



January 1965

Income Shifting - Recent Trends in Leaseback Transactions

Lawrence B. Gibbs

Recommended Citation

Lawrence B. Gibbs, *Income Shifting - Recent Trends in Leaseback Transactions*, 19 SW L.J. 273 (1965)
<https://scholar.smu.edu/smulr/vol19/iss2/4>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

INCOME SHIFTING — RECENT TRENDS IN LEASEBACK TRANSACTIONS

by

Lawrence B. Gibbs*

THE use of intra-family transfers of income-producing properties to reduce the family tax burden has had a long and colorful history in the tax law. Early developments, involving family trusts and partnerships, resulted in court-imposed limitations upon the shifting of income within the family group where the transferor-parent, although purporting to relinquish property interests, actually retained dominion and control over the property.¹ There followed a series of Congressional attempts to provide statutory rules for taxing the income produced by the transferred properties among family members participating in such transactions.² Recently, various other family income-shifting arrangements³—the tax effects of which are not defined by statute—have prompted the Commissioner and the courts to resurrect and extend the rationale and arguments of the early court decisions in this area.

Of special interest to tax practitioners has been the development in the gift and leaseback area of the dialectic between the Commissioner and the taxpayer which involves the application of the principles and policies underlying the *Helvering v. Clifford*⁴ decision to an intra-family transfer of property which is immediately leased back to the transferor. The taxpayer's thesis that for income tax purposes the transfer and subsequent leaseback should be viewed as separate transactions and the Commissioner's antithesis that the two steps should be fused have provided abundant and interesting litigation. The recent decision by the Court of Appeals for the Fifth Circuit in *Van Zandt v. Commissioner*⁵ represents an important synthesis in this area.

* B.A., Yale; LL.B., University of Texas; Attorney at Law, Corpus Christi, Texas.

¹ See *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946); *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Clifford*, 309 U.S. 331 (1940).

² See Int. Rev. Code of 1954, §§ 671-78, 704(e).

³ Thus, in a private annuity transaction, where the annuity payments are to be paid solely out of the property transferred, the Commissioner has succeeded in taxing the income to the transferor-annuitant on the theory of retained dominion and control. See *Samuel v. Commissioner*, 306 F.2d 682 (1st Cir. 1962).

Similarly, it is understood the Service has taken the position that the grantor of a short-term trust remains taxable on the income from oil interests which are transferred to the trust. *Wilson, The Use of Mineral Interests in Short-Term Trusts—A New Tax Problem*, 14 Sw. L.J. 495 (1960).

⁴ 309 U.S. 331 (1940).

⁵ *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965).

I. INTRODUCTION

The gift and leaseback arrangement has become increasingly popular in the last ten years. The intended tax consequences of the arrangement are to substitute a rental deduction for the depreciation deduction⁶ of the donor-lessee and to deflect income in the amount of the rental payments from the high income tax bracket of the parents to the lower brackets of the trust and the children. The net economic result is a tax-saving shift of income within the family. Although structural changes in the Internal Revenue Code have eliminated much of the need for⁷ (and in some cases the desirability of⁸) shifting income and property within the family by inter-vivos gift, the graduated income tax rates and a generally favorable attitude by the courts⁹ have prompted the continued use of the gift and leaseback arrangement.¹⁰

A related transaction, the sale and leaseback, also is used for family tax-planning purposes, but because of the tax problems attendant to the sale of property,¹¹ especially between related parties,¹² this arrangement has been used sparingly to reallocate income within the family

⁶ Tax savings of the donor-lessee are enhanced if the property transferred is nondepreciable (e.g., land) because a deduction is created rather than substituted or, if because of long use or accelerated depreciation, the property, though depreciable, has a low basis and high market value. However, the net tax benefit to the family will depend upon the comparative tax brackets of the parents, the trust and the children. If depreciable property is transferred in trust, the depreciation deduction is shifted to the trust and its beneficiaries. If the trust instrument is worded correctly, the depreciation deduction can be allocated between the trust and the beneficiaries in a manner that will provide the maximum tax benefits. See *Upton v. Commissioner*, 283 F.2d 716 (9th Cir. 1960), *cert. denied*, 366 U.S. 911 (1961); *Estate of Little*, 274 F.2d 718 (9th Cir. 1960); *Treas. Reg. § 1.652(b)-2* (1956); *Rev. Rul. 47, 1960-1 Cum. Bull. 250*; *Rice, Family Tax Planning ch. 8, § 22* (Supp. 1964).

⁷ See *Int. Rev. Code of 1954, §§ 6013* (joint returns), 2056 (estate tax marital deduction).

⁸ For a discussion of the possible adverse tax consequences of making lifetime interspousal gifts, see *Casner, Estate Planning 783-84* (3d ed. 1961).

⁹ The following cases have upheld a trustee intra-family gift and leaseback transaction: *Brown v. Commissioner*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948); *John T. Potter*, 27 T.C. 200 (1956), *acq.* 1957-2 *Cum. Bull. 6*. *But see, Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962), discussed in text accompanying notes 92-93 *infra*.

Cases which have denied the intended tax effects of a nontrustee intra-family gift and leaseback are as follows: *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952).

¹⁰ See generally, *Smith, Shifting Income Within the Family Group*, 30 *Taxes* 995 (1952).

¹¹ If the property is depreciable, a portion of the gain may be ordinary income. See *Int. Rev. Code of 1954, §§ 1245, 1250*; *Proposed Treas. Reg. § 1.1245-1(a)(3)*, 29 *Fed. Reg.* 11366 (1964), which specifically states that a "sale-leaseback transaction" is a disposition to which § 1245 applies. If an investment credit has been taken and if the property is sold prior to termination of its useful life, a portion of the credit may be subject to recapture. *Int. Rev. Code of 1954, § 47*.

¹² See *Int. Rev. Code of 1954, §§ 267* (disallowance of losses, expenses, and interest in transactions between related taxpayers), 1239 (ordinary income treatment of gain on sale of depreciable property between spouses or between an individual and his controlled corporation). See also *Int. Rev. Code of 1954, §§ 482, 707(b), 1551*.

group.¹³ Instead, the sale and leaseback has been used in family situations involving closely held corporations in order to provide additional deductions to the corporation,¹⁴ to eliminate excess profits¹⁵ and to bail out corporate earnings at capital gains rather than ordinary income rates.¹⁶

Other possible uses of the leaseback device to minimize family taxes include the transfer of property to a tax-exempt foundation with a leaseback or leaseover,¹⁷ or the transfer and leaseback of property between a closely held family corporation and its employee retirement fund.¹⁸

An investigation of the cases dealing with the various uses of the transfer and leaseback device reveals an area of *ad hoc* decisions, esoteric distinctions, and a host of tax aphorisms. This is due, in part, to the general sensitivity of the tax law to transactions involving reallocation of income within the family group.¹⁹ Such an atmosphere makes rationalization of past decisions difficult and prediction of future results precarious. Recent decisions in this area and in related areas emphasize the importance in planning the transaction and of carefully arranging the component parts to minimize the potential tax exposures incident to it.²⁰

¹³ For cases involving sale and leaseback between family members, see, e.g., *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *Unger v. Campbell*, 61-1 U.S. Tax Cas. ¶ 9163, 7 Am. Fed. Tax R.2d 547 (N.D. Tex. 1960); *Albert T. Felix*, 21 T.C. 794 (1954). Traditionally, the sale and leaseback has been used as a financing device. See generally *Casey, Tax Shelter in Real Estate* 42 (2d ed. 1961).

¹⁴ See generally, *Lassers, Does a Lease-Back Save You Money?*, 32 *Taxes* 279 (1954); *Mandell, Tax Aspects of Sales and Leasebacks as Practical Devices for Transfer and Operation of Real Property*, N.Y.U. 18th Inst. on Fed. Tax 17, 21 (1960). As in the gift-leaseback situation, rental deductions can be substituted for depreciation of low-basis property. See note 6 *supra*. In addition, if the sale is to a shareholder, corporate earnings can be distributed in the form of rent, which is deductible by the corporation, rather than by a non-deductible dividend.

¹⁵ See *W. H. Armston Co. v. Commissioner*, 188 F.2d 531, 533 (5th Cir. 1951).

¹⁶ See discussion of sale and leaseover or leaseback cases at text accompanying notes 135-49 *infra*.

¹⁷ E.g., *Boman v. Commissioner*, 240 F.2d 767 (8th Cir. 1957) (leaseback); *Huron Clinic Foundation v. United States*, 212 F. Supp. 847 (D.S.D. 1962), *vacated and remanded*, 324 F.2d 43 (8th Cir. 1963) (leaseback); *Royal Farms Dairy Co.*, 40 T.C. 172 (1963) (leaseover); *Anderson Dairy, Inc.*, 39 T.C. 1027 (1963) (leaseover); *Burroughs Corp.*, 33 T.C. 389 (1959) (leaseback); *Estate of Goldenberg*, 23 CCH Tax Ct. Mem. 810 (1964) (leaseover). See generally *Young, Donor Foundation Dealings*, N.Y.U. 22d Inst. on Fed. Tax 956, 993 (1964). See text accompanying notes 116-49 *infra*.

¹⁸ *Colorado Nat'l Bank*, 30 T.C. 933 (1958); cf. *Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner*, 306 F.2d 20 (6th Cir. 1962); *Rev. Rul. 206, 1960-1 Cum. Bull. 201*.

The gift and leaseback approach has been used in some cases as a secondary argument for upholding a shift of income within a family group which failed to meet the standards of the family partnership rules. See *Stanback v. Commissioner*, 271 F.2d 514 (4th Cir. 1959); *Wofford v. Commissioner*, 207 F.2d 749 (5th Cir. 1953).

¹⁹ See cases cited note 1 *supra*.

²⁰ Several articles have suggested planning and drafting techniques in arranging a gift and leaseback transaction. See *Cohen, Transfers and Leasebacks to Trusts: Tax and Planning*

II. THE GIFT AND LEASEBACK

This Article will be concerned primarily with the gift and lease-back arrangement; however, because of its similarity in form and its importance in recent developments, the sale and leaseback also will be considered where relevant.²¹

A. *The Transaction And The Issue*

The gift and leaseback arrangement has taken one of two forms. Either an outright gift is made to a family member with a leaseback to the donor,²² or, as is usually the case, the donor establishes an irrevocable trust (the beneficiaries of which are the members of the donor's family), conveys property to it, and leases the property back.²³ The trustee is ordinarily a third party.²⁴ The donor may or may not retain a reversionary interest in the property given to the trust.²⁵

If a trust is used and if the requirements of sections 671-78²⁶ are met, the donor-lessee is apparently not taxable on the income earned

Considerations, 43 Va. L. Rev. 31 (1957); Webster, *Transfers to Trusts with Leasebacks—Drafting and Other Suggestions for Trusts and Lease Agreements*, So. Cal. 8th Tax Inst. 319 (1956).

²¹ Articles discussing the sale-leaseback transaction include Agar, *Sales and Lease-backs*, 18 Bull. of ABA Tax Section, No. 2, at 61 (January, 1965); Clark, *Changing Considerations in Sales and Leaseback Transactions*, 42 Taxes 725 (1964); Friedman, *Lease or Purchase of Equipment: Sale and Leaseback*, N.Y.U. 14th Inst. on Fed. Tax 1427 (1956); Greenfield, *Corporate Benefits in Using the Sale-Leaseback Device*, 37 Taxes 1017 (1959); Lassers, *supra* note 14; Mandell, *supra* note 14; Wilson, *Sales and Leasebacks*, So. Cal. 16th Tax Inst. 149 (1964). Other articles containing a discussion of both gift and sale and leasebacks are Rice, *op. cit. supra* note 6; Cary, *Current Problems in Sale, or Gift, and Lease-back Transactions* 29 Taxes 662 (1951); Cohen, *supra* note 20; Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 Tax L. Rev. 295, 335 (1962); Webster, *supra* note 20; Yohlin, *Assignment and Deflection of Income*, N.Y.U. 20th Inst. on Fed. Tax 147, 174 (1962).

²² See *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); Rev. Rul. 9, 1954-1 Cum. Bull. 20.

²³ *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); John T. Potter, 27 T.C. 200 (1956); Albert T. Felix, 21 T.C. 794 (1954); Helen C. Brown, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); A. A. Skemp, 8 T.C. 415 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948).

²⁴ The trustee may be a corporate trustee, Albert T. Felix, *supra* note 23; A. A. Skemp, *supra* note 23; or the donor's attorney, Helen C. Brown, *supra* note 23; or the father, the wife, or the accountant of the donor, John T. Potter, *supra* note 23. The *Van Zandt* case is the first in which the donor is also the trustee.

²⁵ Compare the cases cited note 24 *supra* with *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962), discussed in text accompanying notes 92-93 *infra*, and *I. L. Van Zandt*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965).

²⁶ See Int. Rev. Code of 1954, §§ 671-78.

by the property held in trust.²⁷ The regulations²⁸ and the committee reports²⁹ state, however, that these sections have no application in determining the grantor's right to deduct rental payments made to the trust under a leaseback arrangement. The Commissioner, in attacking the gift-leaseback, has usually disallowed the rental deduction to the donor-lessee.³⁰

The Commissioner's position is that the gift and leaseback is a sham transaction without business purpose, and that it should be viewed as a series of prearranged, integrated steps whereby the donor re-allocates income within the family by purporting to relinquish property which in reality he retains and controls.³¹ Under this view, for income tax purposes the donor-lessee is denied a rental deduction; however, he is entitled to a depreciation deduction because he remains the owner of the property.³² For gift tax purposes, the rental obligation under the lease constitutes a gift of a present right to receive the rentals which has a gift tax value equal to the discounted worth of the net rental to be received over the period of the trust.³³

²⁷ See Treas. Reg. § 1.671-1(c) (1956). *But see*, Dwan, *Income Tax Problems in the Administration of Estates, Simple, and Complex Trusts*, University of Texas School of Law 4th Tax Conf. 25, 35 (1956), suggesting that even if the requirements of §§ 671-78 are met, the income may be taxed to the grantor on other grounds, such as assignment of future income. In this respect, it has been suggested that the gift and leaseback arrangement results in assignment of income. See *White v. Fitzpatrick*, 193 F.2d 398, 402 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952), discussed in text accompanying notes 61-64 *infra*; *Helen C. Brown*, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). Although the Commissioner has argued the "assignment of income" theory as an alternative to disallowance of the rental deduction, he never has attempted to disallow the rental deduction and, in addition, to tax the income of the trust to the grantor. Even in cases in which the trust in the gift and leaseback arrangement otherwise would result in a taxation of trust income to the grantor under the provisions of §§ 671-78, it is not clear that the Commissioner would attempt to tax such income to the grantor in addition to disallowing him the rental deduction. See *Cohen*, *supra* note 20 at 42. See also *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962), discussed in text accompanying notes 92-93 *infra*. Under the provisions of each trust in the *Hall* case, the trust was to terminate at the death of either the income beneficiary or one of the grantor-spouses, at which time the property was to revert to the surviving grantor-spouse. In the appellant's brief in the *Van Zandt* case, it is suggested that the trust in the *Hall* case failed to meet the duration requirements on the basis of these facts. Brief for Appellant, pp. 16-17, *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965). This would seem to be true only if it is also true that the life expectancy of one of the grantor-spouses in the *Hall* case was less than ten years. See Treas. Reg. § 1.673(a)-1(c) (1956).

²⁸ Treas. Reg. § 1.671(c) (1956).

²⁹ Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954). For an excellent discussion, which suggests that the attitude of Congress is ambiguous on this point, see *Webster*, *supra* note 20, at 320 n.7. See also *Cohen*, *supra* note 20, at 40-41.

³⁰ See the cases cited in note 23 *supra*.

³¹ Rev. Rul. 9, 1954-1 Cum. Bull. 20.

³² *E.g.*, *W. H. Armston Co. v. Commissioner*, 188 F.2d 531, 533 (5th Cir. 1951); *I. L. Van Zandt*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965); *A. A. Skemp*, 8 T.C. 415, 419 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948).

³³ Rev. Rul. 315, 1957-2 Cum. Bull. 624, which modifies Rev. Rul. 9, 1954-1 Cum. Bull. 20, in which the Commissioner originally indicated that the rental payments would be treated as gifts in the year of payment. The reason for this modification appears to be to avoid the loss of gift tax through annual \$3,000 exclusions which otherwise might result if

In early cases, the Commissioner emphasized the donor's retention and control of the leased property and attacked the rental deduction either on an "incomplete gift"³⁴ theory or under the *Clifford* doctrine.³⁵ Without changing the basis of his argument, the Commissioner recently, and with more success, has changed the form of his argument to an analysis of the code provisions under section 162 (a) (3), which deals with the rental deduction.³⁶

B. *The Statute: "Ordinary and Necessary" Expense*

Section 162 (a) (3) states that:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

. . . .

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.³⁷

the rental payments were treated as annual gifts. If, however, the rentals are based on a percentage of the profits and if the actual annual rentals are in excess of the projected rentals upon which the taxpayer initially pays the gift tax, the Commissioner may attempt to tax the payments as annual gifts. See *Talge v. United States*, 229 F. Supp. 836 (W.D. Mo. 1964).

In Revenue Ruling 315, *supra*, the duration of the trust (ten years) was coextensive with the term of the lease. If, however, the grantor retains no reversionary interest so that the term of the trust is longer than that of the lease, it would appear that for gift tax purposes the period over which the rentals should be computed would have to be adjusted accordingly. Although the gift tax computation in such an event is not without its difficulties, it is believed that the maximum period over which the rentals are to be discounted should not exceed the useful life of the property transferred.

It has been suggested that even if the rentals are treated as gifts, the amounts received as rent by the trust may be taxable as income to the trust or its beneficiaries. See Int. Rev. Code of 1954, §§ 102, 641(b), and the discussion by Cohen, *supra* note 20 at 42-43.

³⁴ *Helen C. Brown*, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *A. A. Skemp*, 8 T.C. 415 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948). This argument apparently originated in *Johnson v. Commissioner*, 86 F.2d 710 (2d Cir. 1936), in which the taxpayer attempted to convert the character of nondeductible insurance policy premiums to deductible interest items. The husband made a gift of the proceeds of a bank loan to his wife, who placed the money in a trust which was to pay premiums on an insurance policy on the husband's life. The husband borrowed the money back from the trust on a long-term installment obligation with 6% interest in order to repay the bank. The husband made annual interest payments to the trust, which he deducted, and the trust used the payments to pay the premiums on the life insurance policy. The court viewed the arrangement as one transaction, and disallowed deduction of the interest on the loan back to the husband on the theory that there was no valid loan since there had been no valid gift of the money initially.

³⁵ *E.g.*, *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952), discussed in text accompanying notes 61-64 *infra*; *John T. Potter*, 27 T.C. 200 (1956).

³⁶ *E.g.*, *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962), discussed in text accompanying notes 92-93 *infra*; *I. L. Van Zandt*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965). It is interesting to note that the Government's appellate brief in the *Van Zandt* case is devoted entirely to an analysis of § 162. Brief for Appellee, pp. 9-19, *Van Zandt v. Commissioner, supra*.

³⁷ Int. Rev. Code of 1954, § 162(a) (3).

The Commissioner has asserted two distinct but related arguments under this section. First, the section requires a business purpose, which, in his view, is lacking in the gift-leaseback situation.³⁸ Second, to be deductible under this section, rental payments must be "ordinary and necessary" and "required to be made as a condition to continued use or possession . . .," whereas, under the Commissioner's theory, the payments by the donor-lessee are gifts made for personal reasons.³⁹

In support of his first argument, the Commissioner cites a number of cases in the sale and leaseback area in which the courts have disallowed the rental deduction because no business purpose could be shown for the sale and leaseback transaction.⁴⁰ In addition, the Commissioner argues that, aside from tax consequences, the net effect of a gift and leaseback is merely to create an economic detriment to the donor-lessee because after the transaction he must pay rent for using property which, prior to the transaction, required no payment for its use and enjoyment.⁴¹

Similarly, the Commissioner argues that the rental payments are neither "necessary" nor "required" within the meaning of the statute because the donor has unrestricted use of the property prior to its conveyance and because the donor voluntarily creates the situation which requires the payment of rent.⁴²

Prior to the *Van Zandt* case, the courts usually had ignored the business purpose argument in the gift and leaseback area, despite their adherence to it in the sale-leaseback area.⁴³ The reason for this differ-

³⁸ The taxpayer usually has asserted three reasons for using the gift-leaseback arrangement: (1) to reduce income taxes, (2) to provide economic security for the children and (3) to protect the property from the claims of creditors. See, e.g., Egbert J. Miles, Jr., 41 T.C. 165 (1963), discussed in note 149 *infra*; Helen C. Brown, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). Occasionally, however, there are additional business reasons, the most common of which is the desire to maintain liquidity. See *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569, 571 (7th Cir. 1949); *Talge v. United States*, 229 F. Supp. 836 (W.D. Mo. 1964); *Southern Ford Tractor Corp.*, 29 T.C. 833 (1958).

³⁹ E.g., *Ingle Coal Corp. v. Commissioner*, *supra* note 38; *Ernest V. Berry*, 23 CCH Tax Ct. Mem. 1077 (1964).

⁴⁰ E.g., *Finley v. Commissioner*, 255 F.2d 128 (10th Cir. 1958); *W. H. Armston Co. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949); *Shaffer Terminals, Inc.*, 16 T.C. 356 (1951), *aff'd*, 194 F.2d 539 (9th Cir. 1952).

⁴¹ Brief for Appellee, p. 15, *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965).

⁴² See cases cited note 39 *supra*.

⁴³ In the cases which have denied the rental deduction, the lack of business purpose has been emphasized. *Kirschenmann v. Westover*, 225 F.2d 69, 71 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); *58th Street Plaza Theater, Inc. v. Commissioner*, 195 F.2d 724, 725 (2d Cir. 1952); *White v. Fitzpatrick*, 193 F.2d 398, 400 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *W. H. Armston Co.*, 188 F.2d 531, 533 (5th Cir. 1951). In the cases in which the rental deduction has been upheld, the courts either have failed to discuss the business purpose of the transaction, compare *Brown v. Commissioner*, 180 F.2d 926 (3d Cir. 1950), with *Helen C. Brown*, 12 T.C. 1095, 1101 (1949), *rev'd*, 180 F.2d 926 (3d

ence in treatment appears to be that the cases dealing with sale-leasebacks normally involve transactions between a corporation and its shareholders, where business purpose traditionally has been an important factor in the determination of the tax consequences.⁴⁴ If the gift is to and the leaseback from an independent trustee, the courts have viewed the gift and leaseback transaction as a series of separate, substantial and bona fide steps and have rejected the "step transaction," "form sham" premise of the Commissioner.⁴⁵

In the two earliest cases⁴⁶ in this area, the taxpayers (a physician in one and a husband-and-wife mining partnership in the other) conveyed realty used in their business to a third-party trustee who, in accordance with a prior understanding, immediately leased the property back to the grantors. In both cases the Commissioner argued and the Tax Court decided that the rental payments were not "required" because the taxpayers had voluntarily relinquished ownership of the property in a prearranged plan under which they would continue to enjoy its use. In each case, however, the court of appeals found that the taxpayers had irrevocably divested themselves of control over the property. The court in *Skemp v. Commissioner*, in language which has often been quoted in later decisions to justify the rental deduction, stated:

The Commissioner argues that the payments as rent were not required because the taxpayer had voluntarily entered into the transaction. 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. The income from the property is not claimed in this proceeding to be that of the taxpayer. We have here only a question of deduction of rental from gross income. There can be no question but what rent required to

Cir.), *cert. denied*, 340 U.S. 814 (1950), or have treated the absence of business purpose as unimportant. Compare *Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F.2d 849, 852 (7th Cir. 1954), with *Stearns Magnetic Mfg. Co.*, 11 CCH Tax Ct. Mem. 535, 537 (1952). Several cases have acknowledged the Commissioner's argument concerning lack of business purpose, but have failed to discuss the issue. *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); *John T. Potter*, 27 T.C. 200 (1956). For further discussion, see *Webster*, *supra* note 20 at 336-37 nn. 44-46.

⁴⁴ See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935). It has been held that reduction of taxes by arranging a transaction to provide capital gain rather than ordinary income treatment is a sufficient business purpose. *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955). However, in that case, the court specifically stated: "On the other hand, where the issue is the recognition . . . of a sale and leaseback arrangement . . . the existence of an independent business purpose may be very important." *Id.* at 174-75.

⁴⁵ See text accompanying note 47 *infra*.

⁴⁶ *Helen C. Brown*, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *A. A. Skemp*, 8 T.C. 415 (1947), *rev'd*, 168 F. 2d 598 (7th Cir. 1948).

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.⁴⁷

A recent Tax Court decision indicates a possible change in the form (but not the substance) of the Commissioner's argument. The case, *Ernest V. Berry*,⁴⁸ draws upon language contained in the decision of the Supreme Court in *United States v. Gilmore*,⁴⁹ which involved the deductibility of a husband's legal expenses under section 23 (a) (2) of the 1939 Code.⁵⁰ The Supreme Court denied the deduction on the grounds that the expenditure was personal in nature and, in the course of its opinion, stated that in order to determine whether payments are "ordinary and necessary," resort should be had to the origin rather than to the consequences of the claim with respect to which the expenses had been incurred.⁵¹

In the *Berry*⁵² case, the taxpayer, owner of a sole proprietorship engaged in precision machine grinding, arranged several purchasing transactions involving expensive machinery so that the machinery was sold to a girl friend who leased it to the proprietorship at a rental that enabled her to make purchase price payments and otherwise to live comfortably.⁵³ One of the alleged reasons for handling the transaction in this manner was to avoid the property settlement claims of the wife of the petitioner who was in the process of obtaining a divorce. The Tax Court, relying upon *Gilmore*⁵⁴ and the trial court decision in *Van Zandt*,⁵⁵ held that to the extent that the transaction originated for this reason, the rental payments were personal in nature and hence not deductible.⁵⁶

Adapting the argument to the gift-leaseback situation, apparently the Commissioner would contend and the Tax Court would hold that the claim with respect to which the rental expense is incurred is the

⁴⁷ 168 F.2d 598, 599-600 (7th Cir. 1948).

⁴⁸ 23 CCH Tax Ct. Mem. 1077 (1964).

⁴⁹ 372 U.S. 39 (1963).

⁵⁰ Int. Rev. Code of 1939, § 23 (a) (2). The 1954 Code re-enacts the provisions of § 23 (a) (2) in § 212. Section 162 of the 1954 Code had as its predecessor § 23 (a) (1) of the 1939 Code. Although the Court in the *Gilmore* case was concerned with what is now § 212, the Court made it clear that § 162 would be construed as comparable to and *in pari materia* with § 212. *Gilmore v. United States*, *supra* note 49, at 45.

⁵¹ 372 U.S. at 49.

⁵² *Ernest V. Berry*, 23 CCH Tax Ct. Mem. 1077 (1964).

⁵³ The purpose of a transaction arranged in this manner is similar to that of the transfer and leaseback, *i.e.*, the substitution of a rental deduction for a depreciation deduction. The courts have treated it as such. See *Consolidated Apparel Co. v. Commissioner*, 207 F.2d 580 (7th Cir. 1953).

⁵⁴ *Gilmore v. United States*, 372 U.S. 39 (1963).

⁵⁵ *I. L. Van Zandt*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965).

⁵⁶ *Ernest V. Berry*, 23 CCH Tax Ct. Mem. 1077, 1084 (1964).

rental obligation under the lease, which arises only because of the voluntary decision of the taxpayer to initiate the gift and leaseback. Since this decision is prompted by the taxpayer's desire to avoid taxes by reallocation of income within the family and to provide financial security for members of his family,⁵⁷ the origin of the lease obligation which necessitates the rental payment is ultimately personal and, therefore, is nondeductible under section 262.⁵⁸

Such an argument, though cogent, is but a variation of the Commissioner's previous position. The conclusion that the rentals originate in and are necessitated by the taxpayer's personal considerations stems from an unwillingness to view the transaction as a series of bona fide, substantial legal relationships. The answer to the argument in the gift-leaseback situation is that the lease obligation on which the deduction is based originates in a bona fide business transaction in which the trustee, as owner of the property, is required to exact rent that the taxpayer, as lessee, is required to pay.⁵⁹

C. *The Independence of the Trustee*

The bona fides of the gift and of the lease have not been sufficient in themselves to make payments thereunder deductible. The courts in the past have predicated their willingness to fragmentize the steps of the gift and leaseback arrangement upon the interposition of an "independent" third party between the taxpayer as donor and as lessee.⁶⁰

In the leading Second Circuit decision of *White v. Fitzpatrick*,⁶¹ the taxpayer transferred patents and real property used in his business to his wife who immediately licensed the patents and leased the property back to him at reasonable rentals. A majority of the court denied the rental deduction and held that the reasonableness of the rental payment was irrelevant because the donor-lessee retained do-

⁵⁷ See note 38 *supra*.

⁵⁸ Int. Rev. Code of 1954, § 262. This section precludes deductibility of "personal, living, or family expenses."

⁵⁹ See text accompanying notes 43-47 *supra*.

⁶⁰ In both sale-leasebacks and gift-leasebacks, the courts have denied the rental deduction where the transaction took the form of an outright gift between family members, *Finley v. Commissioner*, 255 F.2d 128 (10th Cir. 1958); *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952); *Unger v. Campbell*, 61-1 U.S. Tax Cas. ¶ 9163, 7 Am. Fed. Tax R.2d 547 (N.D. Tex. 1960); *Raymond Cassidy*, 10 CCH Tax Ct. Mem. 573 (1951), or a distribution by a closely held corporation to its shareholders and a subsequent reincorporation, *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949), or a sale by a family corporation to its shareholders and leaseback, *W. H. Armston Co. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Shaffer Terminals, Inc.*, 16 T.C. 356 (1951), *aff'd per curiam*, 194 F.2d 539 (9th Cir. 1952), or a sale to a related corporation and leaseback, *Logan Lumber Co.*, 23 CCH Tax Ct. Mem. 735 (1964); *Riverpoint Lace Works, Inc.*, 13 CCH Tax Ct. Mem. 463 (1954).

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

minion and control over the property. The *Skemp*⁶² and *Helen C. Brown*⁶³ decisions were distinguished on the basis of the independence of the trustee in those cases. The court relied upon the *Clifford*⁶⁴ case (which dealt with the includability of income of a trust in the taxable income of the grantor) and concluded that the same considerations should apply to the deductibility of rental payments made by the grantor to the trust. Because of the close family relationship between donor and donee and because of the lack of an independent party, the court concluded that the husband remained the substantial owner of the property and that the rental payments to his wife amounted to assignments of income within the family group.

Although courts and writers alike have emphasized the distinction between leasebacks directly with family members and leasebacks with third parties, other cases in related areas have not made this distinction.⁶⁵ In the case of *Elsie SoRelle*,⁶⁶ for example, the taxpayer, a farmer, made gifts to his children, shortly before harvest time, of undivided interests in land on which there was a growing crop. In accordance with a prior oral understanding, the taxpayer harvested the crop, stored it, sold it, and borrowed the proceeds of the sale from the children in return for an unsecured promissory note.

The Commissioner, relying on the Clifford doctrine, attempted to tax the income from the sale of the crop to the taxpayer; however, the court found that the father had not "retained such control over the wheat as to be regarded as its owner for purposes of income taxation."⁶⁷ In addition, the court held that there had been no assignment of income because there had been a complete and bona fide gift of the income-producing property prior to the realization of income.⁶⁸

Similarly, in the case of *A. N. McQuown*,⁶⁹ the taxpayer, a Texas resident, made gifts of undivided interests in road construction equipment to his children, one of whom was a minor. Acting under authorization by the children, the taxpayer leased the equipment to himself and to others. Rentals were collected and divided equally

⁶² A. A. Skemp, 8 T.C. 415 (1947), *rev'd*, 168 F.2d 598 (7th Cir. 1948), discussed in text accompanying notes 46-47 *supra*.

⁶³ Helen C. Brown, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950), discussed in text accompanying note 46 *supra*.

⁶⁴ *Helvering v. Clifford*, 309 U.S. 331 (1940).

⁶⁵ See, e.g., *Alexander v. Commissioner*, 190 F.2d 753 (5th Cir. 1951); *Visintainer v. Commissioner*, 187 F.2d 519 (10th Cir.), *cert. denied*, 342 U.S. 858 (1951); *John H. Denmark*, 14 CCH Tax Ct. Mem. 487 (1955).

⁶⁶ 22 T.C. 459, 475 (1954).

⁶⁷ *Id.* at 477.

⁶⁸ For an excellent discussion of whether the gift and leaseback constitutes an assignment of income, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 Tax L. Rev. 295, 335 (1962).

⁶⁹ 12 CCH Tax Ct. Mem. 654 (1953).

among family members. The Commissioner attempted to tax all of the income to the husband and wife as community income. The Tax Court found that the gifts of the equipment had been complete despite the father's retention of control because in exercising his control, the father had acted as an agent of the children, who retained the right of control and who had consented to its exercise by their father.⁷⁰

The *SoRelle* and *McQuown* cases stand for the proposition that in allocating income where there has been a direct intra-family gift of property, the mere fact that the donor retains control and use of the property does not make him the substantial owner of the property for purposes of taxing to him income produced by the sale or use of the property. No logical reason appears for making a distinction in the case of the donor-lessee of an intra-family gift and leaseback by treating him as the substantial owner of property for purposes of denying him a rental deduction.⁷¹

This result has received Congressional approval in a related area, the family partnership. Generally speaking, so long as income is produced by property rather than by services, the income may be shifted within the family by transferring ownership of the property through bona fide sales or gifts of family partnership interests.⁷² If the transfer is complete, the donor-parent may continue to exercise effective management powers over the partnership affairs.⁷³ Furthermore, under appropriate circumstances trusts for minor children may be recognized as family partners for income tax purposes even though the donor-parent is the trustee.⁷⁴

In any event, it is doubtful that the distinction between direct leasebacks with members of the family and leasebacks from independent third parties is sound, because the third parties are rarely "independent."⁷⁵ Moreover, it is often true that intra-family relationships will require more businesslike transactions than would be required if the trustee were the donor's bank or personal advisor.⁷⁶ Furthermore,

⁷⁰ *Id.* at 657.

⁷¹ See Judge Chase's dissent in *White v. Fitzpatrick*, 193 F.2d 398, 403 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952), in which it is stated: "The fact that in the *Skemp* and *Brown* cases the transfers were to independent trustees for the benefit of family members is a distinction without a difference since that bore only on the completeness of the gifts and reasonableness of the royalties and rentals paid, both here shown and found."

⁷² Int. Rev. Code of 1954, § 704(e).

⁷³ Treas. Reg. § 1.704-1(e)(2)(ii)(d) (1956).

⁷⁴ Treas. Reg. § 1.704-1(e)(2)(vii) (1956).

⁷⁵ See Note, 51 Colum. L. Rev. 247 (1951); Note, 65 Harv. L. Rev. 1250 (1952).

⁷⁶ In *Joseph N. Neel Co.*, for example, the court stated:

While the actions of a family corporation or family group should be carefully scrutinized, it is entirely conceivable that the relations each with the other, or their respective personalities, may be such that they will deal with each other strictly at arm's length. In fact, it sometimes happens that the very nearness in blood leads them to be more independent in action than strangers in blood. 22 T.C. 1083, 1090 (1954).

if all of the family members are adults,⁷⁷ a trustee ordinarily will not be necessary.

If independence of the trustee is made the test of the deductibility of rental payments on the leaseback, and if the donor's accountant or lawyer will qualify as an "independent trustee,"⁷⁸ one might speculate as to whether a gift by the husband of his separate property to his wife, as trustee for their children, with leaseback to the husband would be sufficient for purposes of allowing him the rental deduction.⁷⁹ Reduced to these terms, the "independence" of the trustee becomes a mere formal test.

D. Reasonable Rent

One requirement of a valid gift-leaseback transaction on which all courts and writers agree is that the lessee must pay a reasonable rental for the use of the property.⁸⁰ There is, however, no statutory requirement that rentals be reasonable in order to be deductible, and an early Tax Court decision holds that even with an agreement between related parties, mere proof that the rent is unreasonable is not sufficient if the rent in fact is required as a condition to the continued use of the property. In the case of *Stanley Imerman*,⁸¹ the petitioners, members of a family partnership, were children of the lessor. The lease provided for an annual rental, based on a percentage of the profits, which exceeded rents paid by neighboring businesses. The court held that proof that the rentals were excessive did not by itself preclude the deductibility of the rentals in the absence of a further showing that any part of the payments was intended as a gift.⁸²

⁷⁷ A direct gift and leaseback within a family group which includes a minor may cause administrative problems in the management of the property as well as certain tax problems incident to a direct gift to a minor. See Branscomb, *Tax Aspects of Gifts to Minors*, University of Texas School of Law 6th Tax Conf. 70 (1958).

⁷⁸ See note 24 *supra*.

⁷⁹ Consider, however, the effect of designating the grantor's wife as trustee for purposes of taxing the rental income earned by the property held in trust. See Int. Rev. Code of 1954, § 674. Query, whether partition of the community property under Tex. Rev. Civ. Stat. Ann. art. 4624(a) (1960), followed by the husband's gift in trust for the benefit of his children with his wife as trustee, would be sufficient for purposes of allowing the husband a rental deduction upon his leaseback of the property. In this respect, see Rice, *Family Tax Planning* ch. 8, § 23, at 202 (1960).

⁸⁰ Courts have denied the rental deduction where the rent was excessive, *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955), and have emphasized the reasonableness of the rentals where the deduction has been upheld, e.g., *John T. Potter*, 27 T.C. 200, 213 (1956); *Albert T. Felix*, 21 T.C. 794, 804 (1954).

⁸¹ 7 T.C. 1030 (1946).

⁸² Prior to the *Imerman* case, the Supreme Court, in construing the phrase "ordinary and necessary," had held that the fact that payment of an expense had been made under a legally enforceable obligation did not in itself make the expense deductible. *Deputy v. Dupont*, 308 U.S. 488, 496 (1940). See also *Interstate Transit Lines v. Commissioner*, 130 F.2d 136, 139 (8th Cir. 1942). Emphasizing these authorities, the dissent in the *Imerman* case stated:

Subsequent decisions involving transactions between unrelated parties have held that if the rent is excessive and if the facts indicate that a portion of the payment is intended as a dividend or gift, the excess will be disallowed; however, the remainder of the payment will be deductible.⁸³ But if the rent is excessive in intra-family transfer-leasebacks, the tendency seems to be to disallow the entire deduction.⁸⁴ Thus, although section 162(a)(3) and early decisions involving related parties do not require that rent be reasonable in order to be deductible, the courts in the gift-leaseback cases have added this requirement by presuming that the payments are intended as gifts rather than as rent if the amount of the payments is in excess of a fair rental value.⁸⁵

E. Retained Equities

Prior to several recent cases, writers had speculated as to the suc-

[T]he test of reasonableness aids in determining whether an expense is ordinary, or necessary, or both. . . . The relationship of the parties to the transaction which gives rise to the payment for which a taxpayer seeks deduction must be examined to determine whether the relationships and circumstances are such that the terms agreed to result in expenses which are both necessary and ordinary in the operation of the particular business. If a contract is an arm's length business agreement, payments made pursuant thereto probably constitute a deductible business expense; if not, the mere fact that the payment for which the deduction is sought is made under a contract is not ground for allowing the deduction. . . . In the instance of rent, even though parties enter into a lease agreement and the payments are made under its terms, if the circumstances are such that the lessee pays, out of his mere willingness, more than the lessor would require as a condition for the continued use of the property, then the sum paid over and above the required amount is not an ordinary and necessary expense, and is not deductible, under section [162(a)(3)]. . . . 7 T.C. at 1039-40.

It is believed that this statement best summarizes the law as it is today in this area. See, e.g., *Roland P. Place*, 17 T.C. 199 (1951), *aff'd*, 199 F.2d 373 (6th Cir. 1952), *cert. denied*, 344 U.S. 927 (1953), *acq.* 1951-2 Cum. Bull. 3; *58th Street Plaza Theater, Inc.*, 16 T.C. 469 (1951), *aff'd in part*, 195 F.2d 724 (2d Cir.), *cert. denied*, 334 U.S. 820 (1952), *acq.* 1951-2 Cum. Bull. 3; *Stanwick's, Inc.*, 15 T.C. 556 (1950), *aff'd per curiam*, 190 F.2d 84 (2d Cir. 1951); 4 *Mertens, Federal Income Taxation* § 25.110, at 323 (1960). See also *Royal Farms Dairy Co.*, 40 T.C. 173 (1963); *Estate of Goldenberg*, 23 CCH Tax Ct. Mem. 810 (1964).

⁸³ E.g., *Roland P. Place*, *supra* note 82; *58th Street Plaza Theater, Inc.*, *supra* note 82; *Stanwick's, Inc.*, *supra* note 82; *Logan Lumber Co.*, 23 CCH Tax Ct. Mem. 735, 744 (1964).

⁸⁴ See *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955). Curiously, the trial court in the *Kirschenmann* case had found that the rental, payable on a "crop share" basis, was in general conformity with crop-share leases in the area. Although the actual rental under the crop-share arrangement was greatly in excess of the fixed yearly rental paid previously by the donor-lessees, there appears to be no discussion of the business risk involved in a crop share lease, as opposed to a lease with a fixed rental. See *Kirschenmann v. Westover*, 53-1 U.S. Tax Cas. ¶ 9126, 44 Am. Fed. Tax R. 1271 (S.D. Cal. 1952).

⁸⁵ If the corporation is the vendor-lessee and the lessor is a shareholder, the disallowed portion may be taxed to the shareholder as a dividend. See *W. H. Armston Co. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949).

cess of the short-term grantor trust in the gift-leaseback situation.⁸⁶ In Revenue Ruling 54-9,⁸⁷ the Commissioner made his position clear that rent would not be deductible under such an arrangement. The basis of the Commissioner's position was that the reservation of a reversionary interest in the property was further indication of the grantor's retention of dominion and control under the *Clifford* doctrine.⁸⁸

Subsequent cases, however, have indicated a statutory ground for disallowance of the rental deduction if the grantor retains a reversionary interest. Section 162(a)(3)⁸⁹ precludes a rental deduction if the taxpayer possesses an equity in the property which he is renting. This language was originally intended to prevent a mortgagor under a mortgage-purchase arrangement from deducting as rent what amounted to purchase payments which otherwise would have been capitalized and, if the property was depreciable, recouped through depreciation deductions.⁹⁰ The courts, however, have interpreted the language of the section literally and have disallowed a rental deduction to a grantor-lessee who has retained a reversionary interest in the property transferred to the trust.⁹¹

In *Hall v. United States*,⁹² three doctors who owned the building in which their offices were located created irrevocable trusts for the benefit of their children with a trust company as trustee, conveyed the building to the trust, and took a leaseback. The terms of the trusts were for ten years, after which time the property would revert to the grantors. The court held that the reversionary interests constituted equities which precluded deduction of the rental, even though the trustee had been given the power to sell the building without the consent of the grantors.⁹³

⁸⁶ Compare Webster, *Transfers to Trusts with Leasebacks—Drafting and Other Suggestions for Trust and Lease Arrangements*, So. Cal. 8th Tax Inst. 319, 348 (1956), with Committee on Publications, Section of Taxation, *Trust and Lease-Back*, 40 A.B.A.J. 714, 715 (1954).

⁸⁷ 1954-1 Cum. Bull. 20.

⁸⁸ *Id.* at 22. Nowhere in the Revenue Ruling does the Commissioner cite statutory authority for disallowance of the rental deduction. Instead, the Commissioner relies upon case authority dealing with family partnerships, *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946), assignment of income, *Helvering v. Horst*, 311 U.S. 112 (1940), and other cases in the family area, *Johnson v. Commissioner*, 86 F.2d 710 (2d Cir. 1936); *Sall v. Smith*, 53-1 U.S. Tax Cas. ¶ 9123, 45 Am. Fed. Tax R. 1018 (E.D. Pa. 1952).

⁸⁹ Quoted in text accompanying note 37 *supra*.

⁹⁰ See Mertens, *op. cit. supra* note 82 § 25.108, at 311; Note, 11 Tax L. Rev. 65, 68 (1955).

⁹¹ *Hall v. United States*, 208 F. Supp. 584 (N.D.N.Y. 1962); *I. L. Van Zandt*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965).

⁹² 208 F. Supp. 584 (N.D.N.Y. 1962).

⁹³ *Id.* at 588. As an alternate ground, the court disallowed the rental deduction because of the retention by the grantors of the reversionary interests and the reservation by the

Another case, *Burroughs Corp.*,⁹⁴ involved a contribution of property by the corporation to a private, charitable foundation established for the benefit of its employees; as a part of the transaction, the corporation took a twenty-five year leaseback with renewal options for an additional thirty years. The taxpayer retained the power to control the administration of the trust and an indirect power to terminate the trust, which if exercised would give the taxpayer the right to reacquire the property at a price equal to the tax deduction allowed on the initial transfer. The court disallowed the charitable deduction on the grounds that the retention of the administrative powers and reversionary rights rendered the gift incomplete.⁹⁵ In addition, the court disallowed the rental deduction for the reason that the retention of broad powers of control by the taxpayer precluded a holding that the taxpayer had no equity in the property.⁹⁶

Apparently, the fact that the property would revert to the grantor only upon termination of the foundation, and only then upon payment of a stated price, did not bar a finding that the taxpayer had retained an equity because these events were wholly controlled by the taxpayer. This case appears to stand for the proposition that for purposes of determining his right to a rental deduction, a taxpayer will be deemed to have retained an equity in property donated and leased back if he reserved a contingent reversionary interest and an indirect power to control the contingency.

It also has been suggested that if property is conveyed subject to an encumbrance which gives the transferor an equity of redemption, such equity will preclude the deduction of rentals under section 162(a)(3).⁹⁷ In Texas it is common practice for a grantor to retain an express vendor's lien and to receive back a deed of trust to secure

grantors of the power to control the trustee's actions by providing them with the right to "settle accounts" with the trustee at any time. *Ibid.*

⁹⁴ 33 T.C. 389 (1959).

⁹⁵ *Id.* at 408-09.

⁹⁶ *Id.* at 410.

⁹⁷ See the concurring opinion in *Kirschenmann v. Westover*, 225 F.2d 69, 71 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955). In the *Kirschenmann* case, the parents, potato farmers, purchased land on an installment basis and immediately conveyed the property to their twelve-year old daughter. The husband's brother was appointed guardian for the daughter and executed a leaseback to the husband and wife. Judge Fee, in his concurring opinion, based the denial of the rental deduction on the fact that under California law if the daughter had defaulted on payment of the mortgage, the parents would have had an equitable right of redemption, which Judge Fee considered an equity under § 162(a)(3). See also *Rice, op. cit. supra* note 79, at 203; *Webster, supra* note 86, at 340-41.

Some states provide a statutory right of redemption under which a mortgagor is entitled to redeem property within a designated time after the foreclosure sale by tendering to the purchaser the amount of the purchase price, plus interest and expenses of the sale. Texas has no such statutory right of redemption. In Texas, the mortgagor and those holding under him possess an equity of redemption prior to the time of sale by a trustee under a deed of trust or by judicial foreclosure; however, the equity is cut off by a trustee's sale

the unpaid balance of the purchase price. Technically, reservation of a vendor's lien carries with it legal title⁹⁸ until the purchase price is paid and gives the vendor the equitable right of rescission⁹⁹ if the purchase price is not paid. It is, perhaps, arguable that if the lien is retained the vendor also has retained title to, or an equity in, the property so that rent upon the subsequent leaseback is not deductible.¹⁰⁰

III. RELATED USES OF THE GIFT AND LEASEBACK

In addition to the use of gifts directly to or in trust for members of the family with leasebacks, the gift-leaseback arrangement also has been used in situations involving employee retirement funds¹⁰¹

as to parties with notice, or by a decree of foreclosure when executed by sale if the parties holding the title and equity of redemption are before the court. See 2 Lange, Land Titles and Title Examination § 463, at 317 (1961). For cases in Texas dealing with the equity of redemption of the mortgagor, see *Pierson v. Pierson*, 136 Tex. 310, 150 S.W.2d 788 (1941); *Willis v. Smith*, 66 Tex. 31, 17 S.W. 247 (1886); *Thompson v. Litwood Oil & Supply Co.*, 287 S.W. 279 (Tex. Civ. App. 1926). It is not clear, however, that the lack of a statutory right of redemption in Texas will protect the mortgagor who sells and leases back because he still retains an equitable right to redeem the property in the event of default before foreclosure. In view of the literal interpretation placed on this part of the statute by the courts in the past, it is suggested that the mortgage should be discharged prior to the time of sale and leaseback.

⁹⁸ The vendor's "legal title" is only a security which gives the vendor no beneficial interest in the land, *Brown v. Canterbury*, 101 Tex. 86, 104 S.W. 105 (1907); *Carey v. Starr*, 93 Tex. 508, 56 S.W. 324 (1900); which may be waived, *Estes v. Browning*, 11 Tex. 237 (1853); *Wickwire-Mitchell Royalty Trust v. Taylor*, 200 S.W.2d 441 (Tex. Civ. App. 1947); which may be released, *Harvey v. Elder*, 191 S.W.2d 686 (Tex. Civ. App. 1946) *error ref.*; *Tetens v. Tetens*, 45 S.W.2d 1018 (Tex. Civ. App. 1932) *error disp.*; or which may be lost as against third parties unless properly perfected in writing and filed for record in the county where the land is located. Tex. Rev. Civ. Stat. Ann. arts. 5520, 5522 (1958). See generally 1 Lange, *op. cit. supra* note 97, at 62-65.

⁹⁹ E.g., *Bradford v. Knowles*, 86 Tex. 505, 25 S.W. 1117 (1894); *McCamy v. Waterhouse*, 80 Tex. 340, 16 S.W. 19 (1891); *Stephens v. Mathews Heirs*, 69 Tex. 341, 6 S.W. 567 (1887); *Roth v. Conner*, 25 S.W.2d 246 (Tex. Civ. App. 1930). The implied vendor's lien, on the other hand, does not provide its holder with the equitable right of rescission. *Johnson v. Smith*, 115 Tex. 193, 280 S.W. 158 (1926); *Rooney v. Porch*, 239 S.W. 910 (Tex. Comm. App. 1922); *Riddlehoover v. Boren*, 260 S.W.2d 431 (Tex. Civ. App. 1924). See 1 Lange, *op. cit. supra* note 97, at 60 n.25.

¹⁰⁰ If the vendor has expressly reserved a lien, it seems equally arguable that he "has not taken" and "is not taking" title to the property within the meaning of § 162(a)(3) of the Code. It might be wise, however, for the vendor who is considering a leaseback to forego an express vendor's lien and to retain only an implied vendor's lien in order to avoid exposure to loss of the rental deduction on the ground that he has retained an "equity" in the form of an equitable right of rescission. See note 97 *supra*.

¹⁰¹ See, e.g., *Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner*, 306 F.2d 20 (6th Cir. 1962); *Burroughs Corp.*, 33 T.C. 389 (1959); *Colorado Nat'l Bank*, 30 T.C. 933 (1958), *acq.* 1959-1 Cum. Bull. 3. See generally Alexander, *Tax Status of Pension Trusts: Requirements for Maintaining Exemption*, N.Y.U. 13th Inst. on Fed. Tax 435, 443 (1955); *Chatterton, Contribute Property To Your Employees' Trust? It Has Great Tax Advantage*, 14 J. Taxation 322 (1961); *Greenfield, Corporate Benefits in Using the Sale-Leaseback Device*, 37 Taxes 1017, 1019 (1959); *Rothschild, Problems of Employer Cost and Coverage: Trusteed Plans*, N.Y.U. 21st Inst. on Fed. Tax 589, 598 (1963); P-H Pension & Profit Sharing Serv. ¶ 7517 (1963).

and private foundations.¹⁰² Depending upon the taxpayer's purpose and financial needs, the transfer may be in the form of a gift,¹⁰³ sale,¹⁰⁴ or a bargain sale.¹⁰⁵ Unlike the gift-leaseback arrangement involving only members of the family, if a gift is made to a qualified employee retirement fund or tax-exempt foundation, there is no gift tax payable¹⁰⁶ and an additional income tax deduction is obtained.¹⁰⁷ However, title to the property conveyed must be transferred outside of the family, and a reversionary interest cannot be retained if full gift and income tax benefits are to be obtained.¹⁰⁸ In addition, if appreciated property is transferred, there may be a taxable gain,¹⁰⁹

¹⁰² See, e.g., *Boman v. Commissioner*, 240 F.2d 767 (8th Cir. 1957); *Huron Clinic Foundation v. United States*, 212 F. Supp. 847 (D.S.D. 1962), *vacated and remanded*, 324 F.2d 43 (8th Cir. 1963). See generally Cutler, *Various Aspects of Contributions to Charities*, N.Y.U. 17th Inst. on Fed. Tax 1117, 1137-40 (1959); Greenfield, *op. cit. supra* note 101, at 1018; Richardson, *Gifts of Property to a Charity*, So. Cal. 9th Tax Inst. 705 (1957); Young, *Donor Foundation Dealings*, N.Y.U. 22d Inst. on Fed. Tax 965, 993-1002 (1964).

¹⁰³ *Boman v. Commissioner*, *supra* note 102; *Burroughs Corp.*, 33 T.C. 389 (1959); *Colorado Nat'l Bank*, 30 T.C. 933 (1958).

¹⁰⁴ *Huron Clinic Foundation v. United States*, 212 F. Supp. 847 (D.S.D. 1962), *vacated and remanded*, 324 F.2d 43 (8th Cir. 1963).

¹⁰⁵ A bargain sale, which is a sale of property at less than its fair market value, is discussed in S. M. Freidman, 41 T.C. 428 (1963); Elizabeth H. Potter, 38 T.C. 951 (1962). See also Richardson, *supra* note 102, at 720; Wilson, *Sales and Leasebacks*, So. Cal. 16th Tax Inst. 149, 163-69 (1964).

¹⁰⁶ In computing an individual's taxable gifts during the year, a deduction is allowed for gifts to certain tax-exempt organizations. See Int. Rev. Code of 1954, § 2522. For gift tax purposes, a transfer of property by a corporation is deemed to be a gift from the individual shareholders of the corporation. Treas. Reg. § 25.2511-1(h)(1) (1958). See *White v. United States*, 59-1 U.S. Tax Cas. ¶ 11862, 3 Am. Fed. Tax R.2d 1814 (W.D. Ark. 1959).

¹⁰⁷ Int. Rev. Code of 1954, §§ 170 (deductibility of donations to tax-exempt foundations), 404 (deductibility of employer contributions to qualified employee plans). If the contribution is in the form of a gift, a deduction will be allowed in an amount equal to the fair market value of the property at the time of the gift. Treas. Reg. § 1.170-1(c) (1958); 2 Nossaman, *Trust Administration and Taxation* § 45.18, at 354 (1964). If a bargain sale is made, the vendor will be entitled to a deduction to the extent that the fair market value of the property exceeds the sales price. See Richardson, *supra* note 102, at 720; Wilson, *supra* note 105, at 163-69.

¹⁰⁸ For income and gift tax purposes, the charitable deduction may be reduced or disallowed entirely if the donor retains an interest in the property. *Burroughs Corp.*, 33 T.C. 389 (1959), discussed in text accompanying notes 94-96 *supra*; Int. Rev. Code of 1954, § 170(f); Treas. Reg. §§ 1.170-1(d) and (e) (1958), 25.2522(a)-2(a) and (b) (1953). Employer deductions for contributions to employee retirement funds established under § 401 will be disallowed if there is any possibility that the property may revert to the employer prior to the satisfaction of all liabilities under the plan. Treas. Reg. 1.401-2(a) (1956); see *Gisholt Machine Co.*, 4 T.C. 699, 706 (1945); *Brush-Moore Newspapers, Inc.*, 5 CCH Tax Ct. Mem. 1014 (1946); Rev. Rul. 121, 1961-2 Cum. Bull. 65, 78-79. As to whether retention of the right to repurchase the property will preclude deduction, compare *Burroughs Corp.*, 33 T.C. 389 (1959), and *Estate of Alldis*, 46 B.T.A. 1171 (1942), *aff'd on other grounds*, 140 F.2d 885 (6th Cir. 1944), with *Colorado Nat'l Bank*, 30 T.C. 933 (1958), *acq.* 1959-1 Cum. Bull. 3.

¹⁰⁹ If the property is transferred by sale or by bargain sale, there is taxable gain to the extent that the sales price exceeds the vendor's adjusted basis. If appreciated property is transferred by gift, however, there is a curious dichotomy in treatment by the Commissioner and the courts between a gift to charity under § 170 and a contribution to a qualified employee retirement plan under § 404. In the former situation, it has been held that

and if the property is also depreciable, a portion of the gain may be ordinary income.¹¹⁰

If a closely held corporation¹¹¹ has established a qualified pension or profit-sharing plan, the corporation may make a deductible contribution by gift or bargain sale of property used in its business, but may

there is no taxable gain to the grantor at the time of the gift. *Campbell v. Prothro*, 209 F.2d 331, 335 (5th Cir. 1954); *Humacid Co.*, 42 T.C. 894 (1964); *Stuart A. Rogers*, 33 T.C. 785, 787-88 (1962), *non-acq.*, 1963-2 Cum. Bull. 6, and the cases cited therein; Rev. Rul. 410, 1955-1 Cum. Bull. 297. On the other hand, the Commissioner and the courts have treated the employer's contribution to a qualified employee retirement plan as a taxable event in which the employer realizes gain or loss. *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961). See also Rev. Rul. 186, 1962-2 Cum. Bull. 279; I.T. 3357, 1940-1 Cum. Bull. 11. A loss on such a transaction would not be deductible, however. *Dillard Paper Co.*, 42 T.C. 588 (1964); Rev. Rul. 163, 1961-2 Cum. Bull. 58. See also Int. Rev. Code of 1954, § 267(a)(1), (b)(9), which disallows losses on sales between a person and a private foundation directly or indirectly controlled by him. In view of the manner in which the *General Shoe* rationale has been extended, the present tax treatment of transfers of appreciated property to charity is not assured. See *Davis v. United States*, 370 U.S. 65, 72 (1962); *Estate of Wood*, 39 T.C. 1, 7 (1962); *John D. Riley*, 37 T.C. 932, 937 (1962), *aff'd per curiam*, 328 F.2d 428 (5th Cir. 1964); *Glassmoyer, Charitable Gifts of Appreciated Property*, N.Y.U. 20th Inst. on Fed. Tax 243, 256-57 (1962).

¹¹⁰ If depreciable property is donated to charity, the amount of the deduction is reduced to the extent that it would have been recaptured under §§ 1245 and 1250 if the property had been sold. Int. Rev. Code of 1954, § 170(e). This is consistent with the nonrecognition of gain treatment accorded to charitable transfers of appreciated property. See note 109 *supra*. There is no corresponding provision to § 170(e) under § 404, which deals with the deductibility of a contribution to a qualified employee retirement fund. Presumably, therefore, the contribution is fully deductible. It would seem to follow logically, under the *General Shoe* rationale, that the portion of the gain realized at the time of the contribution which is subject to recapture under § 1245 or § 1250 should be reported as ordinary income. The wording of §§ 1245 and 1250 appears to be broad enough to support such treatment. Int. Rev. Code of 1954, §§ 1245(a)(1)(ii), 1250(a)(1)(i). See generally Shapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 Yale L.J. 1483, 1488-91 (1963).

If there is a substantial exposure to recapture of depreciation under § 1245 or § 1250, or if the property, though nondepreciable, has a low basis, it would appear from the above analysis that the bargain sale, rather than an outright gift, might be made to a qualified employee retirement plan. If the sales price is equivalent to the adjusted basis of the property in the hands of the taxpayer, there may be no gain to which § 1245 or § 1250 would apply, and the employer would be entitled to a deduction in an amount equal to the difference between the fair market value and the sales price of the property. See Proposed Treas. Reg. § 1.1245-4(a)(3), (4) 29 Fed. Reg. 11366 (1964); *cf.* S. M. Freidman, 41 T.C. 428 (1963); *Elizabeth H. Potter*, 38 T.C. 951 (1962). Query, however, whether the bargain sale would be sufficient to avoid capital gain treatment under the *General Shoe* doctrine? Consider also the implications of applying the *General Shoe* doctrine in conjunction with § 170(e) to transfers of appreciated property to charity. See note 109 *supra*.

¹¹¹ The transfer-leaseback arrangement involving a trustee pension or profit-sharing plan also may be used if the taxpayer is a proprietorship or a partnership, under a so-called "H.R. 10" plan, enacted by the Self-Employed Individuals Tax Retirement Act of 1962, 76 Stat. 809 (codified in scattered sections of the Internal Revenue Code of 1954). See generally, Grayck, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of Self-Employed Individuals' Tax Retirement Act of 1962 and the Professional Association*, 63 Colum. L. Rev. 415 (1963). Because of the limitations upon employer contributions and deductions, the severe penalties for excess contributions under such a plan, and exposure to loss of the trust's exemption for dealings with owner-employees, a transfer and leaseback of business property with a trustee under an H.R. 10 plan normally would be undesirable or not feasible. See Int. Rev. Code of 1954, §§ 401(c)-(e), 404(a)(8), (9) and (e), 503(j)(1).

retain control of the property by leasing it back at a reasonable rental, which is also deductible.¹¹² Although the code sets limitations upon the amount of employer contributions that can be deducted annually,¹¹³ there is a provision for carryover of the excess contribution to succeeding years until the excess is exhausted.¹¹⁴ If properly planned, the gift and leaseback arrangement between the corporation and the trust of its employee retirement fund will enable the corporation initially to fund the plan for its employees without impairing its liquidity and without loss of control over the property. Fur-

¹¹² See generally Chatterton, *supra* note 101, at 333-35. A careful study of accounting data and review of the tax exposures should be made. See Rev. Rul. 46, 1953-1 Cum. Bull. 287; Lurie, *Qualified Pension and Profit Sharing Retirement Plans for Small Companies*, N.Y.U. 12th Inst. on Fed. Tax 327, 345 (1954). See notes 109-10 *supra*.

A substantial initial contribution to satisfy the employer's cost of funding an exempt pension plan normally will produce no difficulty. Rothschild, *supra* note 101, at 601. *But see*, Rev. Rul. 186, 1962-2 Cum. Bull. 279, which indicates that the conveyance is subject to the documentary stamp tax. On the other hand, contributions to a profit-sharing plan must be made only out of profits or accumulated earnings of the employer. Treas. Reg. § 1.401-1(b)(1)(ii) and (iii) (1956); Alexander, *Advantages and Disadvantages of Pension, Profit Sharing and Stock Bonus Plans: A Discussion*, N.Y.U. 14th Inst. on Fed. Tax 1251, 1284 n.127 (1956). A closely held corporation may have accumulated earnings and profits which will allow a contribution equal in amount to the fair market value of the corporate property which is to be contributed. If there are not sufficient profits, it may be necessary to make fractional gifts of the property over a period of years. In this respect, see note 130 *infra* and accompanying text.

¹¹³ If a contribution is made to a profit-sharing plan, the employer can deduct up to 15% of the compensation of all of the employees participating in the plan. Int. Rev. Code of 1954, § 404(a)(3). If the contribution is made to a pension plan, the employer is given several alternative methods of computing the maximum annual deduction. Int. Rev. Code of 1954, § 404(a)(1). For a discussion of these alternatives, see Rice, *Basic Pension and Profit-Sharing Plans 25-26* (1961). If pension and profit-sharing plans are combined, the maximum deduction is 25% of the compensation of the employees who are participating in the plan. Int. Rev. Code of 1954, § 404(a)(7).

¹¹⁴ Int. Rev. Code of 1954, § 404(a)(1)(D), (a)(3)(A), (a)(7). If there are two or more qualified employee retirement plans, and there is an excess contribution, the carryover, or "roll-over," contribution is deductible up to 30% of the compensation of the employees in the plan in any year into which the excess is carried. Int. Rev. Code of 1954, § 404(a)(7); see *Case Study of the Planning and Execution of a Qualified Employee's Retirement Plan*, N.Y.U. 21st Inst. on Fed. Tax 625, 639, 658 (1963).

Careful drafting is necessary to insure the carryover of excess contributions. If a profit-sharing plan contains a predetermined formula for computing the amount of the employer's annual contribution, a contribution in excess of that amount is not deductible and cannot be carried over to a subsequent year. *Gross-Given Mfg. Co. v. Kelm*, 99 F. Supp. 144 (D. Minn. 1951); *Wooster Rubber Co.*, 14 T.C. 1192 (1950), *rev'd on other grounds*, 189 F.2d 878 (6th Cir. 1951); I.T. 4055, 1954-2 Cum. Bull. 30. However, the formula may be amended, either formally or informally, to allow a larger contribution in that year. *McClintock-Trunkey Co. v. Commissioner*, 217 F.2d 329 (9th Cir. 1954); Rev. Rul. 366, 1956-2 Cum. Bull. 366.

A qualified profit-sharing plan no longer is required to contain a predetermined formula for computing the amount of the employer's annual contribution. See Treas. Reg. § 1.401-1(b)(1)(ii) (1956). If the profit-sharing plan does not have a definite predetermined formula, however, there must be a payment (for cash-basis taxpayers) or a liability to make the contribution (accrual-basis taxpayers) before the end of the year in which the deduction is claimed in order to satisfy the provisions of § 461. See Alexander, *Advantages and Disadvantages of Pension, Profit Sharing and Stock Bonus Plans: A Discussion*, N.Y.U. 14th Inst. on Fed. Tax 1251, 1284-85 (1956); *Case Study of the Planning and Execution of a Qualified Employee's Retirement Plan*, *Id.* at 659-660.

thermore, the arrangement will provide the corporation with additional working capital and an annual deduction for its contributions to the trust¹¹⁵ and will secure rental deductions to the corporation for its payments under the lease.

Another use of the gift-leaseback arrangement in family tax planning is suggested by the *Burroughs* case.¹¹⁶ The taxpayer establishes a private foundation, donates business property, and leases the property back. If the property is unencumbered, the private foundation will not be taxed on the rental income received under the lease.¹¹⁷ If the taxpayer is a sole proprietorship or a partner, his maximum charitable deduction for the year in which the contribution is made is twenty per cent of his adjusted gross income,¹¹⁸ or, if the taxpayer is a corporation, five per cent of its taxable income.¹¹⁹ Although the 1964 Revenue Act¹²⁰ provides a limited carryover of

¹¹⁵ Query, however, whether an initial large contribution to a profit-sharing plan which will provide carryovers for a number of years will be sufficient to satisfy the requirement that the plan be permanent rather than temporary. Compare Treas. Reg. § 1.401-1(b)(2) (1956) with *Lincoln Electric Co. Employees' Profit-Sharing Trust v. Commissioner*, 190 F.2d 326, 329 (6th Cir. 1951); *Sherwood, Swan & Co.*, 42 T.C. 299 (1964); *Produce Reporter Co.*, 18 T.C. 69 (1952), *aff'd*, 207 F.2d 586 (7th Cir. 1953), *non-acq.* 1952-2 Cum. Bull. 5. For further discussion, see Rice, *op. cit. supra* note 113, at 54-58.

¹¹⁶ *Burroughs Corp.*, 33 T.C. 389 (1959), discussed in text accompanying notes 94-96 *supra*.

¹¹⁷ Although a charitable organization is normally not subject to federal income taxes, it is taxable on its "unrelated business taxable income," which is income derived from the conduct of a business that is not substantially related to the charitable function of the organization. Int. Rev. Code of 1954, §§ 511-13. Unrelated business taxable income excludes most forms of passive income, such as rent from real property, unless such rent is received under a "business lease." Int. Rev. Code of 1954, §§ 512, 514. A lease of real property is a "business lease" if it is for a term of more than five years and if the lessor organization incurs an indebtedness in order to acquire or improve the property. Int. Rev. Code of 1954, § 514.

Income from the lease of personal property, as such, is not mentioned in the code or the regulations. In one case, involving a qualified employee retirement fund, it was held that if the trust purchases certain equipment with trust assets and later leases the equipment to the employer, the rental is unrelated business taxable income. The court held that the leasing activity, although it involved only one lease of twenty-one pieces of equipment, was sufficient to constitute a business. *Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner*, 306 F.2d 20 (6th Cir. 1962). See also Rev. Rul. 206, 1960-1 Cum. Bull. 201. It is, perhaps, questionable whether the rationale of the above decisions and revenue ruling would be applicable if personal property were received by a charitable foundation as a contribution, because none of the foundation's assets would be used to purchase the property and there would be less in the nature of business activity. Nevertheless, the rationale of the *Cooper Tire & Rubber Co.* case is broad enough to include such a transaction. See 6 Mertens, *Federal Income Taxation* § 34.14A (Supp. 1964).

It is clear, however, that if real property (and personal property attached thereto) is received by gift, the subsequent rental income on a leaseback will not be unrelated business taxable income in the absence of an encumbrance upon the property. See Int. Rev. Code of 1954, §§ 512(b)(3), (4), 514(b)-(d).

¹¹⁸ Int. Rev. Code of 1954, § 170(a), (b)(1)(B), subject to reduction under § 170(e).

¹¹⁹ Int. Rev. Code of 1954, § 170(a), (b)(2), subject to reduction under § 170(e).

¹²⁰ Revenue Act of 1964, 78 Stat. 19 (codified in scattered sections of Int. Rev. Code of 1954).

excess contributions by individuals,¹²¹ this provision does not apply to contributions to private foundations.¹²² A five-year carryover of excess contributions by a corporation is apparently allowed without regard to whether the contribution is made to a private or public foundation.¹²³ A recent amendment to the regulations under section 170 requires the submission of additional information by an individual taxpayer if a noncash contribution is made and a deduction in excess of \$200 is claimed.¹²⁴

There is an approach which avoids loss of the contribution in excess of the amount deductible in the year of the gift and which is discussed in the case of *Andrus v. Burnet*.¹²⁵ There the grantors established a private foundation to which they conveyed land in return for a series of installment obligations. In accordance with their original intention, the grantors cancelled each of the notes as it became due and took an annual charitable deduction in the amount of the cancelled payment. The Commissioner disallowed the annual charitable deduction on the ground that a contribution of the entire property had been made in the year of the purported sale, which was actually a sham. The appellate court, however, upheld the transaction and allowed the annual deductions on the theory that each note was valid and enforceable and could have been negotiated or presented for payment at maturity, so that no gift was actually made until the payment was cancelled.¹²⁶

Although the installment sale provides gift tax advantages, it also raises income tax problems.¹²⁷ Also, if the vendor retains a lien and deed of trust, he may be deemed to have an "equity" in the prop-

¹²¹ Int. Rev. Code of 1954, § 170(b)(5) provides for carryover of contributions to so-called "public charities" to the extent that a contribution in any given year exceeds 30% of the individual donor's adjusted gross income. The contribution may be carried to each of the five succeeding taxable years.

¹²² S. Rep. No. 830, 88th Cong., 2d Sess. 61-62 (1964); see also Weltchek, *Revenue Act of 1964: Major Tax Areas Needing Review*, 42 *Taxes* 296, 297 (1964).

¹²³ Int. Rev. Code of 1954, § 170(b)(2).

¹²⁴ Treas. Reg. § 1.170-1(a)(3) (1958).

¹²⁵ 50 F.2d 332 (D.C. Cir. 1931); see also Nelson Storey III, 38 T.C. 936 (1962), *acq.* 1965 Int. Rev. Bull. No. 8 at 6. The Service recently has indicated that it will issue rulings on such transactions. Rev. Proc. 65-4, 1965 Int. Rev. Bull. No. 8 at 46.

¹²⁶ See Int. Rev. Code of 1954, § 453(b). For recent cases involving a similar transaction between individuals, see Selsor R. Haygood, 42 T.C. 936 (1964); Minnie E. Deal, 29 T.C. 730 (1958).

¹²⁷ Although the seller receives a charitable deduction as each installment is forgiven, he also may realize income to the extent of the gain on each installment. Rev. Rul. 157, 1955-1 Cum. Bull. 293. *But see*, Miller v. Usry, 160 F. Supp. 368 (W.D. La. 1958). A portion of the gain may be taxable as ordinary income under the imputed interest provisions of § 483. If the transaction is cast in the form of a sale, there may be unrelated business taxable income to the purchasing foundation. See note 117 *supra*. In addition, a sale may raise problems under §§ 48, 267, 1239, 1245 and 1250. See notes 11-12, 110 *supra*. See generally, Richardson, *supra* note 102, at 721-22.

erty,¹²⁸ which will result in the loss of the rental deduction. The transaction may be arranged, however, to provide for this contingency by selecting the amount of the annual installments so that if the payment is not deductible as rent, it still may be deductible as a charitable contribution.¹²⁹ Another possibility would be to arrange the transaction so that the donor would annually deed to the foundation an undivided interest in the land equal in value to the desired contribution until the entire property had been transferred.¹³⁰ The donor would lease the amount of the property so conveyed and although he would retain title in the remainder of the property, he would have divested himself of title in the property for which the rental is payable.

There is, of course, the possibility that the leaseback to the donor, who effectively controls the employee retirement fund or the private foundation, will constitute such a retention of dominion and control over the property as to preclude either a charitable deduction for contribution of the property or a deduction of the rental payments under section 162(a)(3).¹³¹ In recent cases involving transfers and leasebacks with private foundations, however, the Commissioner has assailed the deductibility of the contributions by attacking the tax exemption of the foundation under section 503,¹³² rather than the deduction of the contributions under section 170.¹³³ In the absence of facts indicating that the transaction is a sham,¹³⁴ the Commissioner has not attacked the rental deductions.

Recent cases in a related area may be useful in evaluating the future vulnerability of the charitable and rental deductions under a gift and leaseback with a tax-exempt organization. These cases normally involve a three-party arrangement whereby the shareholders of a family corporation sell their stock to a charitable foundation, which

¹²⁸ See notes 97-100 *supra*.

¹²⁹ If the amount of the annual installment payments to be forgiven is selected so that it is less than the maximum charitable deduction to which the individual is entitled, then the payment may be deductible as a charitable contribution if the rental deduction is disallowed in whole or in part. *But cf.* J. M. Coulter, 9 CCH Tax Ct. Mem. 249, 250 (1950), which requires proof of donative intent.

¹³⁰ See Rev. Rul. 261, 1958-1 Cum Bull. 143; Rev. Rul. 511, 1957-2 Cum. Bull. 158. See generally, Cutler, *supra* note 102, at 1138-40; Rudick & Gray, *Bounty Twice Blessed: Tax Consequences of Gifts of Property to or in Trust for Charity*, 16 Tax L. Rev. 273, 279-80 (1961); Young, *Tax Effects of Gifts to Charity*, 41 Taxes 351, 355-56 (1963).

¹³¹ See Louise C. Christenson, 40 T.C. 563 (1963); Burroughs Corp., 33 T.C. 389 (1959); Treas. Reg. § 1.170-1(e) (1958). See generally, Young, *supra* note 102, at 991.

¹³² Int. Rev. Code of 1954, § 503.

¹³³ *Boman v. Commissioner*, 240 F.2d 767 (8th Cir. 1957); *Huron Clinic Foundation v. United States*, 212 F. Supp. 847 (D.S.D. 1962), *vacated and remanded*, 324 F.2d 43 (8th Cir. 1963).

¹³⁴ See Burroughs Corp., 33 T.C. 389 (1959), discussed in text accompanying notes 94-96 *supra*.

liquidates the first corporation and leases the assets to a second corporation in which the original shareholders may or may not have an interest.¹³⁵ The rental paid by the second corporation (usually a percentage of its profits) to the foundation is used to amortize the debt to the shareholders of the original corporation.¹³⁶ Since the dealings between the parties are designed to represent arm's length transactions, there is normally no element of charitable contribution involved.¹³⁷ The transaction is important to our present consideration for the reason that, in spite of the prearrangement of the transaction and the obvious tax motivation behind its adoption, the courts in the past have attributed substance to each step for tax purposes. Thus, several courts have upheld the capital gain treatment to the shareholders on the sale of their stock to the foundation and have allowed a rental deduction to the second corporation upon its lease of the assets from the foundation; the Supreme Court has recently upheld the capital-gain aspect of the transaction.¹³⁸

The tax future of the three-party transaction is not entirely assured,¹³⁹ especially with regard to the tax-exempt status of the vendee-lessor foundation and the deductibility of rent upon the lease-over to the second corporation. The Commissioner presently is attacking the exempt status of a foundation which entered into a sale and leaseover, and his chances for success appear to be good.¹⁴⁰ Although the courts have upheld the exempt status of the foundation in the gift and leaseback area,¹⁴¹ it is not clear what effect a denial of

¹³⁵ E.g., Warren Brekke, 40 T.C. 789 (1963); Royal Farms Dairy Co., 40 T.C. 173 (1963); Anderson Dairy, Inc., 39 T.C. 1027 (1963); Clay B. Brown, 37 T.C. 461 (1961), *aff'd*, 325 F.2d 313 (9th Cir. 1963); Emanuel N. Kolkey, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958); Estate of Goldenberg, 23 CCH Tax Ct. Mem. 810 (1964); Ryegate Paper Co., 20 CCH Tax Ct. Mem. 964 (1961). See generally, Weithorn & Noall, *Dealings Between Donors and Foundations*, N.Y.U. 6th Conf. on Charitable Foundations 129, 140-45 (1963); Wilson, *supra* note 105, at 169-81; Young, *supra* note 102, at 995-1002.

¹³⁶ In a typical arrangement, the leasing corporation agrees to pay as rent 80% of its annual profits. The foundation agrees, in turn, to apply 90% of the rents received as payments on the purchase price of the assets. E.g., Royal Farms Dairy Co., *supra* note 135; Anderson Dairy, Inc., *supra* note 135; Estate of Goldenberg, *supra* note 135.

¹³⁷ The economic inducement for the charity is the annual profit, which is the difference between the rents received and the purchase price paid, as well as the use of the property after it is purchased.

¹³⁸ Commissioner v. Brown, 85 S. Ct. 1162 (1965); Brown v. Commissioner, 325 F.2d 313 (9th Cir. 1963); Anderson Dairy Co., 39 T.C. 1027 (1963); Ryegate Paper Co., 20 CCH Tax Ct. Mem. 965 (1961).

¹³⁹ For an excellent analysis of future problems and solutions in this area, see Young, *supra* note 102, at 1000-02.

¹⁴⁰ The tax-exempt status of the foundation which has engaged in most of the three-party sale and leaseover transactions presently is pending in the Tax Court. University Hill Foundation, No. 73993, Tax Ct., June 16, 1958. The Commissioner previously has taken the position that the involvement of an exempt organization in such a transaction would result in the loss of its exempt status. Rev. Rul. 420, 1954-2 Cum. Bull. 128. See Young, *supra* note 102, at 1001 n.176.

¹⁴¹ See cases cited note 133 *supra*. See also Young, *supra* note 102, at 996-98.

the foundation's tax exemption in the sale and leaseover area would have on the gift-leaseback transaction. The lessee in the sale and leaseover cases usually has been a corporation in which the sellers have only minority interest, but there is nothing in the opinions which indicate that this is a necessary requirement for obtaining the desired tax consequences.¹⁴² The sale and leaseover arrangement is comparable, therefore, to the sale and leaseback arrangement, which traditionally has been considered *in pari materia* with the gift-leaseback arrangement. On the other hand, if a foundation participates in a sale and leaseback or sale and leaseover transaction, it actively participates in a business venture as purchaser of business assets, whereas in the gift-leaseback the foundation risks none of its assets and merely collects rental income.¹⁴³ More significantly, the foundation whose tax exemption presently is being litigated has engaged in a number of sale and leaseover transactions in past years.¹⁴⁴

Recent cases also have disclosed the vulnerability of the rental deduction under a sale and leaseover.¹⁴⁵ If the original sales price is excessive and if the original shareholders repurchase the property shortly after the sale and leaseover, the court will treat the entire transaction as a sham and will disallow the rent.¹⁴⁶ Even where the sales price is reasonable, the Commissioner, after a series of unsuccessful attempts,¹⁴⁷ has succeeded in disallowing a portion of the rental deduction.¹⁴⁸ In the most recent decision in this area, the Tax Court held that if the second corporation fails to show that the rent paid to the foundation was negotiated apart from the sale of the original corporation, the rental deduction will be disallowed to the extent that it is excessive.¹⁴⁹

¹⁴² See Wilson, *supra* note 105, at 176-78.

¹⁴³ See the discussion at note 117 *supra*.

¹⁴⁴ One authority indicates that over an eighteen-year period, the foundation has purchased fifteen to twenty other companies. Young, *supra* note 102, at 1001 n.167. The code requires that to be exempt, the foundation must be organized and *operated* exclusively for charitable purposes. Int. Rev. Code of 1954, § 501(c)(3). See also Treas. Reg. § 1.401-1(a)(3)(ii) (1956), which requires that a qualified pension or profit-sharing plan be for the exclusive benefit of the employees.

¹⁴⁵ The evolution of the Tax Court's thought, concerning the deductibility of rentals in the three-party transaction, can be understood best by reading in order the following cases: Ryegate Paper Co., 20 CCH Tax Ct. Mem. 965 (1961); Anderson Dairy, Inc., 39 T.C. 1027 (1963); Royal Farm Dairy Co., 40 T.C. 173 (1963); Estate of Goldenberg, 23 CCH Tax Ct. Mem. 810 (1964).

¹⁴⁶ Warren Brekke, 40 T.C. 789 (1963).

¹⁴⁷ Anderson Dairy, Inc., 39 T.C. 1027 (1963); Oscar C. Stahl, 22 CCH Tax Ct. Mem. 996 (1963); Isis Windows, Inc., 22 CCH Tax Ct. Mem. 837 (1963).

¹⁴⁸ Royal Farms Dairy Co., 40 T.C. 173 (1963); Estate of Goldenberg, 23 CCH Tax Ct. Mem. 810 (1964).

¹⁴⁹ Estate of Goldenberg, *supra* note 148, at 826. Although the *Royal Farms Dairy* and *Goldenberg* cases are distinguishable from the normal gift-leaseback arrangement on the basis that the rent in those cases was excessive, the Tax Court's concern with the separate negotiation of rent at the time of the leaseover may have important implications in the gift-leaseback area, where the rental usually is agreed upon prior to the original transfer.

IV. THE VAN ZANDT DECISION

The Tax Court and Fifth Circuit decisions in the recent case of *Van Zandt v. Commissioner*¹⁵⁰ provide further cause for concern about the continued deductibility of rent in leasebacks involving related parties. The facts of the case are important to its decision. Dr. Van Zandt, a Fort Worth surgeon, and his wife established irrevocable short-term trusts for the benefit of their two minor children, with Dr. Van Zandt as trustee. Real and personal property used in Dr. Van Zandt's medical practice were transferred by gift to the trust and immediately leased back to him at a rental which was stipulated to be reasonable. Although the grantors retained reversionary interests in the properties conveyed, the trusts were drafted to satisfy the provisions of sections 671-78 of the code, so that the trust income was not taxable to them. For the two years in question, the Van Zandts deducted the rent paid to the trusts on their joint income tax return, and the deduction was disallowed by the Commissioner. The Tax Court upheld the disallowance on the grounds that the rental payments were not "necessary" within the meaning of section 162(a),¹⁵¹ and its decision was affirmed by the Fifth Circuit, which held that

In *Egbert J. Miles, Jr.*, 41 T.C. 165 (1963), the rental deduction was disallowed in a sale and leaseover transaction involving a closely held corporation, a family trust and a partnership whose members were stockholders of the corporation. The case involved a manufacturing corporation owned by three families which was expanding its operations through foreign licensing of its patents and trademarks. In order to provide supervision of the foreign operations, to prevent internal conflict, to lessen the corporate tax burden due to the increased foreign royalty income and to provide economic security for the shareholders' children, the following transaction was arranged. Bermuda trusts with corporate trustees were created by the parent shareholders for the benefit of their children, some of whom were also shareholders in the corporation. The corporation sold the patents and trademarks to the trust at a price well below their fair market value. The trustees licensed the patents and trademarks to a partnership, which was controlled primarily by the adult trust beneficiaries, who were stockholders of the corporation. A royalty equal to 90% of the partnership profits was reserved to the trust. The trust was to terminate at the end of ten years, at which time the corpus was to be distributed to the trust beneficiaries. Tax-wise, the net effect of the transaction was to shelter income earned by a domestic partnership through the use of a foreign trust and to provide a tax-free return of the income to the beneficiaries upon termination of the trust.

The Tax Court held that the royalties were not ordinary and necessary business expenses and, therefore, were not deductible by the partnership. The court, relying upon the *Van Zandt* and *Ingle Coal Corp.* cases, held that the trusts were merely conduits in a prearranged plan to avoid taxes. The court emphasized the nominal consideration received by the corporation upon the sale of the patents, but failed to discuss the reasonableness of the royalty payments. In addition, the court failed to discuss the independence of the trustees, and it distinguished the *Brown*, *Skemp*, *Felix*, and *Potter* cases on the ground that they were "arm's length transactions." 41 T.C. at 180. The decision is difficult to rationalize in view of the past history in the family transfer and leaseback area. Although the transaction may have lacked sufficient business purpose, as evidenced by the nominal purchase price paid by the trust for the patents and by the tax avoidance purpose of the plan, the Tax Court appears to have based its decision on a much broader rationale—tax avoidance through reallocation of income within a family group.

¹⁵⁰ *I. L. Van Zandt*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965).

¹⁵¹ Int. Rev. Code of 1954, § 162(a).

the entire transaction lacked the business purpose implicitly required by section 162(a).

The Tax Court opinion distinguishes prior cases involving intra-family leasebacks on the grounds of an "independent" trustee in those cases;¹⁵² however, the principal rationale of the decision is much broader. The Tax Court holds that the rental payments, although "ordinary," are not "necessary" within the meaning of section 162(a) because the taxpayer continued to use the leased property in his business in exactly the same manner after the gift-leaseback as he did before the transaction occurred.¹⁵³

It is difficult to reconcile the language of the Tax Court decision with that of the Seventh Circuit in the *Skemp* case, quoted earlier.¹⁵⁴ To the extent that there is an enforceable obligation requiring the payment of rent which is reasonable in amount, the actual rental payments would appear to be necessary.¹⁵⁵ As the court in *Skemp* points out, mere voluntariness in creating a legal obligation does not make satisfaction of the obligation, once created, unnecessary or not required.

It will be recalled that the Tax Court originally held that the rentals paid under a family leaseback were not deductible¹⁵⁶ and that this position was changed¹⁵⁷ only after two appellate court reversals.¹⁵⁸ Although the Tax Court has declined to overrule its later decisions upholding the deductibility of the rentals,¹⁵⁹ the broad rationale of the *Van Zandt* case may represent a trend toward its original position.

The Fifth Circuit decision, in its emphasis upon the lack of business purpose of the gift-leaseback arrangement, likewise represents a departure from past authority. The court relies upon its decision in the *Armston*¹⁶⁰ case, which involved the *sale* of corporate property to a shareholder with a subsequent leaseback to the corporation and in which it was held that the rentals were not deductible by the corporation in the absence of evidence showing a business purpose for the entire transaction. As mentioned previously,¹⁶¹ lack of business purpose has been emphasized to deny rental deductions in cases involving sale-leasebacks; however, in prior cases involving gift-lease-

¹⁵² I. L. Van Zandt, 40 T.C. 824, 830 (1963).

¹⁵³ *Id.* at 830-31.

¹⁵⁴ Quoted in text accompanying note 47 *supra*.

¹⁵⁵ See note 82 *supra*.

¹⁵⁶ Helen C. Brown, 12 T.C. 1095 (1949); A. A. Skemp, 8 T.C. 415 (1947).

¹⁵⁷ Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).

¹⁵⁸ See John T. Potter, 27 T.C. 200 (1956); Albert T. Felix, 21 T.C. 794 (1954).

¹⁵⁹ See Egbert J. Miles, Jr., 41 T.C. 165 (1963), discussed at note 149 *supra*.

¹⁶⁰ W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951).

¹⁶¹ See note 43 *supra*.

backs the courts have either ignored the business purpose argument or dismissed it as unimportant. No reason appears for distinguishing between the two methods of transfer.

As factors which preclude the finding of business purpose in *Van Zandt*, the Fifth Circuit lists the short term of the trust, the reversion to the grantors and the predetermination of the right to possession of the property.¹⁶² Interestingly enough, however, the decision does not mention the absence of an independent trustee. The *Skemp* case is distinguished factually with emphasis on the fact that the properties transferred in *Skemp* contained considerably more space than was rented back to the grantor, the implication being that there may have been business purpose to establish management of the property other than the property leased back to the grantor.¹⁶³ The court is careful to emphasize that the determination of business purpose depends upon a factual evaluation of each case and refuses to condemn absolutely all transfers between related parties.¹⁶⁴

The decision of the Fifth Circuit appears to stand for the proposition that if the only justification for the leaseback transaction is the reduction of income tax, this by itself is not a sufficient business purpose to sustain the rental deductions under section 162(a). Any final analysis of the authoritativeness of the decision for subsequent family tax planning must take cognizance of the unfavorable fact situation presented by the taxpayer. Ultimately, the case may be explainable as an expression of "the usual judicial unfriendliness toward clever tax schemes that are highly or exclusively tax motivated."¹⁶⁵

V. CONCLUSION

The trend of the decisions in the area of leasebacks involving related parties appears to be toward a restriction of the tax benefits previously enjoyed through intra-family transfers, transactions involving family foundations and arrangements between closely held corporations and its employee benefit plans. The law in each of these areas is in flux at the present time; however, the Internal Revenue Service has recently indicated a willingness to provide a measure of certainty to proposed leaseback transactions by reversing its prior "no-rulings" policy in this area.¹⁶⁶

Recent cases involving the gift-leaseback transaction provide an interesting study in the Commissioner's attack upon income shifting

¹⁶² *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965).

¹⁶³ *Id.* at 442.

¹⁶⁴ *Id.* at 443.

¹⁶⁵ Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 Supreme Court Review 135, 157, also in 40 Taxes 296 (1962).

¹⁶⁶ Compare Rev. Proc. 64-31, 1964 Int. Rev. Bull. No. 30, at 14, 17, with Rev. Proc. 62-32, 1962-2 Cum. Bull. 527, 531, and Rev. Proc. 62-30, 1962-2 Cum. Bull. 512, 514.

through related-party transfers. Whereas the Government originally assailed the rental deduction of the donor-lessee under the *Clifford* theory of retained dominion and control, recent developments indicate a shift of emphasis to the statutory provisions of section 162 (a). This shift is illustrated in the Fifth Circuit's disposition of the taxpayer's contention in *Van Zandt* that the question of the deductibility by the grantor of payments made to the trust should be resolved by a determination of the taxability of the trust income to the grantor. Thus, it was argued, if the grantor is the "substantial owner" of the trust under the tests laid down in sections 671-78,¹⁶⁷ then items such as rent paid by the grantor (which by their nature are income to the trust) necessarily become trust income includable in the income of the grantor, with the result that the deduction and the related items of income cancel each other.¹⁶⁸ In answer to this argument, the court acknowledged that the trust income is not taxable to the grantor under sections 671-78, but holds that the question is controlled by section 162 (a) and that the lack of business purpose results in the disallowance of the deduction under that section.¹⁶⁹

Although the court in *Van Zandt* may be technically correct as to the applicability of the provisions of sections 671-78 to the deductibility of rentals in a gift-leaseback arrangement,¹⁷⁰ the taxpayer's contention has practical merit in that it suggests that the problem of the deductibility of rent in a leaseback arrangement may be susceptible to statutory solution. It is believed that with relatively minor adjustments, the provisions of sections 671-78 could be extended to deal with this problem. In this regard, it is submitted that the rentals paid under the lease should be deductible by the grantor if, in addition to compliance with the other requirements of the sections, the rental is reasonable, the grantor retains no reversionary interest in the property transferred and the trustee is not a related or subordinate party to the grantor.¹⁷¹ Imposition of such requirements would appear to meet the principal objections of the Commissioner to the gift-leaseback arrangement and to eliminate the subjective elements of the business purpose test under section 162 (a).

¹⁶⁷ Int. Rev. Code of 1954, §§ 671-78.

¹⁶⁸ Brief for Appellant, pp. 10-13, *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965).

¹⁶⁹ 341 F.2d 440, 443 (5th Cir. 1965).

¹⁷⁰ See text accompanying notes 28-29 *supra*.

¹⁷¹ In the trust area, generally the use of a related trustee does not defeat the transaction from a tax standpoint, except in those circumstances where the code so provides. However, as pointed out previously, the independence of the trustee has been a prerequisite to favorable tax treatment in the gift-leaseback transaction. See discussion at text accompanying notes 60-79 *supra*. If circumstances of this sort are to be used to defeat an otherwise bona fide leaseback transaction, then it would appear that codification of such rules would be appropriate in order to provide a reasonable guide to the taxpayer.

Southwestern Law Journal

VOLUME 19

JUNE 1965

NUMBER 2

BOARD OF EDITORS

JOHN R. JOHNSON
Editor-in-Chief

JAMES W. BRENNAN
Managing Editor

ROBERT C. GIST
Notes Editor

WALLACE M. SWANSON
Leading Articles Editor

JOHN M. STEPHENSON
Comments Editor

JOE SCOTT MORRIS
Research Editor

ARTHUR E. HEWETT
Business Manager

R. BRUCE LABOON
Recent Decisions Editor

JAMES WM. CARDWELL
Associate Editor

MICHAEL T. GARRETT
Associate Editor

REBA GRAHAM RASOR
Associate Editor

BOARD MEMBERS

TOM J. STOLLENWERCK

ADVISORY BOARD

Hon. Frederick G. Hamley
United States Court of Appeals
San Francisco, California

Wm. Warfield Ross
Wald, Harkrader & Rockefeller
Washington, D.C.

Page Keeton
School of Law
University of Texas

George Slover
Johnson, Bromberg, Leeds & Riggs
Dallas, Texas

Hon. Jack Pope
Supreme Court of Texas
Austin, Texas

Henry Weihofen
School of Law
University of New Mexico

Hon. John Minor Wisdom
United States Court of Appeals
New Orleans, Louisiana

ALAN R. BROMBERG
Faculty Advisor

Member, National Conference of Law Reviews