Is Trustee Independence a Prerequisite to Deductible Gift-Leaseback Rental Payments?: May v. Commissioner

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The gift-leaseback arrangement is a commonly used tax saving device which effectively splits income among family members. Typically, the donor makes a gift of the property used in his business to a trust created for the benefit of his children, and the trustee simultaneously leases the property back to the grantor for use in his business. The trust income will be taxed to the beneficiary or to the trust at a lower tax rate than that of the donor. An
additional objective of a gift-leaseback transaction is to permit the donor to deduct from his income the rental payments made to the trust as ordinary and necessary business expenses under section 162(a)(3) of the Internal Revenue Code (the Code). Although courts have considered a variety of factors in determining whether such a transaction meets the requirements for deductibility of rental payments, particular significance has been attached to the

trust is determined "in the same manner as in the case of an individual," I.R.C. § 641(b), and includes "income which is to be distributed currently . . . to the beneficiaries," I.R.C. § 641(a)(2). If all of the income of a trust is required to be distributed currently, however, that amount may be deducted from the trust's taxable income as long as the trust has no power to make charitable donations. I.R.C. § 651(a). For a computation of after-tax savings, see Note, Quinlivan v. C.I.R.: Limiting Tax Liability Through Gift and Leaseback, 25 S.D.L. Rev. 91, 92 & n.8 (1980).  

I.R.C. § 162(a)(3). Section 162(a)(3) of the Internal Revenue Code provides:

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.


I.R.C. § 162(a)(3); see Quinlivan v. Commissioner, 599 F.2d 269, 272 (8th Cir.), cert. denied, 444 U.S. 996 (1979); Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir.), cert. denied, 382 U.S. 814 (1965); Skemp v. Commissioner, 168 F.2d 598, 599 (7th Cir. 1948); Mathews v. Commissioner, 61 T.C. 12, 18-19 (1973), rev'd, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 987 (1976). The Tax Court's standard for deductibility of rent was set forth in Mathews v. Commissioner. Id.; see notes 25-29 and accompanying text infra. Apart from the Mathews criteria, other factors to be considered include the grantor's reversionary interest, Brooke v. United States, 468 F.2d 1155, 1157 (9th Cir. 1972), the powers of the trustee, Furman v. Commissioner, 45 T.C. 360, 365 (1966), aff'd per curiam, 381 F.2d 22 (5th Cir. 1967), and whether the grantor is the sole occupant of the rental property, see Van Zandt v. Commissioner, 341 F.2d 440, 442 (5th Cir.), cert. denied, 382 U.S. 814 (1965).  

Examining the language of section 162(a)(3) of the Internal Revenue Code, the Eighth Circuit formulated its own standard for deductibility of rental payments:

(1) the payments are required to be made for the continued use or possession of the property; (2) the continued use or possession of the property is for the purposes of the trade or business; (3) the taxpayer has not taken and is not taking title to the property; and (4) the taxpayer has no equity in the property.

Quinlivan v. Commissioner, 599 F.2d 269, 272 (8th Cir.), cert. denied, 444 U.S. 996 (1979). The Quinlivan court did not expressly adopt the Mathews requirements, but stated that if the Mathews test were not satisfied, the statutory requirements would not be met either. Id. at 273.

In the earliest case involving the gift-leaseback, the Seventh Circuit considered such
degree to which the trustee is independent of the grantor.\(^7\) There is some confusion, however, whether the presence of an independent trustee is a prerequisite to the rental deduction\(^8\) or merely a factor to be considered by a court.\(^9\) Recently, in *May v. Commissioner,\(^{10}\)* the Tax Court held that rental payments made to an irrevocable trust created for the benefit of the grantor's children were deductible as ordinary and necessary business expenses, but upon noting that the trustee in the instant case was sufficiently independent,\(^1\) the court implied that trustee independence may not be required in every case.\(^12\)

Dr. Lewis May and his wife owned the land and building in which Dr. May's medical practice was situated.\(^13\) In 1970, they executed a declaration of trust, transferring all of their rights, title, factors as whether rent was required and whether there was a true change in economic status. *Skemp v. Commissioner, 168 F.2d 598, 598-600 (7th Cir. 1948).* On the latter point, the court was persuaded by the fact that the grantor gave away his entire interest in the property and had assumed an obligation to pay rent. *Id.* at 600. The fact that the obligation was created voluntarily by the taxpayer's gift was stated to be irrelevant to the issue of deductibility of rentals. *Id.* In a similar case, *White v. Fitzpatrick, 193 F.2d 396 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952),* the Second Circuit distinguished *Skemp* on the grounds that *White* did not involve a trustee. *Id.* at 401. The court disallowed the deduction of royalty and rental payments made from husband to wife because there was no evidence that the wife controlled the property and because the husband retained beneficial enjoyment. *Id.* The Second Circuit has not otherwise spoken in this area.

Since the deductibility issue has not been resolved by either the Supreme Court or Congress, the Internal Revenue Service considers the deductibility of rental payments in gift-leasebacks one of its "prime issues" for litigation. I.R.S. Prime Issue List, Nov. 19, 1974, *reprinted in* [1979] STAND. FED. TAX REP. (CCH) § 195.

\(^7\) *Brooke v. United States, 468 F.2d 1155, 1157 (9th Cir. 1972); see, e.g., Perry v. United States, 520 F.2d 235, 238 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976); Engle v. United States, 400 F. Supp. 5, 6 (W.D. Pa. 1975), aff'd mem., 562 F.2d 41 (3d Cir. 1977) (en banc); Van Zandt v. Commissioner, 40 T.C. 824, 830 (1963), aff'd, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965). Since it is difficult to determine when a trustee will be considered independent, it is wise to use a bank or a corporate trustee, *e.g., Serbousek v. Commissioner, 36 T.C.M. (CCH) 479, 480 (1977); Felix v. Commissioner, 21 T.C. 794, 804 (1954), but this will not ensure a finding of independence. See, *e.g., Hall v. United States, 208 F. Supp. 584, 587 (N.D.N.Y. 1962); Butler v. Commissioner, 65 T.C. 327, 330 (1975).*

\(^8\) *See, e.g., Brooke v. United States, 468 F.2d 1155, 1157 (9th Cir. 1972); Skemp v. Commissioner, 168 F.2d 598, 599 (7th Cir. 1948); Van Zandt v. Commissioner, 40 T.C. 824, 830 (1963), aff'd, 341 F.2d 440 (5th Cir.), cert. denied, 382 U.S. 814 (1965); Felix v. Commissioner, 21 T.C. 794, 803-04 (1954).*

\(^9\) *See, e.g., Goodman v. Commissioner, 74 T.C. 684, 708-09 (1980); Penn v. Commissioner, 51 T.C. 144, 153 (1968).*

\(^10\) *76 T.C. 7 (1981).*

\(^11\) *Id.* at 15.

\(^12\) *See id.*

\(^13\) *Id.* at 8. The property was valued at $46,504 and encumbered by trust deed notes totalling $21,619. *Id.* at 9.
and interest in the property to four irrevocable trusts created for the benefit of their four children.\textsuperscript{14} The declaration of trust named Dr. May and his friend Mr. Gross as co-trustees of the four trusts,\textsuperscript{15} granting them broad powers of management and administration.\textsuperscript{16} Although the grantor and the trustees never executed a written lease,\textsuperscript{17} Dr. May continued his medical practice at that location as the sole occupant,\textsuperscript{18} leasing the property from the trust at a rental of $1,000 per month.\textsuperscript{19}

The Mays claimed a deduction for rental payments made to the trusts in 1973.\textsuperscript{20} The Commissioner disallowed the deduction, arguing that the transfer should not be recognized for tax purposes because even if there had been an effective transfer in trust, the grantors never sufficiently relinquished control of the property.\textsuperscript{21} In the performance of his duties as trustee, there was evidence that Mr. Gross was aware of his duties as a fiduciary, that he "felt independent" of Dr. May, and that four times a year he ascertained whether rental payments had been made by Dr. May to the trust.\textsuperscript{22} A divided Tax Court\textsuperscript{23} upheld the deductibility of these payments as ordinary and necessary business expenses under section 162(a)(3).\textsuperscript{24}

\textsuperscript{14} Id. at 8. Although the trust was formed in 1970, no deed was executed until September 20, 1973. Id. at 10. The declaration of trust stated that the grantors "have delivered" the property to the trustees. This created an issue whether the instrument validly transferred an interest in property to the trust. Id. at 12.

\textsuperscript{15} Id. at 8.

\textsuperscript{16} Id. at 9-10. In particular, the trustees were granted "all the rights, powers and privileges" of an absolute owner, as limited by their fiduciary obligations. Id. at 10.

\textsuperscript{17} Id. at 11. Although there was no written lease, a valid lease agreement was "understood" between the parties. Id. at 14.

\textsuperscript{18} Id. at 10-11. It should be noted that, if other tenants besides the grantor occupy the trust property, a basis for finding a business purpose for the gift may exist. See Van Zandt v. Commissioner, 341 F.2d 440, 442 (5th Cir.) (dictum), cert. denied, 382 U.S. 814 (1965).

\textsuperscript{19} May v. Commissioner, 76 T.C. 7, 11 (1981). The parties stipulated that the amount of $1000 per month represented a reasonable rental fee for the property. Id. at 12.

\textsuperscript{20} Id. at 11.

\textsuperscript{21} Id. at 12. The Commissioner also argued that no valid trust was created because there was no effective transfer in trust under California law. Id. The court disposed of this argument, finding a valid transfer. Id. at 15.

\textsuperscript{22} Id. at 14-15. There was evidence that Mr. Gross had been a trustee for other trusts and was aware of the fiduciary obligations of the position. Id. at 14.

\textsuperscript{23} There were five written opinions in May. Judge Ekman authored the majority opinion. A concurring opinion was written by Judge Goffe, with which Judges Irwin and Wiles agreed. Judges Simpson and Wilbur each wrote dissenting opinions and, with Judge Parker, concurred in each opinion. Judge Chabot dissented in a separate opinion, and Judge Dawson did not participate.

\textsuperscript{24} May v. Commissioner, 76 T.C. 7, 15 (1981).
Writing for the majority, Judge Ekman applied the criteria set forth in *Mathews v. Commissioner*, wherein four factors were said to determine the deductibility of rental payments: the control retained by the grantor must not be substantially the same as before he made the gift; the lease normally should be in writing and always must require payment of a reasonable rental amount; there must be a bona fide business purpose for the lease; and the grantor must not retain a disqualifying equity in the property within the meaning of section 162(a)(3). The court easily disposed of the latter three requirements in favor of Dr. and Mrs. May. Judge Ekman gave greater consideration to whether the grantors relinquished sufficient control over the trust property. Since the taxpayers irrevocably transferred their entire interest, retaining no reversion, and because Dr. May was not the sole trust-
tee, this *Mathews* factor was considered satisfied.\textsuperscript{31} Judge Ekman noted that the independence of the trustee is frequently a factor in determining whether a grantor has retained control over the property.\textsuperscript{32} Finding Mr. Gross to be sufficiently independent of Dr. May, however, he concluded that it was unnecessary to decide whether such independence would be required in all cases.\textsuperscript{33}

In a concurring opinion, Judge Goffe posited that the control element of *Mathews* should be merged with its requirement that the grantor not retain a disqualifying equity.\textsuperscript{34} He reasoned that the control factor arose from a judicial concern that the tax treatment of trust transactions must depend on whether these transfers have substance.\textsuperscript{35} When there was a "lack of apparent substance," he noted, the grantor would be deemed to have an equity for purposes of trust income and business deductions because he retained constructive ownership.\textsuperscript{36} Judge Goffe looked to *Helvering v. Clifford*,\textsuperscript{37} where the Supreme Court held that a grantor must be taxed on trust income when he retains a reversion, maintains control

\textsuperscript{31} Id. at 14-15.
\textsuperscript{32} Id. at 14; see Lerner v. Commissioner, 71 T.C. 290, 302 (1978) (dictum); Quinlivan v. Commissioner, 37 T.C.M. (CCH) 346, 348 (1978), aff'd, 599 F.2d 269 (8th Cir.), cert. denied, 444 U.S. 996 (1979); Mathews v. Commissioner, 61 T.C. 12, 18 (1973), rev'd, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976).
\textsuperscript{34} Id. at 31 (Goffe, J., concurring). Judge Goffe traced the origins of the *Mathews* test, see id. at 17 (Goffe, J., concurring), giving particular attention to the requirement that the grantor not retain substantially the same control over the trust property that he had before he made the gift, id. at 23-33 (Goffe, J., concurring). He stated that the majority's treatment of the control element as a separate factor was an analytical error. Id. at 31 (Goffe, J., concurring).
\textsuperscript{35} Id. at 26 (Goffe, J., concurring). Judge Goffe stated that the requirement that the grantor relinquish control derives from a combination of the *Clifford* doctrine of treating a grantor with control over trust property as owner for the purpose of taxation on the income and the rationale of Johnson v. Commissioner, 86 F.2d 710 (2d Cir. 1936). In *Johnson*, a taxpayer who borrowed money from a trust was deemed to be the true owner of the funds because of his continued control. He, therefore, was not allowed an interest deduction. *Id.* at 713. In both cases, Judge Goffe reasoned, the lack of substance in the gift justified continued treatment of the grantor as owner. May v. Commissioner, 76 T.C. at 23 (Goffe, J., concurring). Relating this to gift and leasebacks, Judge Goffe reasoned that if a grantor retains substantial control over property which he has placed in trust, he will be denied a rental deduction because he will be deemed to be the true owner and therefore will possess a disqualifying equity in the property. *Id.* at 23 (Goffe, J., concurring).

The idea of treating the "control" and "equity" facets of the *Mathews* test as one is not a new idea in the Tax Court. See Penn v. Commissioner, 51 T.C. 144, 149-50 (1968); Skemp v. Commissioner, 8 T.C. 415, 421 (1947), rev'd, 168 F.2d 593 (7th Cir. 1948).

\textsuperscript{37} 309 U.S. 331 (1940).
over the property by acting as trustee, and names a relative as beneficiary.\(^3\) In the *Clifford* situation, Judge Goffe noted, the grantor is taxed because there is no substance to the transfer and there is justification for treating the grantor as the owner of the property for tax purposes.\(^3\) He reasoned, however, that when control or retention of the reversion is absent, the principles of *Clifford* are “inapposite.”\(^4\) Thus, Judge Goffe concluded that when a grantor divests himself of “perpetual control” by appointing an independent trustee, or does not retain a reversionary interest, thereby removing the property from his “eventual ownership,” there is no reason to treat him as possessing an equity in the property for purposes of section 162(a)(3).\(^4\) Therefore, since Dr. and Mrs. May did not retain a reversion, he reasoned that trustee independence was irrelevant to the deductibility of rent.\(^4\)

All of the dissenting judges agreed that the lack of trustee independence in *May* should be a material factor in disallowance of the deduction.\(^4\) In his dissenting opinion, Judge Simpson stated that the transaction did not have sufficient economic reality.\(^4\) This was so, he reasoned, because the grantor did not really part with control, as evidenced by the absence of a written lease.\(^4\) Judge Wilbur agreed, observing that the failure of Mr. Gross to determine whether the deed was acknowledged or whether a lease had been executed indicated a lack of trustee independence and a retention of control by the grantor.\(^4\) Judge Chabot contended that

\(^3\) See id. at 335; note 3 supra.
\(^3\) See May v. Commissioner, 76 T.C. 7, 22-23 (1981) (Goffe, J., concurring).
\(^4\) Id. at 26 (Goffe, J., concurring). Judge Goffe noted that the significant facts in *Clifford* were that the grantor retained a reversionary interest and appointed himself as trustee. See id. (Goffe, J., concurring). Thus, the absence of either of these facts, he reasoned, obviates treating the grantor as owner under the *Clifford* doctrine. Id. (Goffe, J., concurring).
\(^4\) Id. at 30 (Goffe, J., concurring). See note 40 supra.
\(^4\) See id. at 34 (Simpson, J., dissenting); id. at 37-39; (Wilbur, J., dissenting); id. at 41 (Chabot, J., dissenting).
\(^4\) Id. at 33-34 (Simpson, J., dissenting). Judge Simpson also found that a valid trust was not created under California law due to a defect in the conveyance. See id. at 34-35 (Simpson, J., dissenting); but see id. at 15 (Judge Ekman found a valid transfer).
\(^4\) See id. at 33-34 (Simpson J., dissenting). Judge Simpson reasoned that a written lease is necessary in gift-leaseback transactions to show the terms of the lease and to evaluate the grantor's control. See id. at 34 (Simpson, J., dissenting).
\(^4\) See id. at 37-38 (Wilbur, J., dissenting). Judge Wilbur also placed importance on the absence of a written lease. See id. at 36-37 (Wilbur, J., dissenting). A written lease was mandated, according to Judge Wilbur, due to business exigencies and to the California statute of frauds. Id. at 37 (Wilbur, J., dissenting).
Mr. Gross' independence was purely a matter of form and caused the requirement of an independent trustee to serve no purpose in reality.\(^{47}\)

Although discounted by the May majority and concurrence,\(^{48}\) it is submitted that trustee independence is a necessary precondition to the deductibility of gift-leaseback rental payments. Indeed, trustee independence was cited when gift-leasebacks first were sanctioned over three decades ago in *Skemp v. Commissioner*\(^{49}\) and *Brown v. Commissioner*.\(^{50}\) Moreover, an even earlier attempt

\(^{47}\) Id. at 41 (Chabot, J., dissenting). Judge Chabot noted that a majority of the court adhered to the requirement of an independent trustee, but found that Mr. Gross' actions did not satisfy the *Mathews* test. See id. (Chabot, J., dissenting). Like Judge Ekman, however, he did not commit himself to the requirement of an independent trustee in every case. See id. (Chabot, J., dissenting).

\(^{48}\) See id. at 15; id. at 31-32 (Goffe, J., concurring).

\(^{49}\) 168 F.2d 598, 599 (7th Cir. 1948); see text accompanying notes 60-62 infra.

\(^{50}\) 190 F.2d 926, 929 (3d Cir.), cert. denied, 340 U.S. 814 (1950); see notes 63 & 64 and accompanying text infra. Courts place great emphasis on trustee independence in determining whether to allow rental deductions in gift-leaseback transactions. See, e.g., *Brooke v. United States*, 468 F.2d 1155, 1157-58 (9th Cir. 1972); *White v. Fitzpatrick*, 193 F.2d 398, 402 n.2 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952); *Felix v. Commissioner*, 21 T.C. 794, 804 (1954). This element has been described as a material fact, see *Engel v. United States*, 400 F. Supp. 5, 6 (W.D. Pa. 1975), and a pivotal issue, see *Brooke v. United States*, 468 F.2d 1155, 1157 (9th Cir. 1972).

Independence has not been considered a major factor in those jurisdictions which effectively have disallowed all gift-leaseback rental deductions by requiring a business purpose for the entire transaction. In *Perry v. United States*, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976), the court stated that independence was not a crucial factor. Id. at 238. Rather, the obligation to pay rent was not viewed as required under a single transaction with a real business purpose. See id. The business purpose requirement is derived from the language of section 162(a)(3), which states that rent must be paid for purposes of the taxpayer's trade or business. See *Quinlivan v. Commissioner*, 599 F.2d 269, 272 (8th Cir.), cert. denied, 444 U.S. 996 (1979); I.R.C. § 162(a)(3). For the entire transaction to have "economic reality" in the Fourth and Fifth Circuits, a business purpose is required for the gift portion as well as the leaseback. See *Perry v. United States*, 520 F.2d 235, 238-39 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976); *Van Zandt v. Commissioner*, 341 F.2d 440, 443-44 (5th Cir.), cert. denied, 382 U.S. 814 (1965). Nonetheless, given that a tax recognized gift must "[proceed] from a 'detached and disinterested generosity,'" *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Commissioner v. Lo Bue*, 351 U.S. 243, 246 (1956)), and that it is difficult to establish a business purpose for a gift, it is submitted that the requirement of a business purpose for the entire transaction reflects a policy decision to disallow rental deductions in the gift-leaseback context. In *Perry v. United States*, 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976), however, the court indicated that a business purpose might be established when a grantor transfers more property to the trust than he leases back. See id. at 238. Thus, the transfer of responsibility for management and administration of property which is not leased back may be considered a valid business purpose for the entire transaction. See id.; Note, *Gifts and Leasebacks: Is Judicial Consensus Impossible?*, 49 U. Cin. L. Rev. 379, 391 (1980).
in *Johnson v. Commissioner*\(^5\) to employ the gift-leaseback device to create rental deductions failed in large measure because of the absence of trustee independence.\(^5\) The gift-leaseback disallowed in *Johnson* involved an arrangement wherein *X*, the grantor, borrowed money from a bank and made a gift of the money to an irrevocable and nonreversionary family trust.\(^5\) The trust agreement provided that *X* could at any time borrow "the whole or any part of the principal of the trust estate."\(^5\) Exercising this provision, *X* borrowed the entire amount of money he had initially put into the trust and returned the reacquired funds to the original lending bank.\(^5\) *X* paid interest to the family trust and attempted to deduct the interest payments from his gross income.\(^5\) The Second Circuit prohibited the deduction, reasoning that *X* retained control over the funds and that the trustee was not "free from a duty to return" the trust corpus to *X*.\(^5\) Notably, these two interrelated factors, the absence of grantor control and the presence of trustee independence, were extant in *Skemp* and *Brown*.\(^5\) Not coincidentally, the *Skemp* and *Brown* gift-leaseback deductions were upheld.\(^5\) In *Skemp*, *Y*, the grantor, donated his medical office building to an irrevocable family trust, leaving the remainder to his children after twenty years, and immediately leased back the property.\(^5\) *Y* sought to deduct his rental payments to the trust.\(^5\) The Seventh Circuit permitted the deduction, reasoning that since

\(^{51}\) 86 F.2d 710 (2d Cir. 1936).

\(^{52}\) See id. at 712. The *Johnson* court reasoned that because *X*, the grantor, never relinquished control over the donated property, the gift portion of the transaction was invalid. Thus, any payments for use of the donated money were gratuitous and not required interest payments. See id. at 713.

\(^{53}\) Id. at 711.

\(^{54}\) Id.

\(^{55}\) Id. at 712.

\(^{56}\) Id.

\(^{57}\) Id. at 712-13. Because the gift portion was deemed invalid, the *Johnson* court reasoned that the note was given without consideration. See id. at 713. Thus, the interest payments were not considered required and could not be deducted. See id.

\(^{58}\) See *Brown v. Commissioner*, 180 F.2d 926, 929 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *Skemp v. Commissioner*, 168 F.2d 598, 599-600 (7th Cir. 1948). The terms "grantor control" and "absence of independent trustee" are frequently used interchangeably. The Tax Court has stated that the requirement of a relinquishment of control by the grantor is often met through appointment of an independent trustee. See *Mathews v. Commissioner*, 61 T.C. 12, 18 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975), *cert. denied*, 424 U.S. 967 (1976).

\(^{59}\) *Brown v. Commissioner*, 180 F.2d 926, 929 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950); *Skemp v. Commissioner*, 168 F.2d 598, 599-600 (7th Cir. 1948).

\(^{60}\) *Skemp v. Commissioner*, 168 F.2d 598, 599 (7th Cir. 1948).

\(^{61}\) Id.
Y could use the trust corpus “only upon payment of rent, the amount of which was to be fixed by the trustee,” Y was not in control of the trust corpus and the trustee was, in effect, independent.\textsuperscript{62} Similarly, in \textit{Brown}, Z, the grantor, conveyed land to an irrevocable and nonreversionary trust with the “understanding” that a lease back to Z would be executed.\textsuperscript{63} Echoing the Seventh Circuit’s reasoning in \textit{Skemp}, the Third Circuit permitted Z to deduct reasonable business-related rental payments made to the trust, citing the existence of a “new independent owner, the trustee.”\textsuperscript{64}

Interestingly, while the \textit{May} concurrence stated that the absence of a reversionary interest in the grantor could supplant the need for trustee independence,\textsuperscript{65} neither the \textit{Johnson}, \textit{Skemp}, nor \textit{Brown} courts attached particular significance to whether a reversion to the grantor was part of the trust agreement.\textsuperscript{66} Although all

\textsuperscript{62} See id. at 599-600. The court stated that unless a fiduciary violation was to be imputed to the trustee, he could not allow Y to use the premises except on payment of rent. The payments therefore were not gratuitous as in \textit{Johnson}. See id. at 599; note 52 supra.
\textsuperscript{64} See id. at 929. The court noted that the trustee’s requirement of rental and royalty payments regardless of the success of the taxpayers’ operations was an indication of the trustee’s independence. \textit{See id.}
\textsuperscript{65} 76 T.C. 7, 30 (1981) (Goffe, J., concurring). Notably, in \textit{Penn v. Commissioner}, 51 T.C. 144 (1968), the court stated in dictum that had the taxpayer transferred his reversionary interest, a rental deduction would still be denied because he retained excessive control. \textit{Id.} at 154. Similarly, in \textit{White v. Fitzpatrick}, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952), no reversionary interest in the property was retained by the donor but there was no independent trustee and the deduction was denied, partially because there was no change in control over the property. \textit{See id. at 402. But see Hall v. United States}, 208 F. Supp. 584, 588 (N.D.N.Y. 1962) (reliance on lack of independence of trust company and grantor’s reversionary interest to deny a deduction). This seems to be at variance with Judge Goffe’s statement that sufficient control is relinquished by transferring a reversionary interest. \textit{See May v. Commissioner}, 76 T.C. at 30 (Goffe, J., concurring).
\textsuperscript{66} In \textit{Skemp}, the court noted that the trust wholly divested the grantor of any interest in the property and that there was thus a real change in his economic status. \textit{Skemp v. Commissioner}, 168 F.2d 598, 600 (7th Cir. 1948). Greater emphasis, however, was placed on the existence of a trustee who would require the payment of rent. \textit{See id.} at 599-600. In \textit{Brown}, the fact that the grantor had no reversionary interest in the property was not discussed by the court. Rather, the court emphasized that “[w]hat is controlling is that there came into the picture a new independent owner, the trustee.” \textit{Brown v. Commissioner}, 180 F.2d 926, 929 (3d Cir.), cert. denied, 340 U.S. 814 (1950). In \textit{Johnson}, the trust technically was nonreversionary to the grantor. \textit{See Johnson v. Commissioner}, 86 F.2d 710, 712 (2d Cir. 1936). Nonetheless, the \textit{Johnson} court clearly disregarded the absence of a reversionary interest and disallowed the gift-leaseback on the basis of trustee dependence. \textit{See id.} Indeed, had the grantor in \textit{Johnson} not retained control over the trust corpus and had the trustee of the trust been independent, it appears that the \textit{Johnson} court would have approved of the
three gift-leasebacks were nonreversionary, the courts in all three cases stressed the presence or absence of trustee independence, not of a reversionary interest in the grantor. Indeed, considerations other than trustee independence were cited by the Johnson,

patently obvious tax avoidance scheme, for the court stated that:

If such were indeed the legal relations of the parties, it would follow as of course that the taxpayer should be allowed the claimed deduction, for it is too well settled to require discussion that legal transactions cannot be upset merely because the parties have entered into them for the purpose of minimizing or avoiding taxes which might otherwise accrue.

_id._ (citing Gregory _v._ Helvering, 293 U.S. 465, 469 (1935)).

68 The presence or absence of a reversionary interest does affect the viability of the gift-leaseback tax avoidance shelter since gift-leaseback trusts of 10 years or less duration will result in taxation of the trust income to the grantor under the Clifford provisions of the Code. I.R.C. §§ 671-678; note 3 _supra_. Because all of the grantor's rental deductions would then become his taxable trust income, his gross income would remain unchanged. Therefore, upon distilling gift-leasebacks into four categories, it is evident that only one category contains an effective tax avoidance vehicle. Using trustee independence and grantor reversion as intersecting axes, the four resultant gift-leaseback species are:

1. dependent trustee, reversionary in ten years or less;
2. dependent trustee, reversionary after ten years or nonreversionary;
3. independent trustee, reversionary in ten years or less;
4. independent trustee, reversionary after ten years or nonreversionary.

The first class of gift-leasebacks is an ineffective tax avoidance device due both to the Johnson-Skemp-Brown trustee independence rule and the Clifford provisions of the Code. See I.R.C. §§ 671-678; note 66 _supra_. The second class is ineffective due to the trustee independence rule. The Johnson gift-leaseback was within this category. See notes 51-57 _supra_. The third class of gift-leasebacks is ineffective pursuant to the Clifford provisions of the Code. See I.R.C. §§ 671-678. Only the fourth class of gift-leasebacks is effective for tax avoidance purposes. The gift-leasebacks upheld in Skemp and Brown were within this category. See notes 59-64 _supra_. Nevertheless, Judge Goffe questioned the necessity for trustee independence here. May _v._ Commissioner, 76 T.C. 7, 30 (1981) (Goffe, J., concurring). Clearly, such uncertainty is unfounded in light of the oft-cited Johnson, Skemp, and Brown decisions, all of which relied heavily upon the presence or absence of trustee independence. See note 66 _supra._
Skemp, and Brown courts. Nonetheless, such considerations clearly were subsidiary. It is submitted that these early gift-leaseback decisions held trustee independence to be a necessary, if not sufficient, ingredient in gift-leaseback transactions.

The propriety of dictating trustee independence becomes apparent when one considers that a principal factor in ascertaining the validity of any tax-avoidance scheme is whether the transaction has substance. Surely, gift-leasebacks are not exempt from this requirement, and given that gift-leaseback tax shelters could not exist but for the fact that the tax law, in this instance, is subservient to the legal niceties of the trust law, it is fitting that grantors should be prohibited from eschewing such legal niceties when it suits their needs. In this vein, it is urged that trustee independence is a necessary element of substantive gift-leaseback arrangements. Indeed, an independent trustee cannot be influenced to

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69 In Johnson, the interest payments to the trust were used by the trustee to pay life insurance premiums. Thus, the device was cited as an attempt by the taxpayer to create a rental deduction for what was in reality a nondeductible expense. See Johnson v. Commissioner, 86 F.2d 710, 711 (2d Cir. 1936). In Skemp, the court characterized the Johnson device as a "formal sham," Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948), and distinguished it from the Skemp transaction which the court found "involved substance," see id. at 600. See also Fabreka Prods. Co. v. Commissioner, 294 F.2d 876, 878 (1st Cir. 1961) (citing Johnson v. Commissioner for the proposition that sham transactions cannot create tax benefits); Lynch v. Commissioner, 273 F.2d 867, 872 (2d Cir. 1959) (noting that the Johnson court "looked at the end result rather than at an intermediate stage having no practical significance"). Relying principally on the Seventh Circuit's decision in Skemp, the Brown court looked to the express language of section 162(a)(3) as well as to the fact that the trusts were created in good faith and upheld the deduction. See Brown v. Commissioner, 180 F.2d 926, 929-30 (3d Cir.), cert. denied, 340 U.S. 814 (1950).

70 See note 66 supra.

71 See Mathews v. Commissioner, 520 F.2d 323, 325 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976) (courts must examine taxable transactions "with substance rather than form in mind"); Kirschenmann v. Westover, 225 F.2d 69, 71 (9th Cir.), cert. denied, 350 U.S. 834 (1955) ("[t]ax consequences are determined not from the formal aspect of a transaction, but from the actual substance of a piece of business"); Furman v. Commissioner, 45 T.C. 360, 366 (1966), aff'd per curiam, 381 F.2d 22 (5th Cir. 1967).

72 See Mathews v. Commissioner, 520 F.2d 323, 325 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976); Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948).

73 See Helvering v. Clifford, 309 U.S. 331 (1940), wherein the Court commented that "[t]echnical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct... should not obscure the basic issue" of whether, for tax purposes, the grantor is the owner of property. Id. at 334.

74 Of course, all of the circumstances surrounding a transaction must be examined to determine whether a transaction has substance. See Helvering v. Clifford, 309 U.S. 331, 336 (1940). Nonetheless, it is submitted that when the grantor retains possession as lessee and control as trustee, there is no substance to the transfer for purposes of a rental deduction, regardless of whether a reversionary interest is retained. This is because the combination of
take actions against the best interests of a trust, such as installing fixtures, maintaining the curtilage, and excusing a grantor from lease obligations. Trustee independence also comports with the Restatement of Trusts, which states that trustees who lease property to themselves have breached a fiduciary duty owed to trust beneficiaries. Clearly, if such fiduciary responsibilities could be breached freely, the substance of the gift-leaseback would be diminished.

The question has arisen whether trustee independence is necessary to imbue a gift-leaseback with substance, or whether some less exacting standard might suffice. The concurring opinion in May, for instance, contended that the Mathews disqualifying equity standard did not presuppose trustee independence in all in-

the rights of a lessee and the powers of a trustee add up to virtually the same rights and powers as those of a true owner. A lessee has a right to possession and use of property. See R. Powell, The Law of Real Property § 225, at 97-101 (Rohan ed. 1968). Conversely, a trustee may not use trust property for his own profit or benefit. See G.G. Bogert & G.T. Bogert, The Law of Trusts and Trustees § 543, at 200 (2d ed. 1978). Thus, as lessee, the grantor retains the right to beneficial use of the property. What he has transferred to the trust is title, so he can no longer dispose of the property. The trustee, however, is often given this power in the trust instrument. See, e.g., Helvering v. Clifford, 309 U.S. 331, 332-33 (1940). Thus, as both lessee and trustee, the grantor has the right to use the property and to dispose of it, the same powers which he had before making the gift. Indeed, the only thing the grantor has given up is the right to make a gift of the property. In Clifford, however, the Court noted that the inability to make a gift of the property and to make loans to himself "[seemed] to be insignificant and immaterial, since control over investment remained." Id. at 335.

It is submitted that by transferring the reversion under these circumstances, the only property interest transferred is a future interest. Until this interest becomes possessory, or unless an independent trustee is appointed, there is no substantial change during the period in which deductions are claimed. Thus, it is suggested that where the grantor can act as owner for all other purposes, he should also be treated as owner for tax purposes.

When a grantor acts as both trustee and lessee, he has the power to deal with the trust property in order to protect his leasehold interest. Because there is no arm's-length negotiation, the grantor has absolute control over the lease terms. While rent must be reasonable to meet the statutory requirements for deductibility, I.R.C. § 162(a)(3), there is no such control over other lease terms. Indeed, the possibilities for the exercise of grantor control are numerous. First, by granting himself an option to renew, the grantor can ensure that the property will be available for as long as he desires. Second, a dependent trustee may excuse an influential grantor/lessee from rent or other lease obligations if his business is failing. See Brown v. Commissioner, 180 F.2d 926, 929 (3d Cir.), cert. denied, 340 U.S. 814 (1950). Third, if an opportunity to sell the property arises, the grantor may decide not to sell in order to retain his possession and control of the property, despite the fact that it may be beneficial to the trust to sell it. Fourth, the grantor may want to benefit his possessory interest by improving the property or buying equipment for use in his business at the trust's expense. Cf. Lerner v. Commissioner, 71 T.C. 290, 295 (1978) (independent trustee refused to buy equipment which was too expensive for trust fund).

See Restatement (Second) of Trusts § 170, Comment l (1959).
Nevertheless, it is urged that the May concurrence un-
justifiably obscured the fact that trustee independence is essential
to the deductibility of gift-leaseback rental payments by sub-
suming this requirement within the Mathews disqualifying equity
stated that if there is a change in the grantor's control over the property, the grantor will
not retain a disqualifying equity and the transfer will have substance. The rationale is that
if the grantor relinquishes “eventual ownership,” that constitutes a sufficient change in con-
trol, even without an independent trustee. See id. (Goffe, J., concurring).} Indeed, it is suggested that if an absence of trustee inde-
pendence is not alone sufficient to constitute a disqualifying equity, then the disqualifying equity standard itself is insufficient to lend
substance to gift-leaseback transactions. Admittedly, the disquali-
fying equity standard is derived from a section of the Code which
is employed in determining the validity of rental deductions, a sec-
tion which mentions neither trustee independence nor grantor con-
trol.\footnote{Id. at 28 (Goffe, J., concurring). Judge Goffe stated:
[the] first prong of the Mathews test [grantor control] should not be considered as
an independent test, but rather as a factor to be considered under the fourth
prong of the Mathews test, i.e., whether the grantor has a disqualifying equity in
the rented property within the meaning of section 162(a)(3).} Nonetheless, this Code provision was enacted long before
gift-leasebacks first were sanctioned by the courts.\footnote{See Int. Rev. Code of 1939, ch. 2, § 23(a)(1), 53 Stat. 12 (now I.R.C. § 162(a)(3)).} Surely, there-
fore, the prerequisites of tax effective gift-leasebacks set forth in
the seminal Skemp and Brown decisions should be accorded more
weight than a test contained within an antecedent provision of the
Code, especially since these courts were aware of the possibility
that, without adequate safeguards, gift-leaseback arrangements
could be mere “shams.”\footnote{See, e.g., Skemp v. Commissioner, 168 F.2d 598, 600 (7th Cir. 1948); note 69 supra.} It appears appropriate, therefore, that
the trustee independence precondition espoused by the Skemp and
Brown courts should control.\footnote{See notes 60-64 and accompanying text supra.} Otherwise, if a grantor with no dis-
qualifying equity were permitted to be a lessee and trustee of the
gift-leaseback corpus, he would be motivated and able to enhance
this present possessory interest to the detriment of the trust.\footnote{Judge Goffe reasoned that as trustee and remainderman, a grantor would have more
motivation and ability to deal with trust property to benefit his remainder interest. See 76
T.C. 7, 30 n.6 (1981) (Goffe, J., concurring). It is submitted, however, that the danger of a
trustee acting in his own interest is equally significant when the trustee has a possessory
interest. See note 75 supra.}
deed, as earlier noted, it appears that only trustee independence can check such inclinations.¹⁴

CONCLUSION

It has been demonstrated that disparagement of the trustee independence requirement in the gift-leaseback context, evinced by the majority and concurring opinions in May,⁶⁶ is unfounded. Notably, since gift-leasebacks first were sanctioned by the courts, not by Congress, and because Congress has not codified its opinion respecting such arrangements, the judiciary has been left to its own devices in determining when rental payments properly may be deducted. In an attempt to lend consistency to this area of the tax law, at least one commentator has suggested that the Clifford provisions of the Code should be used to test the deductibility of gift-leaseback rental payments.⁸⁸ This solution would require legislation, however, since present Treasury regulations indicate that sections 671 through 678 of the Code are not applicable to deductibility.⁸⁷ Whether the Clifford provisions are employed or whether a new statutory scheme is devised, it is hoped that Congress will act quickly to provide guidance for tax planners.

Nancy Scappaticci