interest in the trust property.[61] Simultaneously with execution of the trust agreements, Van Zandt leased the property back for his medical practice.[62] The Fifth Circuit distinguished the situation from *Skemp*, where the trust term was twenty years, the grantor did not retain a reversion, and the trustee was a bank.[63] The court granted that in *Skemp* there may have been a business purpose for conveying the property to the trust, since the grantor transferred more property than he leased back.[64] Since the trust property in *Van Zandt* was "irrevocably committed to the possession of the grantor the moment the trust was created,"[65] the court viewed the gift-lease-

53 The business purpose test originated in Gregory v. Helvering, 293 U.S. 465 (1935), where the Supreme Court struck down a corporate reorganization designed solely to minimize taxes. The Court refused to exalt form over substance when the transaction performed no corporate or business purpose. Application of the business purpose test has not been limited to reorganizations. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960) (interest payments on cash surrender value of annuity savings bond were without substance); Shaffer Terminals, Inc. v. Commissioner, 16 T.C. 356 (1951) (sale and leaseback not recognizable for tax purposes), *aff'd per curiam*, 194 F.2d 539 (9th Cir. 1952).

54 *But see* Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979), where the court questioned the existence of a true split among the courts of appeals and suggested that the only conflict lies within the Fifth Circuit. *Id.* at 273 n.4.

55 *See* notes 57-71 *infra* and accompanying text.

56 *See* notes 72-80 *infra* and accompanying text.

57 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

58 *See* note 5 *supra*.

59 341 F.2d at 441.

60 *Id.*

61 *Id.*

62 *Id.*

63 *Id.* at 442.

64 *Id.*

65 *Id.* at 443.

back as a single transaction, and finding no business purpose present, denied the deductions under section 162(a)(3).[66]

The Fourth Circuit followed *Van Zandt* in *Perry v. United States*.[67] In *Perry*, two physicians transferred their one-half interests in a medical office building to two Clifford trusts, naming a bank as trustee.[68] The taxpayers had prearranged a leaseback to be coterminous with the trust.[69] The court denied the rental deductions, since the obligation to pay rent did not originate from a transaction with a legitimate business purpose.[70] The trustee's independence was "largely illusory."[71] Thus, those courts using the integrated approach clearly analyze the gift and the leaseback as one transaction, for which a valid business purpose must exist.

Both *Skemp* and *Brown* provided early precedent for a bifurcated view of the gift-leaseback situation. In *Oakes v. Commissioner*,[72] the Tax Court recognized the gift-leaseback as two independent transactions. Having determined that the taxpayer made a valid gift to an irrevocable trust, whereby he relinquished all control, the court found it unnecessary to require a business purpose for the gift. "[T]he test of business necessity should be made by viewing the situation as it exists after the gift is made."[73] The Tax Court continues to apply this view.[74]

The Ninth Circuit implicitly adopted the bifurcated approach in *Brooke v. United States*,[75] where a taxpayer/physician transferred offices, a pharmacy, and an apartment to his children.[76] The Montana State Probate Court appointed the taxpayer guardian of the chil-

66 *Id.* at 443-44. The Fifth Circuit reaffirmed *Van Zandt* ten years later in Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *rev'g* 61 T.C. 12 (1973). The facts in *Mathews* paralleled those in *Van Zandt*, except that Mathews' attorney acted as trustee and the lease was not coterminous with the trust. *Id.* at 324. The Fifth Circuit dismissed both distinctions. Intent on examining the substance of the transaction, the court found it critical that the prearranged lease assured the taxpayers of effective control over the property. *Id.* at 325.

67 520 F.2d 235 (4th Cir. 1975), *cert. denied*, 423 U.S. 1052 (1976).

68 *Id.* at 236-37.

69 *Id.* at 237.

70 *Id.* at 238.

71 *Id.* "The bank had virtually no function save to hold legal title and to receive and remit the rental payments arranged by the settlors at the time the trusts were created." *Id.*

72 44 T.C. 524 (1965).

73 *Id.* at 532.

74 *See* May v. Commissioner, 76 T.C. 7, 13 n.3 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984).

75 468 F.2d 1155 (9th Cir. 1972); *see also* May v. Commissioner, 723 F.2d 1434, 1436 (9th Cir. 1984) ("By requiring only that the transfer be grounded in professional or economic reality, [*Brooke*] implicitly rejected application of the business purpose test to the gift portion of the gift-leaseback transaction.").

76 468 F.2d at 1157.

dren, and as guardian, he collected reasonable rent for the offices.[77] The court, emphasizing that the transfer was grounded in economic reality with legitimate non-tax motives, rendered judgment for the taxpayer.[78]

Likewise, in *Quinlivan v. Commissioner*,[79] practicing attorneys were allowed to deduct rental payments to Clifford trusts after transferring their previously-owned office building to the trusts. Examining section 162(a)(3) literally, the Eighth Circuit applied the business purpose test only to the "continued use or possession" of the property without inquiring "into the origin of the lessor's title."[80] The bifurcated approach, then, requires a business purpose only for the subsequent leaseback, and the motive for the prior gift is largely ignored if the transfer was valid.

C. *The Taxpayer Has No Title To The Property*

The requirement that the taxpayer have no title in the property stems from the proposition that an owner of property cannot deduct rental payments to himself.[81] In a gift-leaseback situation, the grantor divests himself of title when he establishes a trust; legal title belongs to the trustee who is subject to equitable duties to the trust's beneficiaries.[82] Since divestiture of title poses little obstacle to the taxpayer, this requirement of section 162(a)(3) is rarely a source of litigation. The issue of retained ownership does appear more frequently in the statutory mandate proscribing an equity in the property.[83]

D. *Disqualifying Equity*

Although section 162(a)(3) forbids a taxpayer from having an "equity" in the property, neither the I.R.C. nor the legislative his-

---

77 *Id.*

78 *Id.* at 1158. The Ninth Circuit concluded that "[t]he transfer of a sufficient property interest justifies . . . the deduction of rental payments." *Id.* at 1157. The following factors are relevant in that determination: (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. *Id.* In a strong dissent, Judge Ely argued that rentals were deductible business expenses only if a legitimate business purpose motivated the transfer of the leased property. 468 F.2d at 1159 (Ely, J., dissenting).

79 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

80 *Id.* at 273.

81 *See* May v. Commissioner, 71 T.C. at 22 (1981) (Coffe, J., concurring).

82 RESTATEMENT (SECOND) OF TRUSTS § 2 (1959).

83 *See* notes 84-122 *infra* and accompanying text.

tory defines the term.[84] Clearly, if the "lease" transaction is in fact a disguised purchase plan, the lessee will not be allowed to deduct the rental expenses.[85] Instead, the lessee must capitalize the payments, since he is building up equity in the property.[86] Likewise, a grantor who owns the property he purports to lease has a disqualifying equity under section 162(a)(3). The grantor will have transferred his legal title to the leasehold. But despite this formal divestiture, two issues still surface in the gift-leaseback cases: whether the donor's retention of control causes him to be treated as the "constructive owner," and whether a reversionary interest in the property, granting a future ownership, constitutes a disqualifying equity.

1. Retention of Control

To ensure that the gift-leaseback transaction is not a sham, courts require the transferor/lessee to give up that control over the property he previously enjoyed as its owner.[87] Retained control merely exalts form over substance, despite the legal terminology employed by the taxpayers.[88] The United States Supreme Court has long recognized that transactions not grounded in economic reality will not be recognized for tax purposes.[89]

In *Helvering v. Clifford*,[90] a husband named himself trustee of se-

---

84 *See generally* Froehlich, *supra* note 16, at 975 & n.74 (the term equity first appeared in the Revenue Act of 1916 without explanation of congressional purpose).

85 *Cf.* Estate of Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959) (disallowing the deduction of "rental" payments which were in fact capital expenditures to purchase a fire sprinkler system).

86 Mathews v. Commissioner, 61 T.C. 12, 21 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975); *see also* 4A J. MERTENS, *supra* note 24, § 25.108, at 479.

87 *See* Helvering v. Clifford, 309 U.S. 331 (1940), explained in notes 90-92 *infra* and accompanying text.

88 "[T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." Corliss v. Bowers, 281 U.S. 376, 378 (1930).

89 *See, e.g.*, Commissioner v. Sunnen, 333 U.S. 591, 610 (1948) (husband's assignments of license contracts and royalty payments to wife merely "a reallocation of income within the family group" and not sufficient to shift the burden of taxation); Commissioner v. Tower, 327 U.S. 280, 292 (1946) (family partnership resulted in "a mere paper reallocation of income among the family members"); Helvering v. Clifford, 309 U.S. 331, 336 (1940) (husband's retained control over family trust made him the owner for tax purposes); Griffiths v. Commissioner, 308 U.S. 355, 356-57 (1939) (creation of corporation to convey shares and installment payments elaborate scheme to disguise simple sale); Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) (money paid to stockholders under plan of reorganization in effect payment to creditors using stockholders as conduits); Gregory v. Helvering, 293 U.S. 465, 469 (1935) (corporate reorganization had no business purpose and was merely a device to transfer shares to taxpayer).

90 309 U.S. 331 (1940).

curities he had donated to his wife. Income was payable to her over a five-year period, with the corpus reverting to the husband after that time. The Supreme Court affirmed the finding that the husband retained such control over the gift that he remained the owner of the property for tax purposes.[91] Thus, the income from the securities should have been included in the husband's gross income under section 22(a) (predecessor to 1954 I.R.C. section 61(a)).

> For as a result of the terms of the trust and the intimacy of the familial relationship [the husband] retained the substance of full enjoyment of all the rights which previously he had in the property . . . . [W]hen the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had.[92]

The *Clifford* doctrine soon found its way into an intra-family, sale-leaseback transaction. In *W.H. Armston Co. v. Commissioner*,[93] the Fifth Circuit refused to recognize a construction company's sale and subsequent leaseback of its equipment to its chief stockholder. In affirming the Tax Court's decision, the Fifth Circuit noted that "the Company's right to use the equipment supposedly sold . . . was in no wise affected by the alleged transfer of title. . . . It was merely a device for minimizing tax liability, with no legitimate business purpose, and must therefore be disregarded for tax purposes."[94]

Retention of control and the doctrine of substance over form then appeared in the gift-leaseback context. In *Van Zandt*,[95] the Tax Court found the determinative factor to be the lack of an independent third party trustee, and based on that alone, distinguished the prior holdings of *Skemp* and *Brown*.[96] "Complete control over these

91 *Id.* at 336.

92 *Id.*

93 188 F.2d 531 (5th Cir. 1951).

94 *Id.* at 533. In another sale-leaseback case, White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952), the Second Circuit denied a taxpayer's deductions for rents and royalties paid to his wife. The taxpayer had sold a patent to his wife and had given her money to purchase property which he leased back. The Second Circuit stated: "Gift and retained control must be regarded as inseparable parts of a single transaction . . . . To isolate them . . . is to hide business reality behind paper pretense." *Id.* at 400. The court distinguished *Skemp* and *Brown*, noting that in those cases the independent trusteeship was a crucial factor, and the leases were not coterminous with the trusts. *Id.* at 401 n.1, 402 n.2.

95 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965).

96 *Id.* at 830. The Tax Court also distinguished Albert T. Felix, 21 T.C. 794 (1954). In *Felix*, the taxpayers established an irrevocable trust for their children and transferred $6000 to the corporate trustee. The trustee used the money to purchase and lease back the taxpayer's mining equipment. The taxpayers were allowed to deduct the rentals as ordinary and necessary business expenses. *Id.* at 804.

trusts is in the hands of [the grantor], who is the sole trustee and will continue as such until he dies, becomes incapacitated, resigns or is removed."[97] Since the transfers and the leases lacked economic reality, the deductions were disallowed.[98]

After *Van Zandt*, the inquiry into whether the grantor retained control over the donated property became an inquiry into whether an independent trustee existed.[99] Many cases turned on this factor alone, since courts believed it to be a prerequisite to deductibility of rentals under section 162(a)(3).[100] Courts focused on two facets of independence: the subjective relationship of the trustee to the grantor and the actual powers given to and exercised by the trustee.

The relationship between the grantor and the trustee can take many forms. At one end of the spectrum, the grantor may name himself trustee. The bare change in legal title however may not be enough to divest the owner of control over the property, and the rental deduction will be disallowed.[101] As sole trustee, a grantor who exercises broad powers of management and investment over the property retains inordinate control despite the imposition of fiduciary duties.[102] But, sufficient independence may exist where the grantor is appointed trustee under a court supervised guardianship.[103] At the other end of the spectrum, use of a bank or trust company as trustee carries a strong presumption of independence, since such an institution would be unlikely to act under the grantor's influence.[104]

97 40 T.C. at 830.

98 *Id.* at 831.

99 *See* May v. Commissioner, 76 T.C. 7, 25 (1981) (Coffe, J., concurring).

100 *See, e.g.*, Brooke v. United States, 468 F.2d 1155, 1157 (9th Cir. 1972); Penn v. Commissioner, 51 T.C. 144, 154 (1968) and cases cited therein; *see also* Note, *Gift and Leaseback—Tax Planning in the Shadows of Assignment of Income and Business Purpose*, 62 GEO. L.J. 209, 220 (1973).

101 Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); Wiles v. Commissioner, 59 T.C. 289 (1972), *aff'd per curiam without opinion*, 491 F.2d 1406 (5th Cir. 1974); Penn v. Commissioner, 51 T.C. 144 (1968).

102 *Penn*, 51 T.C. at 152.

103 Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972). *But see* Kirschenmann v. Westover, 225 F.2d 69 (9th Cir), *cert. denied*, 350 U.S. 834 (1955).

104 *See, e.g.*, Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Duffy v. United States, 343 F. Supp. 4 (S.D. Ohio 1972), *rev'd on other grounds*, 487 F.2d 282 (6th Cir. 1973); Alden B. Oakes, 44 T.C. 524 (1965); Albert T. Felix, 21 T.C. 794 (1954); Serbousek v. Commissioner, 1977 T.C.M. (P-H) ¶ 77,105; *cf.* Evans v. United States, 572 F. Supp. 74 (C.D. Ill. 1983) (court upheld the rental deductions in a sale-leaseback transaction). The court in *Evans* found that the trustee bank was independent despite its previous relationship with the transferor/lessee. "[T]he use of a Bank, as opposed to one's personal accountant or lawyer, seems to be deserving of an inference of independence." *Id.* at 78.

However, this presumption has been rebutted.[105]

Somewhere in the middle of the spectrum are trustees associated with the grantor: employees,[106] friends and relatives,[107] or professionals such as the grantor's accountant or attorney, acting alone or in combination.[108] Cases have been less than consistent in this area, thus necessitating inquiry into the second facet of independence, the actual powers and functions of the trustee. The powers of the trustee can be gleaned from the two documents involved in the gift-leaseback transaction: the trust instrument created to receive the gift, and the lease agreement governing the subsequent leaseback.

The trust instrument will usually enumerate the trustee's powers as well as any powers retained by the grantor. Generally, if the trustee's power to manage or invest the property is restricted or subject to the grantor's control, the trustee lacks independence.[109] In addition, a trustee who ignores his fiduciary duties, such as failing to periodically collect the rent, will not be treated as a "new independent owner."[110] Consequently, a showing that the trustee is acting for the benefit of the trust beneficiaries, as opposed to the grantor, strongly supports a finding of independence. In *Lerner v. Commissioner*,[111] for example, the grantor's attorney, acting as trustee, repeatedly refused to acquiesce in the grantor's requests for costly

105 *See* notes 67-71 *supra* and accompanying text for discussion of *Perry*. *See also* Hall v. United States, 208 F. Supp. 584 (N.D.N.Y. 1962).

106 Commissioner v. Greenspun, 156 F.2d 917 (5th Cir. 1946) (grantor's employee sufficiently independent).

107 May v. Commissioner, 723 F.2d 1434 (9th Cir. 1984) (grantor and friend independent); John T. Potter, 27 T.C. 200 (1956) (grantor's wife and father in conjunction with grantor's accountant sufficiently independent). *But see* Kirschenmann v. Westover, 225 F.2d 69 (9th Cir.) (grantor's brother as appointed guardian not independent), *cert. denied*, 350 U.S. 834 (1955); Chace v. United States, 303 F. Supp. 513 (M.D. Fla. 1969) (wife and brother-in-law not independent), *aff'd per curiam*, 422 F.2d 292 (5th Cir. 1970); Furman v. Commissioner, 45 T.C. 360 (1966) (wife lacked independence), *aff'd per curiam*, 381 F.2d 22 (5th Cir. 1967).

108 Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983) (grantor's accountant, attorney, and later beneficiary daughter adequately independent); Lerner v. Commissioner, 71 T.C. 290 (1978) (grantor's attorney independent); John T. Potter, 27 T.C. 200 (1956) (grantor's wife and father in conjunction with grantor's accountant sufficiently independent). *But see* Audano v. United States, 428 F.2d 251 (5th Cir. 1970) (grantor, attorney, and accountant lacked requisite independence).

109 *See, e.g.*, Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965); Hall v. United States, 208 F. Supp. 584, 587 (N.D.N.Y. 1962); Penn v. Commissioner, 51 T.C. 144, 151-52 (1968).

110 *See, e.g.*, Audano v. United States, 428 F.2d 251, 258 (5th Cir. 1970) (trustees failed to exercise ordinary duties of a fiduciary); Wiles v. Commissioner, 59 T.C. 289, 298-99 (1972) (informality of rental arrangement evidence of grantor's retained control), *aff'd per curiam without opinion*, 491 F.2d 1406 (5th Cir. 1974).

111 71 T.C. 290 (1978).

improvements, questionable investments, or loans at favorable interest rates, thus buttressing a finding of his actual independence.[112]

The lease agreement may also provide evidence of a trustee's independence.[113] Where the essential elements of the lease agreement have been determined by the grantor, some courts have inferred that the trustee's ability to manage the trust corpus may be merely superficial. Thus, courts have found insufficient trustee independence in cases with a prearranged lease or with an agreement containing terms not arrived at by arm's length negotiation.[114]

The emphasis on trustee independence seems to steer courts away from their original inquiry — whether the grantor's retention of significant control over the gift constituted a prohibited equity under section 162(a)(3). A second inquiry became relevant before these transactions would comport with the fourth statutory requirement of section 162(a)(3). This inquiry questioned whether the grantor's reversionary interest would be a prohibited equity.

2. Reversionary Interest

Whether the grantor's retained reversionary interest is a prohibited equity under section 162(a)(3) depends upon the definition of "equity."[115] The IRS has consistently maintained that equity encompasses a reversionary interest, and some courts have adopted this

112 *Id.* at 302-03.

113 *See* Robert F. Zumstein, 1973 T.C.M. (P-H) ¶ 73,045, at 202. The Tax Court found that where the lease provided that rental would remain the same for renewal periods if the parties failed to agree, it "deprived the trustee-lessor of all independence regarding the trust res." *Id.* at 204.

114 *See, e.g.*, Perry v. United States, 520 F.2d 235, 238 (4th Cir. 1975) (lease terms and conditions established prior to the creation of trusts made trustee's independence "illusory"), *cert. denied*, 423 U.S. 1052 (1976); Mathews v. Commissioner, 520 F.2d 323, 325 (5th Cir. 1975) (trustee's pre-execution agreement assured taxpayers of effective control of the property), *cert. denied*, 424 U.S. 967 (1967); Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.) (trustee obligated to convey property the moment the trust was created), *cert. denied*, 382 U.S. 814 (1965). *But see* Brown v. Commissioner, 180 F.2d 926, 929 (3d Cir.) (prior understanding between taxpayers and trustee insignificant), *cert. denied*, 340 U.S. 814 (1950); Skemp v. Commissioner, 168 F.2d 598, 599-600 (7th Cir. 1948) (even though trust and lease executed same day, taxpayer did not retain significant control over the property); John T. Potter, 27 T.C. 200, 204, 214 (1956) (royalty payments deductible despite prearranged license agreement for patent transferred to trust).

115 The term "equity" first appeared in the Revenue Act of 1916 with an absence of congressional purpose. *See* H.R. REP. NO. 922, 64th Cong., 1st Sess. (1916); S. REP. NO. 793, 64th Cong., 1st Sess. (1916). Commentators have suggested that Congress intended to prevent deduction of mortgage payments. *See, e.g.*, Froehlich, *supra* note 16, at 975 n.74; Lukins, *Tax Treatment of the Lease with Option to Purchase: Is Allocation the Answer?*, 11 TAX L. REV. 65, 68 (1955).

view,[116] which naturally leads to the denial of the grantor's rental deductions. The Tax Court, however, explicitly rejected such a broad definition in *Mathews v. Commissioner*,[117] holding "that the property in which the taxpayer should have no equity does not include a reversionary interest, not derived from the lease or from the lessor, which is scheduled to become possessory after the expiration of a lessor's term of years."[118] Similarly, if the grantor has incorporated his practice, the professional service corporation would not have an equity in the leased property even though the grantor retains a reversionary interest.[119]

In *Quinlivan v. Commissioner*,[120] the Eighth Circuit adopted the Tax Court view that a reversionary interest was not a disqualifying equity under section 162(a)(3).[121] Reading the statutory prohibition on equity in conjunction with the requirement against taking title to the property, the court said that "[t]aken together [the requirements] were intended to prevent the taxpayer from receiving or improperly benefiting from the deducted rental payments."[122] Retaining a reversionary interest, to take effect at some future time, provides no benefit from current rental deductions under section 162(a)(3).

The courts' awkward handling of section 162(a)(3) made gift-leasebacks uncertain and confusing to taxpayers and practitioners alike. Taking the initiative to solve the dilemma, the Tax Court developed a four-prong test based on the factors relevant in many of the gift-leaseback decisions.[123] In order to deduct rental payments under section 162(a)(3):

116 *See, e.g.*, Chace v. United States, 303 F. Supp. 513, 516 (M.D. Fla. 1969) (alternative holding), *aff'd per curiam*, 422 F.2d 292 (5th Cir. 1970); Hall v. United States, 208 F. Supp. 584, 588 (N.D.N.Y. 1962); Gibbons v. United States, [U.S. Tax Cases] STAND. FED. TAX REP. (CCH) ¶ 9365 (D.N.M. 1970).

117 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

118 *Id.* at 23.

119 In Lerner v. Commissioner, 71 T.C. 290 (1978), an opthalmologist who had incorporated his practice established a trust for his children. Lerner conveyed his medical office to the trust, retaining a reversionary interest. The corporation then rented the property back for business purposes. The court allowed the corporation's deductions under § 162(a)(3), rejecting the very application of the equity argument since the corporation rather than the grantor paid the rent. *Id.* at 298.

120 599 F.2d 269 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979).

121 *Id.* at 272.

122 *Id.*

123 *See* Mathews v. Commissioner, 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (1975), *cert. denied*, 424 U.S. 967 (1976). The Fifth Circuit reversed *Mathews* because the gift-leaseback had no business purpose and was without substance.

a) The grantor must not retain substantially the same control over the property that he had before he made the gift.
b) The leaseback should normally be in writing and must require payment of a reasonable rental.
c) The leaseback (as distinguished from the gift) must have a bona fide business purpose.
d) The grantor must not possess a disqualifying "equity" within the meaning of section 162(a)(3).[124]

The Tax Court's attempt in the new test to integrate the express provisions of section 162(a)(3) with the case law as it had developed has proven fairly successful.[125] However, those circuits which require a business purpose for the entire transaction must necessarily reject the third prong.[126] And those circuits which reject the integrated analysis recognize the validity of the Tax Court test but do not rely on it as their sole analysis.[127] Finally, the Tax Court's decision in *May v. Commissioner*[128] exhibits the internal inconsistency within the Tax Court as to the appropriate significance and necessity of each prong of the test.[129]

II. An Analysis of the *May* and *Rosenfeld* Decisions

In *May v. Commissioner*,[130] the taxpayer and his wife deeded their entire right, title, and interest in real property to four irrevocable trusts to benefit their children (the property had previously been used for the taxpayer's medical practice).[131] The parties failed to record the deed, however, until two years after its execution.[132] Dr.

---

124 Lerner v. Commissioner, 71 T.C. 290, 301 (1978).

125 The Tax Court has followed its four-prong test except where the *Golsen* rule applies. Under Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971), the Tax Court will follow a court of appeals decision directly in point when appeal lies in that circuit alone. Thus, in Butler v. Commissioner, 65 T.C. 327 (1975), the Tax Court relied on *Van Zandt* to deny a taxpayer's gift-leaseback rental deductions under § 162(a)(3).

126 *See* notes 57-71 *supra* and accompanying text.

127 *See, e.g.*, May v. Commissioner, 723 F.2d 1434 (9th Cir. 1984) (recognizing the Tax Court's four-prong test but relying on criteria set forth in Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972)); Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983) (employing the Tax Court test but requiring a change in the economic interests of the parties); Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir.) (applying the plain meaning of § 162(a)(3) but using the Tax Court test as a second basis of analysis), *cert. denied*, 444 U.S. 996 (1979).

128 76 T.C. 7 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984).

129 The majority opinion in *May* was accompanied by a concurring opinion and three dissenting opinions. *See also* Friedlander, *Gift-Leaseback: The IRS' Misguided Campaign*, 19 CAL. W.L. REV. 288, 295 (1983).

130 76 T.C. 7 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984).

131 76 T.C. at 8-9.

132 *Id.* at 10.

May and a friend, Mr. Gross, were named trustees and given broad powers of management over the trust property.[133] Pursuant to an oral agreement, May leased the property back at a monthly rental of $1000.[134] The Tax Court held that the rental payments were deductible as ordinary and necessary business expenses under section 162(a)(3).[135]

In applying its four-prong test, the court dealt primarily with the first and second prongs.[136] Initially addressing the second requirement of reasonable rental and a written lease, the court held that absence of a written lease was not fatal in *May*, where "the terms of the lease were clearly understood by the trustees and faithfully observed by the parties."[137] Since the parties had stipulated that a reasonable rental had been paid,[138] further inquiry into the trustee's independence was only relevant in examining the grantor's control (first prong).[139] The court then turned to the first prong and distinguished *May* from both those cases where the grantor retains a reversionary interest and those cases where the grantor names himself sole trustee.[140] The court proceeded to find the trustee Gross independent, based on his feeling of independence and his awareness of the required fiduciary obligations. Given the size and simplicity of the trust, however, the execution of these fiduciary duties required only that Gross inspect the checking account four times to ensure that rent had been paid.[141] The majority opinion intimated that trustee independence might vary according to the nature and complexity of the trust corpus but left open the question of whether trustee independence would be required in every gift-leaseback situation.[142] Clearly, then, the majority of the Tax Court in *May* muddled the four-prong test, disregarding some aspects totally while hedging on others.

Four dissenting judges rejected any finding that Gross acted independently or performed the required fiduciary duties.[143] More-

133 *Id.* at 8-10.

134 *Id.* at 11.

135 *Id.* at 15.

136 The court adhered to the requirement of business purpose for the leaseback alone, as stated in the third prong. The court also dismissed the argument that May retained an equity in the property since May's children were the only equitable owners of the property. *Id.* at 13.

137 *Id.* at 14.

138 *Id.*

139 *Id.*

140 *Id.*

141 723 F.2d 1434, 1435 (9th Cir. 1984).

142 76 T.C. at 15.

143 Judges Wilbur and Parker joined in Judge Simpson's dissent which stated, "Mr. Gross

over, two judges would have dispensed with the necessity of an independent trustee in the *May* case.[144] The Tax Court's inconsistency in applying its four-prong test in *May*, thereby undermining its viability, merely added confusion and unpredictability to the evolving body of gift-leaseback law.

On appeal, the Ninth Circuit affirmed *May*, agreeing with the Tax Court's findings but applying different criteria.[145] The Ninth Circuit ignored the four-prong test and based its holding on *Brooke v. United States*, which focused on "the sufficiency of the property interest transferred" to determine whether rental payments could be deducted under section 162(a)(3).[146] The court upheld the validity of the conveyance which occurred upon execution of the trust instrument.[147] The court also affirmed the findings that the grantors did not retain the same control they had as owners after establishing the irrevocable trusts, that the trustees were sufficiently independent, and that the grantor's use of the property was limited to his rights as a lessee.[148] Because control over the property had been relinquished, the transfer had economic reality; when coupled with a leaseback required for May's medical practice, the rental payments were deductible under section 162(a)(3).[149]

After *May*, the future of the Tax Court's four-prong test seemed questionable. In another gift-leaseback case, however, the Tax Court rejuvenated its test, which the Second Circuit subsequently adopted. In *Rosenfeld v. Commissioner*,[150] a taxpayer established three irrevocable trusts to benefit his children, appointing his attorney and accountant co-trustees.[151] He then transferred his medical property to the trusts for a period of ten and one-half years, retaining a reversionary inter-

---

was not the type of independent trustee who would assure that the trust and lessee dealt with each other at arm's length." *Id.* at 34 (Simpson, J., dissenting). Judge Wilbur's separate dissent found that "[h]is performance was not independent by any stretch of the imagination." *Id.* at 37 (Wilbur, J., dissenting). Finally, Judge Chabot wrote that Gross, "the supposedly independent trustee," did not demonstrate any independence. *Id.* at 41 (Chabot, J., dissenting).

144 *See* 76 T.C. 7, 16 (1981) (Goffe, J., concurring); *id.* at 41 (Chabot, J., dissenting).

145 723 F.2d 1434 (9th Cir. 1984).

146 *Id.* at 1436-37; *see also* notes 75-78 *supra* and accompanying text.

147 "Under California law the gratuitous transfer of real property can be accomplished by the delivery of a written instrument, executed by the transferor, which contains language plainly showing a present intent to transfer." *Id.* at 1437 (citations omitted).

148 *Id.*

149 *Id.*

150 706 F.2d 1277 (2d Cir. 1983).

151 *Id.* at 1278-79.

est effective upon expiration of the term.[152] On the same day that the parties executed the trust agreement, Rosenfeld leased the property back for the entire trust term.[153] The trustees had the power to manage the property; in essence, they collected and invested the rental income, paid the property taxes, and filed the tax returns for the trust.[154] Rosenfeld remained responsible for the mortgage payments and for maintenance of the property.[155] After four years, Rosenfeld transferred his reversionary interest to his wife.[156] Later, the parties amended the trust agreement to designate Rosenfeld's daughter, a trust beneficiary, as a third trustee, to extend the trust term and to shorten the rental period to one year with an option to renew.[157]

The Tax Court upheld the deduction of the rental payments, once again refusing to require a business purpose for the entire arrangement.[158] The court determined that Rosenfeld did not own a prohibited equity in the property; his reversionary interest was not a right derived from the lease arrangement, and in any event he had transferred it to his wife prior to the years in issue.[159] Rosenfeld required the medical property for his practice, thus the leaseback had a valid business purpose.[160] Moreover, the lease agreement was written, and the Commissioner had not objected to the reasonableness of the rental.[161] Finally, Rosenfeld did not retain substantially the same control over the property as he had as owner.[162]

The Tax Court noted that a prearranged leaseback is at least implicit in the gift-leaseback situation; a grantor would not part with his office unless he could be assured of continued possession in return for the stipulated rental.[163] Furthermore, a lease period equivalent to the trust term did not effectively negate the trustees' powers of negotiation, where the trustees would be unlikely to evict the grantor and

---

152 *Id.* at 1279.

153 An independent firm appraised the fair rental of the property to be $14,000 annually, which Rosenfeld paid. *Id.* The appraisal also recommended converting a storage area in the rear one-third of the building into an office space for rent, which Rosenfeld declined to do. *Id.* at 1284 (MacMahon, J., dissenting).

154 Brief for Appellant at 6, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).

155 723 F.2d at 1279.

156 *Id.*

157 706 F.2d at 1279, 1288 (MacMahon, J., dissenting). The trust, as amended, required action by majority vote of the trustees, provided the daughter was in the majority. *Id.*

158 1982 T.C.M. (P-H) ¶ 82,263, at 1096.

159 *Id.*

160 *Id.*

161 *Id.*

162 *Id.* at 1096-97.

163 *Id.* at 1097.

could still negotiate a higher rental prior to the lease expiration, as accomplished in *Rosenfeld*.[164] Furthermore, the trustees in *Rosenfeld* were aware of their duties and participated more actively than did the trustees in *May*.[165]

The Second Circuit affirmed *Rosenfeld* and joined the growing majority of courts adhering to the bifurcated approach. On appeal, the government had argued that the rental obligation "arose out of a transaction serving no business purpose, resulting in no loss of control over the property and having tax avoidance as its sole objective."[166]

The court of appeals, however, following the four-prong test of the Tax Court, disagreed with the government and found that the transfer sufficiently diminished Rosenfeld's control over the property.[167] The court rejected application of the business purpose standard to the entire gift-leaseback transaction, because imposing that requirement would deny the rental deduction in every gift-leaseback case.[168] Moreover, since Congress has explicitly approved the Clifford trust as a valid income-splitting device,[169] the Second Circuit determined that it would be unreasonable to require a taxpayer to have a business purpose to establish the trust.[170] The Second Circuit proceeded then from the four-prong test to an examination of all the relevant circumstances and, in particular, to an inquiry into the economic interests of the parties. "If their legal rights and beneficial interests have changed, there is no basis for labeling a transaction a 'sham' and ignoring it for tax purposes."[171] The court found a sufficient change in the economic interests to uphold the gift-leaseback transaction. In addition, the court found that Rosenfeld's desire to provide for his children generated a legitimate non-tax motive for the creation of the trust, and the business necessity of an office prompted the leaseback.[172]

Judge MacMahon argued forcefully in his dissent that the gift-leaseback in substance did not affect Rosenfeld's beneficial interests;

164 *Id.*

165 *Id.*

166 Brief for Appellant at 9, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).

167 706 F.2d at 1281. "[T]he broad grants of power to the trustees, the concomitant diminution of Rosenfeld's rights, and the actual independence of the trustees, adequately satisfies the first element of the Tax Court's test." *Id.*

168 *Id.*

169 I.R.C. §§ 671-678 (1976).

170 706 F.2d at 1281-82.

171 *Id.* at 1282.

172 *Id.*

rather, it merely reduced his tax.[173] MacMahon then chastised the majority for misconstruing the government's business purpose argument.[174] Indeed, the government did not argue that the initial gift must have a business purpose, but rather, when viewing the transaction as related steps in a single plan, the series of events must have a legitimate business purpose.[175] The Second Circuit had previously denied the rental deductions in a gift-leaseback case,[176] thus implicitly recognizing an integrated approach, but the majority opinion did not find it controlling.[177]

MacMahon further disagreed that denial of the rental deduction runs afoul of Congressional intent by excluding a tax benefit to those persons whose only assets are business property.[178] Rather, the inherent unfairness, in his view, rested with persons possessing non-income producing property unable to take advantage of the Clifford provisions.[179] In addition, MacMahon refuted the majority's argument that because the grantor could have leased property from a third person and deducted the rental payments under section 162(a)(3), he should be accorded the same treatment in a gift-leaseback context; the potential for exerting control over property given in trust to family members and leased back sufficiently distinguishes the two.[180] In fact, MacMahon argued that Rosenfeld maintained control by instructing the trustees not to improve the unfinished portion of the building, by amending the trust, and by appointing his daughter trustee.[181]

III. The Appropriate Test To Determine Rental Deductibility

Rosenfeld and *May* both exhibit the government's unsuccessful attempts to invalidate rental deductions in a gift-leaseback transaction. The government contends that a taxpayer must show a business purpose for the gift and leaseback since these events are "designed and executed as integrated parts of a single plan."[182] Thus, unless the

173 *Id.* at 1283 (MacMahon, J., dissenting).

174 *Id.*

175 Brief for Appellant at 10-11, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).

176 The apparent integrated approach of White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952), is discussed in note 94 *supra*.

177 The majority acknowledged *White* only in scattered references but clearly did not base its holding on it. 706 F.2d at 1281-82.

178 706 F.2d at 1286 (MacMahon, J., dissenting).

179 *Id.*

180 *Id.*

181 *Id.* at 1288.

182 Brief for Appellant at 15, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).

whole transaction is entered into with a business purpose, the expenses incurred should not be deductible business expenses under section 162(a)(3). Alternatively, the government argues that a grantor/lessee retains such dominion and control over the property that he continues to be its owner.[183] Thus, the transfer of legal title in the gift-leaseback situation lacks economic reality, and it should not be recognized for tax purposes.[184]

Underlying each argument, as well as each court's analysis, is the concern that the gift-leaseback have economic reality: whether the transaction in substance has effectuated a bona fide change in the beneficial interests of the parties. If so, then the transaction is not a sham. "[T]he Government should honor the allocation of rights and duties effectuated by the parties."[185]

The problem with employing a business purpose test in the gift-leaseback context is that the two relevant transactions require different determinations to prove they are legitimate transactions rather than tax avoidance schemes. Initially, a grantor will establish a short-term Clifford trust or will make an outright conveyance of his entire interest in property to his children. The grantor's motive in making such a gift must by definition arise from a "detached and disinterested generosity."[186] The taxpayer, as a parent, wants to promote the welfare of his children. This motive should be distinguished from the motive of the same taxpayer as a businessman entering into a lease.

To prove that a gift to a trust has economic substance, the grantor must show that he no longer exerts the same dominion and control over the property that he had as owner.[187] In the case of a Clifford trust where the grantor retains a reversionary interest, two distinct factors negate a grantor's control: an independent trustee or a transfer of the reversion. The independent trustee, acting in a

183 *Id.* at 24-25. Courts frequently reject this argument where a Clifford trust is involved. Unless the trust fails to comply with I.R.C. §§ 671-677, Congress has provided that the grantor should not be treated as the owner for tax purposes. Applying §§ 671-677 and § 162(a)(3) *in pari materia*, some courts will not look behind a valid trust to determine that the grantor remains the owner for purposes of denying the rental deduction. *See Rosenfeld*, 706 F.2d 1277, 1281-82 (2d Cir. 1983); *Quinlivan*, 599 F.2d 269, 273-74 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); *see also* note 16 *supra*.

184 Brief for Appellant at 24-25, Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).

185 Frank Lyon Co. v. United States, 435 U.S. 561, 584 (1978) (recognizing the validity of a three-party sale-leaseback transaction).

186 Commissioner v. Duberstein, 363 U.S. 278, 285 (1960).

187 *See* notes 87-98 *supra* and accompanying text.

fiduciary capacity, ensures that the gift-leaseback transaction is at arm's length. Similarly, where the grantor transfers his reversionary/remainder interest, the disposition resembles an outright gift of property. In that case, the gift transfer has substance and there need be no added requirement of an independent trustee.[188] The grantor has effectively relinquished all present and future rights in the property.

The subsequent leaseback, unlike the gift to the trust, occurs in a commercial context and is therefore properly within the business purpose test. In order to deduct rental payments, the taxpayer must enter into the lease agreement for commercial purposes. A physician, attorney, or any sole practitioner who requires an office building for his practice enters into a lease with a business purpose. It is that simple.

The government erroneously relies on cases like *Armston* and *White* which denied rental deductions for intra-family transfers and leasebacks because the arrangements lacked economic substance. Those cases, however, did not involve a trust. As previously mentioned, a trust with an independent trustee subject to fiduciary obligations, or a trust composed of property which will not revert to the grantor, is sufficient evidence of the bona fides of the transfer and proof that the transactions are grounded in economic reality.

Likewise, the government's argument that transactions designed as a single plan will not be given independent significance is inapplicable to a gift-leaseback transaction. Only where a transaction is a series of steps designed to circumvent taxation will courts disregard the intervening event which has no utility or significance apart from its use as a vehicle to obtain favorable tax consequences.[189] In the gift-leaseback situation, both the gift and the leaseback have legitimate non-tax objectives.[190]

The appropriate test to determine the deductibility of rentals under section 162(a)(3) in a gift-leaseback situation must ensure that the transaction is grounded in economic reality. A valid gift need not have a business purpose; rather, it should divest the owner of control over the property. A leaseback should be entered into for commercial purposes. The parties effectuating the leasehold must

188 May v. Commissioner, 76 T.C. 7, 30 (1981) (Coffe, J., concurring), *aff'd*, 723 F.2d 1434 (9th Cir. 1984).

189 *See* Griffiths v. Commissioner, 308 U.S. 355 (1939); Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); Gregory v. Helvering, 293 U.S. 465 (1935).

190 *See* Friedlander, *supra* note 129, at 299.

derive their rights from the lease and act according to their legal status as lessor or lessee.

IV. Conclusion

For the professional doctor, attorney, or sole practitioner who owns business realty, the gift-leaseback transaction looks attractive and desirable at first glance. Realistically, however, the taxpayer should be wary of conveying his property and deducting the rental payments under I.R.C. section 162(a)(3). At a minimum, the IRS may assess a deficiency for the rental deductions, forcing the taxpayer into litigation. And, although the taxpayer may ultimately prevail, the time and expense of litigation may nullify any advantage obtained by the transaction.

Moreover, a taxpayer's success in court will depend, quite fortuitously, upon the circuit in which his appeal lies and also upon the state of the evolving gift-leaseback jurisprudence. The requirements which ensured deductibility of rental payments yesterday may differ or may even be largely ignored tomorrow. Thus, unless the Supreme Court rules on the deductibility of rentals issue, taxpayers and attorneys must monitor the gift-leaseback situation carefully.

Karen W. Kiley