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INCOME TAXATION—GIFT AND LEASEBACK SCHEMES

Taxpayer-physician gratuitously transferred to his minor children real property consisting of a pharmacy, a rental apartment, and the offices of taxpayer's medical practice. Subsequently, taxpayer obtained judicial appointment as legal guardian of the minors, and by oral arrangement leased the offices from his children. Under section 162 of the Internal Revenue Code, taxpayer claimed a business deduction for the rent which the Internal Revenue Service disallowed.¹ On appeal the Ninth Circuit held, "that the property interest transferred to the children was sufficient to justify both the deduction for the donor and taxation of the rental income to the minors." *Brooke v. United States*, 468 F.2d 1155 (9th Cir. 1972).

Many courts have refused to give favorable treatment to intra-family transactions that result in tax benefits for the participants if their relative economic positions before and after such transactions remain substantially the same.² Such devices as partnerships,³ corporations,⁴ straw men,⁵ step-transactions,⁶ or combinations thereof,⁷ have been used to mask such purposes, but many have been perceived and disallowed.⁸ Donation and leaseback is one such device and since there is little legislation in this area, the courts have developed a federal common law to occupy the vacuum.

For example, since *Lucas v. Earl*⁹ a mere assignment of income will not suffice to relieve the assignor from initial tax liability; some type of ownership in the income-producing property must also be transferred.¹⁰ Resolution of gift and leaseback cases has frequently

1. *Brooke v. United States*, 292 F. Supp. 571 (D. Mont. 1968).

2. *Harrison v. Schaffner*, 312 U.S. 579 (1941); *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Douglas v. Willcuts*, 296 U.S. 1 (1935).

3. *Egbert J. Miles, Jr.*, 41 T.C. 165 (1963).

4. *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949).

5. *Ernest v. Berry*, ¶ 64,181 P-H Tax Ct. Rep. of Mem. Dec. (1947).

6. *Kirschermann v. Westover*, 225 F.2d 69 (9th Cir. 1955); *W.H. Armston Co. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Granberg Equip., Inc.*, 11 T.C. 704 (1948).

7. *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949); *Egbert J. Miles, Jr.*, 41 T.C. 165 (1963).

8. See also *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Commissioner v. Tower*, 327 U.S. 380 (1946); *Harrison v. Schaffner*, 312 U.S. 579 (1941); *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Clifford*, 309 U.S. 331 (1940); Note, 51 COLUM. L. REV. 247 (1951); Note, 59 YALE L.J. 1529 (1950).

9. 281 U.S. 111 (1930).

10. The *Lucas v. Earl* "fruit of the tree" metaphor requires that the tree as well as the fruits be transferred. But the problems persist: what if only the right to all future income is assigned? See *Helvering v. Horst*, 311 U.S. 112 (1940). What if a tree laden

focused on the reality of the original transfer tested by duration and retained controls, and whether subsequent use of the property or income is essentially for the donor's benefit.¹¹ Those cases favorable to the taxpayer usually involve a donor who has adhered to the *Clifford* rules,¹² and has insulated himself from retained control by establishing an independent trustee.¹³ Decisions generally adverse to taxpayers emphasize various mechanisms to maintain control such as excessive retained interests, continued de facto control by the donor, use of the donated items for donor's benefit, or failure to adhere to the *Clifford* rules.¹⁴

An early attempt to gain tax advantages by gift and leaseback was thwarted in *White v. Fitzpatrick*.¹⁵ In *White* taxpayer donated patents and cash to his wife whereupon she used the donated funds, plus some of her own, to buy commercial property suitable for her donor-husband's business. She then leased the patents and commercial property to him. The Service disallowed rental deductions on the ground that absence of original business purpose for the donations negated any subsequent business purpose for rental deductions. The court agreed with the Service stating "[i]t is now too late to question

with ripened fruit is transferred? See *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945).

11. While commentators have differed in use of descriptive phrases, this seems to be a fair synopsis. In *Brooke* the court weighed four factors: (1) the duration of the transfer; (2) the controls retained by the donor; (3) the use of the transferred property for the benefit of the donor; and (4) the independence of the trustee. Factors 1, 2 and 4 seem to be covered by the author's first consideration while factor 3 is covered by the author's second consideration. See also Simmons, *Gift and Leaseback Arrangements Involving Property Used in Professional Practice*, 48 L.A. BAR. BULL. 62, 63 (1972); Soll, *Intra-Family Assignments: Attribution and Realization of Income*, 6 TAX L. REV. 435 (1951); Gibbs, *Income Shifting—Recent Trends in Leaseback Transactions*, 19 SW. L.J. 273 (1965); Note, 51 COLUM. L. REV. 247 (1951); Note, 59 YALE L.J. 1529 (1950).

12. These rules of grantor trusts were set out in *Helvering v. Clifford*, 309 U.S. 331 (1940), and are now found in sections 671-678 of the Internal Revenue Code. These sections provide that a grantor will be treated as owner of the trust and thus taxed with its income when he: (1) retains certain reversionary interests; (2) has power to determine who enjoys the trust income; (3) controls certain important administrative functions; and (4) has substantial dominion over the trust corpus or income.

13. See *Brown v. Commissioner*, 180 F.2d 926 (3d Cir. 1950); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948); *John T. Potter*, 27 T.C. 200 (1956); *Albert T. Felix*, 21 T.C. 794 (1954).

14. See *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965); *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir. 1955); *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951); Gibbs, *Income Shifting—Recent Trends in Leaseback Transactions*, 19 SW. L.J. 273 (1965).

15. 193 F.2d 398 (2d Cir. 1951).

the well-established proposition that mere assignment of such a right will not suffice to insulate the grantor from tax liability under 22(a), and we think that like tax results must obtain under 23(a)(1)(A)."¹⁶

A leaseback deduction appears statutorily allowable if the assignment effectively shifts income and the rentals paid are reasonable and necessary in the ordinary course of business. However, possibly recognizing an avenue of tax avoidance,¹⁷ the court refused to distinguish the concept of an assignment of income under section 61 from a section 162 ordinary and necessary business deduction. Although the court conceded that the transfer was sufficient to shift income to the donee under section 61,¹⁸ it was insufficient to justify the section 162 deduction because the de facto controls, coupled with the absence of original transfer business purpose,¹⁹ "render the assignment ineffective for federal tax purposes."²⁰

Prior to *White* a contrary result obtained in the Third and Seventh Circuits where there was no business purpose in the original transfer but the donor retained only minimal ownership attributes and a trust was interposed between donor and donee. In *Skemp v. Commissioner*²¹ and *Brown v. Commissioner*,²² the properties were transferred to trusts with independent trustees and wives as income beneficiaries; subsequently donor leased back the donated properties from the trustees. The courts allowed rental deductions finding taxpayers had irrevocably divested themselves of control over transferred property. The *Skemp* court further indicated that taxpayers had a duty to pay lease rental as the trustees were correlatively bound to exact the rents "just as much as if the taxpayer had moved across the street into the property of a third party."²³

16. *Id.* at 402.

17. The court's language is illustrative of the effort to close tax loopholes: "Assignment and gift cannot be divorced for tax purposes from their accompanying agreements whereby the husband retained dominion. . . . Gift and retained control must be regarded as inseparable parts of a single transaction especially since it was only in their sum total that they had any reality in regard to the conduct of plaintiff's business." *Id.* at 400.

18. "The bare assignment of the patent was legally adequate to transfer all rights adhering thereto to the wife." *Id.* at 400.

19. *Id.* at 401: "[t]he principles governing the intramarital transfer of income enunciated in *Helvering v. Clifford* . . . are decisive here The Clifford rule is clear that this direct control, when fused with the indirect control which we must imply from a formal but unsubstantial assignment within a closed family group displaying no obvious business purpose, renders the assignment ineffective for federal tax purposes."

20. *Id.* at 401.

21. 168 F.2d 598 (7th Cir. 1948).

22. 180 F.2d 926 (3d Cir. 1950).

23. 168 F.2d 598, 600 (7th Cir. 1948).

In *White* and subsequent cases, the courts seem primarily concerned with degree of control exercisable by the assignor. Where the settlor retains no reversionary interest, the courts seem satisfied that the interposition of a trust plus the independence of a trustee preclude residuary dominion by the settlor. However, where no trust is interposed, donor must establish a business purpose for the original gift in order to justify the deduction. Later decisions seem to concede that the purpose of the original transfer is immaterial where the donor retains no control.²⁴

A mere formal trust will not protect the taxpayer; the trust instrument must not subject the grantor to tax on the trust income under sections 671-677.²⁵ Taxpayer-settlor must retain no reversionary interest except that permissible under the *Clifford* rules. Until the *Brooke* case, it was also necessary that at least one trustee be someone other than the donor to satisfy the independence test,²⁶ although the settlor could retain some administrative rights or powers over the trust.²⁷ The further requirement that trustees act independently of the donor was articulated in *Audano v. United States*.²⁸ There, the court taxed the trust income to settlor, indicating that failure of the trustees to act independently *in fact* could result in disqualification under grantor trust provisions.²⁹

24. Support for this may be found by close analysis of the court's reasoning process. Whenever the formal trust is found, the court next examines the *amounts* expended and the *type* of property rented in light of section 162. It is significant that the interim step of business purpose behind the initial transfer is not even mentioned in this situation.

25. The stringent requirements of sections 671-677 coupled with the jurisprudential prerequisite of an independent trustee make gift-leaseback trusts among the most circumscribed in tax law. For example, the "independence in fact" language of *Audano v. United States*, 428 F.2d 251 (5th Cir. 1970) (*see text at note 28 infra*) is more limited than section 672.

26. *See Audano v. United States*, 428 F.2d 251 (5th Cir. 1970); *Van Zandt v. Commissioner*, 341 F.2d 440 (5th Cir. 1965); *Sidney W. Penn*, 51 T.C. 144 (1968); *Alden B. Oaks*, 44 T.C. 524 (1965); *Albert T. Felix*, 21 T.C. 794 (1954).

27. INT. REV. CODE OF 1954 § 674. For example, the power to effect the beneficial enjoyment after expiration of a ten-year period; powers, other than powers of appointment, exercisable only by will; and power to allocate irrevocably payable beneficial interests among several charitable beneficiaries will not result in taxability of trust income to settlor.

28. 428 F.2d 251 (5th Cir. 1970).

29. *Id.* at 258. Taxpayer-physician transferred to a trust interests in medical equipment used in his practice. The trust beneficiaries were his children. Trustees were the taxpayer, his accountant, and his lawyer. Taxpayer's medical partnership rented the equipment from the trust under an oral lease-purchase agreement. The original cost of equipment was less than \$15,000; the partnership paid approximately \$58,000 in rent over a five-year term; the value of the equipment at the beginning of the rental was \$8,000 to \$10,000.

Brooke seems to recognize guardianships as an alternative device for insulating the donated leaseback property from the donor's control and represents the first appellate decision in which a section 162 deduction was allowed where the taxpayer had actual post-transfer administrative control of the donated property, albeit in a fiduciary capacity. Even though guardianship was deemed sufficient to satisfy the requirement of independent management,³⁰ the court appeared reluctant to base the decision on this ground alone. The court noted that the "non-tax motives, as borne out by the record, are abundant and grounded in economic reality."³¹ Under Montana law, state court control of legal guardianship was deemed substantially equivalent to both trust and trustee.³² Despite the absence of a formal trust the original transfer was not subjected to the business purpose test and only business purpose at the time of rental payments was necessary.

While *Brooke* seems to invite new forays into income assignment via the intra-family gift and leaseback, the careful planner will recognize the hazards involved. First, successful attack by the Service may result in effective double taxation of the rental income.³³ Second, the decision itself can easily be distinguished or limited to an alternative rationale in support of the holding.³⁴ Third, even if the planner is

30. The court isolated from prior cases four factors to consider in gift-leaseback situations: "(1) the duration of the transfer; (2) the controls retained by the donor; (3) the use of the gift property for the benefit of the donor and; (4) the independence of the trustee." As to the first the court said "No issue is presented here as to the duration of the transfer—it was absolute and irrevocable, it was by warranty deed, unconditioned and unencumbered." The court next stated that "[t]he taxpayer in this instance has retained few, if any controls over the trust property." Factor three was disposed of summarily: "It is also apparent that trust benefits have not inured to the taxpayer as donor." After analyzing Montana law the court resolved the final issue in favor of taxpayer stating, "[a] court appointed trustee—even though the taxpayer—offers sufficient independence." *Brooke v. United States*, 468 F.2d 1155, 1157 (9th Cir. 1972).

31. *Id.* at 1158. Note, however, that while business purpose was not required, the court found that the transactions were such that "[n]either substance nor impact denies this transfer professional or economic reality." This "grounded in substantial economic reality language" appears also in *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957), *Alden B. Oakes*, 44 T.C. 524 (1965), and *Albert T. Felix*, 21 T.C. 794 (1954), and seemingly is just a modification of the rules that a transfer solely to avoid taxes will not be recognized whereas mere benefit to the taxpayer alone is not fatal.

32. 468 F.2d at 1158.

33. This occurs when the reallocation of income is allowed under section 61 but the corresponding rental deduction is disallowed. The rental income is thus twice taxed—once to the donor and again, albeit in a lower bracket, to the donee. See Simmons, *Gift and Leaseback Arrangements Involving Property Used in a Professional Practice*, 48 L.A. BAR BULL. 62, 63 (1972).

34. "The non-tax motives, as borne out by the record, are abundant and grounded in economic reality." 468 F.2d at 1158. See note 31 *supra*.

able, by revenue ruling or otherwise, to ascertain the effect of state law in this area, any change in that law could be fatal.

In Louisiana, a minor's property may be administered by the minor himself,³⁵ a tutor,³⁶ a trustee,³⁷ his parent,³⁸ or a custodian.³⁹ There is no positive law authorizing the appointment of a parent as a tutor of his child during the existence of parental authority;⁴⁰ however, the father, as the administrator of the child's property, is accountable for both the revenues and property during minority.⁴¹ Thus, if a father were to donate property to his child without express reservation of the usufruct⁴² his position as administrator of that property might be the equivalent of the *Brooke* guardianship. After dissolution of the marriage, or upon separation from bed and board the parental authority ceases⁴³ and the minor is placed under authority of a tutor⁴⁴ who administers the minor's property. If the natural tutor donated property to the child without express reservation of the usufruct, the tutor seemingly could benefit from *Brooke*.⁴⁵ If, as is often the case, the mother is awarded custody, she can accept the parental usufruct and refuse the tutorship,⁴⁶ possibly allowing the father⁴⁷ to qualify as tutor and capitalize on *Brooke*.⁴⁸

Even assuming that a parent could be a tutor or administrator without the right of usufruct over the particular property involved, the continuing obligation of the parents to support minor children

35. LA. CIV. CODE art. 1785; Pascal, *Contracts of a Minor or His Representative Under the Louisiana Civil Code*, 8 LA. L. REV. 383 (1940).

36. LA. CIV. CODE art. 246.

37. LA. R.S. 9:1791-2212 (1950).

38. LA. CIV. CODE art. 221.

39. Uniform Gifts to Minors Act, LA. R.S. 9:735-42 (Supp. 1961).

40. Control and use of a minor's property during parental authority is discussed in Nelson, *Administration of a Minor's Property in Louisiana Under Paternal Authority*, 22 LA. L. REV. 615 (1962). See LA. CODE CIV. P. art. 4361-63 (for an exception when parent and child hold property in common and wish to partition. These articles replaced Civil Code articles 343 and 344).

41. LA. CIV. CODE art. 221, 226.

42. LA. CIV. CODE art. 226 provides in part: "Neither shall such usufruct extend to such estate as is given the children by donation inter vivos by either the father or mother unless . . . the right to such usufruct has been reserved . . ." (Emphasis added.) Since the parent is fully accountable for this property, an argument may be made that the theory in *Brooke* is available.

43. LA. CIV. CODE art. 221.

44. *Id.* art. 246.

45. *Id.* arts. 225, 226.

46. *Id.* art. 253.

47. *Id.* art. 301. The father may not refuse the tutorship of his own children.

48. See note 42 *supra*.

may create new difficulties with respect to section 677 of the Internal Revenue Code.⁴⁹ Section 677 (b) penalizes the settlor in situations where trust income is utilized to discharge his obligations by including and taxing such sums in the settlor's return. The court in *Brooke* discussed this issue and resolved it in favor of settlor-donor, finding that under Montana law the use of rental income was in fact for purposes other than *legally* enforceable support obligations of donor.⁵⁰

It can be seen that application of *Brooke* may result in inequitable taxpayer treatment depending upon idiosyncrasies of state law.⁵¹ This type of discrimination, which both Congress and the courts continually strive to eliminate, combined with the spectre of tax avoidance, bodes ill for reliance upon *Brooke*.

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CREDITORS' RIGHTS AND THE COMMUNITY OF GAINS

Mr. Creech endorsed a promissory note given to his divorced wife by Capitol Mack, Inc. in payment for the purchase of stock she had acquired in the partition of the community of gains. Creech remarried and subsequently both Capitol Mack and Creech defaulted on this note. In a suit by Creech's first wife, the Louisiana supreme court overruled *United States Fidelity & Guaranty Co. v. Green*¹ and held that the husband's antenuptial creditor may enforce his right by execution against those assets of the husband forming part of the community of gains of the second marriage. *Creech v. Capitol Mack, Inc.*, 287 So. 2d 497 (La. 1973).

At first glance, the court's decision is in apparent conflict with the literal language of Louisiana Civil Code article 2403:

In the same manner, the debts contracted during the marriage enter into the partnership or community of gains, and must be acquitted out of the common fund, whilst the debts of both husband and wife, anterior to the marriage, must be acquitted out of their own personal and individual effects.

This article has been subjected to varying constructions for over a century. Prior to *Green*, virtually all the decisions indicated that the

49. See LA. CIV. CODE art. 227. The third factor used by the *Brooke* court in testing the gift-leaseback was "use of the donated property for the donor's benefit." *Brooke v. United States*, 468 F.2d 1155, 1158 (9th Cir. 1972).

50. 468 F.2d at 1158.

51. A primary example was the passage of an income splitting provision in 1948 to equalize tax treatment of spouses without community property regimes with those in states such as Louisiana where income splitting between spouses is accomplished by local law.

1. 252 La. 227, 210 So. 2d 328 (1968).