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Thomas: Leasebacks

Leasebacks in Commercial and Family Transactions

by J. Miles Thomas, Jr.*

INTRODUCTION

A leaseback may afford a client many tax and commercial advantages, if the transaction is undertaken with a thorough understanding of the necessary requirements. However, when improperly used, a leaseback may result in expensive and embarrassing income tax deficiencies. The purpose of this article is to outline the general rules by which a taxpayer can take advantage of a leaseback transaction for income tax purposes.

LEASEBACKS

A "leaseback" for purposes of this article includes the following:

- (1) A transfer of property used in a trade or business, by sale or gift, followed by a lease of the same property from the transferee to the transferor;
- (2) A lessor acquiring property from a third person using a cash gift or a trade in of property given by the donor-lessee to the donee-lessor; or
- (3) A lessor acquiring specific property under an installment purchase contract from a third person for use in the lessee's trade or business, with the rental used to satisfy the purchase obligation.

The second and third methods above outlined are generally used in acquiring new or used replacement property to be used in the business of the lessee.

ADVANTAGES OF LEASEBACKS

A valid leaseback transaction may involve one or more of the following advantages to the seller-lessee:

- (1) An improved balance sheet;
- (2) Rental expense is deductible in full, whereas depreciation is a piecemeal recovery of a portion of the asset;
- (3) Depreciated business property or business property with a low book value with respect to its current fair market value can be sold at long term capital gain rates; and
- (4) Splitting of income between related taxpayers.

An improved balance sheet results from the increased cash position of the taxpayer, and from the substitution of the balance of the contract receivable (assuming an installment sale to the purchaser-lessor) for the

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undepreciated balance of the asset which is sold. Also, any mortgage indebtedness against the property is removed from the financial statement.

The full rental on property used entirely in the taxpayer's trade or business is currently deductible when paid or accrued.¹ Ownership of an asset, on the other hand, requires a periodic partial cost recovery by depreciation.² Depreciation does not allow full cost recovery because of salvage value and the inability to depreciate land cost.³ Furthermore, depreciation may involve the consequences of "recapture" when the depreciable asset is sold or disposed of in a taxable exchange.⁴ One consequence of recapture is that it changes a capital gain to ordinary income.

A third possible advantage to the seller-lessee is the realization of the current value of the subject of the leaseback transaction. It is not uncommon in this era that the true value of an asset is in excess of the asset's original cost as adjusted for federal income tax purposes. This is particularly true of real property and improvements which have been owned and used by the taxpayer over a considerable period of time. Assuming that a depreciation recapture problem does not exist which will turn a hoped-for tax advantage into a tax trap, substantially depreciated business assets can be sold with the resulting gain taxed at long term capital gains rates.⁵

The practitioner is cautioned to thoroughly examine the consequences of a sale of depreciable property before advising a client to enter into a sale-leaseback transaction, especially with respect to the provisions on recapture and recognition of gain on a sale of depreciable property between certain related taxpayers.⁶

Leasebacks may also provide a method for splitting income between family members, particularly children, at substantial tax savings. Generally, there would be little savings of federal income taxes in a leaseback between husband and wife because of the desirability of filing a joint federal income tax return. However, a Montana income tax advantage could be obtained in a husband-wife leaseback transaction, because there is no advantage in filing a joint Montana income tax return where both spouses have income in excess of deductions and exemptions during the taxable year.⁷ Leasebacks between parent and children, on the other hand, would result in a savings of both federal and state in-

¹INTERNAL REVENUE CODE OF 1954, § 162(a)(3). (Hereinafter INTERNAL REVENUE CODE OF 1954 will be cited as I.R.C.).

²I.R.C. 1954, § 167; Reg. § 1.167(a)-1(a).

³4 MERTENS, FEDERAL INCOME TAXATION §§ 23.12, 23.50 (rev. ed. 1966).

⁴I.R.C. 1954, §§ 1245, 1250.

⁵I.R.C. 1954, § 1231.

⁶I.R.C. 1954, § 1239.

⁷REVISED CODES OF MONTANA, 1947, § 84-4902, establishing the rate of income tax does not contain any provision similar to the language of I.R.C. 1954, § 2(a), providing: "In the case of a joint return of a husband and wife . . . the tax imposed by section 1 shall be twice the tax which would be imposed if the taxable income were cut in half."

come taxes, because the children would file their return separately from the parents and usually would have less income subject to tax.

Some advantages of a leaseback transaction which may be available to the lessor are:

- (1) Use of accelerated depreciation;
- (2) Use of the investment credit; and
- (3) Deduction of taxes, interest, or insurance charged against the property.

In the absence of the enactment of a proposed Congressional amendment to Section 167 of the Internal Revenue Code, the lessor of property acquired for leaseback purposes can take advantage of available accelerated depreciation methods. If the property is new, has not been used (whether or not for business purposes) by any other taxpayer, and has a useful life of three years or longer the Internal Revenue Code establishes a presumption of reasonableness where an accelerated method of depreciation is used.⁸ In the case of used assets, including assets not originally used in a trade or business, the taxpayer is allowed a deduction for "reasonable"⁹ depreciation of business or income producing property. The Internal Revenue Service¹⁰ has announced that depreciation by use of the declining balance method using a rate not exceeding 150% of the applicable straight line rate is permissible if its use results ". . . in a reasonable allowance for depreciation, and

- "(a) was elected by new taxable entitye in an initial return, or
- "(b) permission to use such method has been granted by the Commissioner, or
- "(c) it was elected in the first return filed in which depreciation was sustained, or
- "(d) for taxable years ending after December 31, 1953, it was elected in the return for the first year in which the property was subject to the allowance for depreciation regardless of the method of computing depreciation employed for other depreciable property."¹¹

The availability of the investment credit to the purchaser of property to be used in a leaseback transaction would depend upon the type of property involved,¹² its useful life,¹³ and the relationship between the parties to the transaction.¹⁴

⁸I.R.C. 1954, § 167(b)(2) and (c).

⁹I.R.C. 1954, § 167(a).

¹⁰Rev. Rul. 57-352, 1957-2 CUM. BULL. 150; as amplified by Rev. Rul. 59-389, 1959-2 CUM. BULL. 89.

¹¹*Ibid.*

¹²I.R.C. 1954, § 48.

¹³I.R.C. 1954, § 48(a).

The lessor in a leaseback transaction is further entitled to claim the costs of taxes, insurance, interest on indebtedness against the leased property, and maintenance.¹⁵ Such deductions offset the gross rental in arriving at the lessor's adjusted gross income.¹⁶

TESTS FOR VALID LEASEBACK ARRANGEMENTS

The courts have indicated that the substance of a leaseback transaction will control over the form that is adopted.¹⁷ In determining the validity of a leaseback arrangement, four tests have been considered:

- (1) whether there is a business purpose connected with the transaction;
- (2) whether the property was transferred at its fair market value;
- (3) the reasonableness of the rental upon the leaseback property; and
- (4) the length of term of the lease and the effect of any options to renew.

Usually, no one of these tests is controlling.

In *Riverpoint Lace Works, Inc. v. Commissioner*,¹⁸ a rental deduction was disallowed where property was sold by a closely held corporation controlled by two brothers and their wives to another similar corporation with a concurrent leaseback of the property to the seller. The sale price of the property was not commensurate with the fair market value of the property, and there was no bona fide purpose in the transaction. The court said:

Obviously the petitioner would be entitled to deduct rent under Section (now 165) if it had sold its property in an arms-length transaction to a buyer having adverse interests and then had leased property back at a fair rental. The same might have been true had it sold to J & G at a price commensurate with the fair market value of the property and then had entered into a lease made up of provisions which adverse parties dealing at arm's-length might have agreed to, including a reasonable rental, and particularly if the sale and leaseback had been made by the petitioner for some good business reason.

This decision required the taxpayer to meet three of the tests of a valid leaseback arrangement; namely, fair market value of the property sold, reasonableness of the rental, and a valid business purpose.

In *W. H. Armstrong Co., Inc. v. Commissioner*,¹⁹ the taxpayer corporation was engaged in the construction business. The stock of the corporation was owned principally by W. H. Armstrong and his wife. During the early part of World War II, the taxpayer purchased heavy con-

¹⁵I.R.C. 1954, §§ 162(a), 163(a).

¹⁶I.R.C. 1954, § 62(5).

¹⁷*Van Zandt v. Comm'r.*, 40 T.C. 824 (1963).

¹⁸13 CCH Tax Ct. Mem. 463, 466 (1954).

¹⁹138 F.2d 551 (3d Cir. 1951).

struction equipment which it sold to Mrs. Armstrong for \$30,000.00. The equipment was then leased back to the corporation, and during the first year of the lease, over \$70,000.00 was paid in rentals. The court found that the sale was not made for the fair market value of the equipment, that there was no legitimate business purpose accomplished by the transaction because the corporation's right to use the equipment was not altered in any way, and that the rentals were unreasonable.

An earlier case involving a sale and leaseback arose over a claimed loss on the part of the seller. In *May Department Stores Co. v. Commissioner*,²⁰ the taxpayer was a successor to Kaufmann Department Stores, Inc. In 1936, Kaufmann had constructed a parking garage in downtown Pittsburgh located across the street from his store. The property was leased out until 1941. Between 1941 and 1943, it was operated by Kaufmann at a loss. In 1943, the garage was sold to a group associated with the law firm representing the taxpayer, and concurrently leased by the purchaser to the seller. The sale resulted in a claimed loss of approximately \$2,000,000.00, which was disallowed by the Commissioner. The tax court sustained the loss upon a finding that the title to the property had been validly transferred to the purchasers for its fair market value; that the purchasers were not subject to the dominion or control of the taxpayer, and that the rental agreement, containing no renewal rights, was reasonable.

The *May Department Stores Co.* case also illustrates the importance of establishing the fair market value of the property which is to be the subject of the leaseback transaction. Naturally, if the sale is to be made to a disinterested third party investor, the establishment of the fair market value of the property should be simply a matter of arm's-length negotiation. However, if the sale is to be made to a related party, or to one who is under the control of the seller, it will be necessary to exercise great caution in establishing the fair market value of the property. This is particularly true if the transaction will involve an employer's pension or profit sharing trust because of the risk of the drastic consequences to the qualification of the plan resulting from a prohibited transaction.²¹ The practitioner would be well advised to seek independent appraisal of any property which is the subject of a leaseback transaction to establish its fair market value unless the sale is to a disinterested third party.

In *Century Electric Co. vs. Commissioner*, a loss on a sale of a foundry building with a leaseback of the property to the seller was disallowed.²² The seller sold the property to an exempt college for \$150,000.00 at which time it had an adjusted basis of \$530,000.00. Concurrently the property was leased back to the seller for a term of 95 years, with the lessee having the right to terminate the lease at the end of 25 years, and at other intervals during the leased period. Because the taxpayer could

²⁰16 T.C. 547 (1951).

²¹I.R.C. 1954, § 503(c).

not establish the fair market value of the property at the time of the transfer, the claimed loss was disallowed.

In *Jordan Marsh Co. vs. Commissioner*,²³ the Court of Appeals for the Second Circuit distinguished the *Century Electric Company* case and found that the taxpayer sustained a loss upon the sale of the property at its fair market value. It is to be noted that both the *Jordan Marsh* and the *Century Electric Co.* cases principally involved an attack by the Commissioner on the transactions as tax free exchanges because of the long term leases.

The test of a reasonable rental becomes important when the tax commissioner attacks the transaction as a substitute device for distribution of corporate profits.²⁴ Such an attack may be defeated by seeking an independent appraisal of the rental value of the property. As illustrated by the *Armston* and *Shaffer* cases, the rental charged should not allow an unreasonable return based on the cost of the leased property to the lessor.

It is quite common in leaseback arrangements for the rentals to be on a net basis to the lessor. In other words, the lessee is generally required to pay a cash rental and also to furnish all repairs, maintenance and insurance upon the property. In some leases, the lessee will also be directly responsible for the payment of property taxes upon the leased premises. An arrangement of this nature would not be struck down if the rent is found to be reasonable. Section 162 of the Internal Revenue Code does not impose a "reasonable" test upon rentals as is the case of compensation,²⁶ but the cases do look to the reasonableness of the rental when determining whether there is in fact a substitution for distribution of corporate profits.²⁷ The rent should be computed on a uniformly reasonable basis. If the rent dropped sharply after the early years of a lease, there is every likelihood that the court would consider the rental excessive for the first years. The excess would be treated as a non-deductible expense to be amortized over the remaining life of the lease, or in the alternative, if the lessor were a related party, as a distribution of corporate profits to the lessor.

Another form of lease may provide that the rent shall be a percentage of the lessor's income. In arriving at a percentage rental, the term of the lease should cover more than one or two years, especially if the parties to the leasing arrangement are related or there is a close association between them. There is more justification for a percentage rental in a long term lease because a percentage rental is based on a reasonable expectation of income. Because of the probability of income fluctuation, a long

²³269 F.2d 453 (2nd Cir. 1959).

²⁴*W. H. Armston Co., Inc.*, *supra* note 19.

²⁵194 F.2d 539 (9th Cir. 1952).

²⁶I.R.C. 1954, § 162(a), provides in part: "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 . . . (1) a reasonable allowance for salaries . . . (3) rentals or other payments . . ." (Emphasis added).

²⁷*W. H. Armston Co., Inc.*, *supra* note 19.

term lease will more likely be predicated upon cautious and realistic negotiation. With a shorter lease period, the parties may tend to vary the percentage from year to year, causing the transaction to appear as a device for distribution of corporate profits rather than an arm's-length rental agreement.

The client must be impressed with the importance of actually paying the rental in a leaseback transaction. Naturally, if a disinterested third party is to be the purchaser-lessor, the problem will probably not arise. However, in cases of related taxpayers, the rent must be paid or the court will be inclined to treat the transaction as a sham. In *Riverpoint Lace Works, Inc.*,²⁸ the rental quite frequently went unpaid for prolonged periods of time. The court was quick to grasp this as a reason for treating the transaction as a sham between the taxpayer and a corporation controlled by the taxpayer and his brother.

In *Southern Ford Tractor Corporation vs. Commissioner*²⁹ the taxpayer corporation sold its real property to a corporation controlled by the children of the taxpayers' stockholders. Concurrently, the purchaser executed a lease of the property back to the taxpayer providing for a minimum rental, plus an additional rental of 1½% of the net sales of the lessee in excess of the minimum rental. The lessor also acquired certain other properties which were leased to the taxpayer. The term of the lease was for ten years, with an option for an additional five year extension. The Tax Court allowed the transaction as a legitimate sale and leaseback. The court discussed the use of a percentage rental as follows:

As to the 'reasonableness' of the rent, our only evidence is that of the petitioners. The practice of fixing rentals for commercial properties on a percentage of sale basis instead of a flat rate basis is a recognized and accepted basis. Such an arrangement is particularly adaptable to a business which is prone to fluctuate more than usual. That the amount of rent rises and falls with the trend of the business and is greater in the year or years when business is best is an accepted characteristic of a percentage lease.' Stanley Imerman, *Supra*.³⁰

The *Southern Ford Tractor Corporation* case also discusses at great length the importance of a business purpose and establishing the fair market value of the property sold when dealing with related taxpayers.

The term of the lease is important to avoid an argument by the Internal Revenue Service that the taxpayer has either engaged in a tax-free exchange or has acquired a fee interest in the property. The regulations under Section 1031, dealing with tax-free exchanges, and preceding regulations under earlier Revenue Codes, provide that a leasehold interest with a duration of thirty years or more constitutes a fee interest.³¹

²⁸*Riverpoint Lace Works, Inc.*, *supra* note 18.

²⁹29 T.C. 833 (1958).

³⁰*Id.* at 843.

³¹Reg. § 1.1031(a)-1(c) provides: "No gain or loss is recognized if . . . (2) a taxpayer who is not a dealer in real estate . . . exchanges a leasehold of a fee with 30

In *Jordan Marsh Co. vs. Commissioner*³² the taxpayer had entered into a sale and leaseback arrangement involving a lease for a term of thirty years plus three days, with an option to renew for an additional thirty years if the lessee should erect new buildings on the property. The Court of Appeals for the Second Circuit found that there was in fact a sale intended, and as long as there was a sale, the transaction could not be classified as an exchange. The Internal Revenue Service has announced that it will not follow the *Jordan Marsh* decision.³³

In the case of *Century Electric Co. vs. Commissioner*,³⁴ the leaseback was for a period of ninety-five years. The term of the lease was instrumental in the court's determination that the transaction constituted an exchange and not a valid sale-leaseback. However, in *Century Electric Co.*, the Court did allow the taxpayer to amortize the claimed loss over the ninety-five year period of the lease.

Related to the duration of the lease is the effect of an option to renew a lease with an initial term of less than thirty years. It would appear from an examination of the earlier cases that where a lease term is for a reasonable period, and the lessee has an option to renew the same either at the same rental or at a rental to be agreed upon subject to arbitration by the parties, that the option period is not to be considered in determining whether or not the lease is for more than thirty years. Although in the *Jordan Marsh* case there were extensive options for renewal involved, this did not bother the court in holding that the transaction resulted in a sale between the parties.

In *City Investing Co. and Subsidiaries v. Commissioner*,³⁵ the court held that there was a valid sale and leaseback arrangement despite the presence of options for renewal possessed by the lessee. However, in dealing with options to renew the lease between related taxpayers, a lease should be silent on the question of renewals; or in the alternative, the initial term of the lease and any renewal period, when combined, should be less than thirty years in duration.

Whenever there is an option to repurchase the property, the court may be requested by the Commissioner to hold that the transaction is a sham or constitutes a mortgage. In *Leeds & Lippincott Company v. United States*³⁶ the taxpayer owned two hotels, and deeded a service building used in connection with the operations of the hotels to an insurance company, reserving an option to repurchase. The agreement provided that if the option to repurchase was exercised, the rentals would be applied to the purchase price. The transaction was held to constitute a mortgage.

If it can be avoided, it would be best not to have any provision with

³²*Jordan Marsh Co.*, *supra* note 23.

³³Rev. Rul. 60-43, 1960-1 CUM. BULL. 687.

³⁴*Century Electric Co.*, *supra* note 22.

³⁵38 T.C. 1 (1962).

respect to repurchase contained in a sale-leaseback transaction. Where necessary, the repurchase option should express a purchase price commensurate with the fair market value of the property, with no reduction thereof because of payments made as rent by the seller-lessee.

LEASEBACKS IN FAMILY TRANSACTIONS

The leaseback arrangement in private family transactions is subject to the closest scrutiny by the Internal Revenue Service. The key to a successful family leaseback arrangement is to divorce the interest and control of the transferor from that of the transferee.

The tests of business purpose, reasonableness of rental, and duration of the lease are equally applicable in the family leaseback transaction. However, the test of fair market value of the property is not often involved, because generally speaking, the lessor acquires the property in an arrangement involving a gift from the lessee.

A leading case on family leasebacks is *Skemp vs. Commissioner*.³⁷ In *Skemp*, the taxpayer, a Wisconsin physician, created a trust with an independent corporate trustee for a period of twenty years. The taxpayer's wife and children were the income beneficiaries. Upon termination of the trust, the property was to be distributed among the trustor's children. The taxpayer retained the right to rent all or a part of the building a a rental "to be determined by he Trustee." The trustee leased the property to the taxpayer for ten years. In ruling for the taxpayer, the Court of Appeals for the Seventh Circuit said:

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 * * * There can be no question but what rent required to be paid is properly deductible. The trustee was duty bound to exact rent of the taxpayer and the taxpayer was legally bound to pay it, just as much as if the taxpayer had moved across the street into the property of a third party. No one doubts that he would have had to pay rent then, and would have been entitled to deduct it even though he had voluntarily created the situation. We are not impressed with the argument of the Government that the taxpayer voluntarily created the present situation.³⁸

The *Skemp* case, decided in 1948, was followed in 1950 by the Third Circuit in *Helen Brown vs. Commissioner*.³⁹ The *Skemp* and *Brown* cases are the foundation upon which subsequent taxpayers have attempted to build valid family leaseback arrangements.

The important leaseback cases reaching opposite results were decided in 1965. In *Van Zandt et al, v. Commissioner*,⁴⁰ the taxpayer lost,

³⁷168 F.2d 598 (7th Cir. 1948).

³⁸*Id.* at 600.

³⁹180 F.2d 926 (3rd Cir.) cert. denied, 340 U.S. 814 (1950).

but in *Alden B. Oakes et al, v. Commissioner*,⁴¹ the taxpayer won. An analysis of these decisions indicates the importance of initial care by a taxpayer seeking the benefits of a leaseback transaction.

In *Van Zandt*, the taxpayer was a surgeon. On April 29, 1957, he and his wife created two Clifford type trusts with the taxpayer as trustee for the benefit of each of their children. Thereafter, on May 23, 1957, the taxpayer and his wife executed and delivered to the trustee a deed to the property wherein the taxpayer's office was located, together with a bill of sale for the office and professional equipment used by the taxpayer in his medical practice. The property was leased back to the taxpayer at a reasonable rental. The Internal Revenue Service asserted that the rent was not a "necessary" expense in relation to the taxpayer's medical practice. The tax court rejected the taxpayer's attempt to rely upon the *Skemp* and *Brown* decisions because there was no independent trustee. The court went on to say:

Moreover, it is well recognized that intrafamily transactions resulting in the distribution of income within a family unit are subject to the closest scrutiny. * * * Where, as here, the trust and leasebacks are steps in a prearranged transaction, we think it is necessary to examine the true nature of the transaction and aim our inquiry to seeing if the *net effect* has been a shift in family income. Clearly the effect of this transaction, while valid, was to cause a shift of family income and thus subvert the intended coverage of the statute. It would seem that the economic reality, rather than the validity of the documents creating the trusts, the transfer and the leases, must serve as the basis upon which the right to the deduction rests. To hold for the petitioner would be inconsistent with another line of decisions. Where a sale and leaseback does not serve a utilitarian business purpose, but is in reality a camouflaged assignment of income, the expenses have not been considered 'ordinary and necessary.' Since deductions are matters of legislative grace and the taxpayer has the burden of proving he is entitled to them, the petitioner here must establish that the rental payments were in fact 'ordinary and necessary' expenses in his medical practice. While they may be ordinary, were they necessary under these circumstances? We think not. The petitioner owned and used the building and medical equipment in his 'trade or business' before he ever created the trusts, transferred the property to the trusts, and then leased it back. Actually he continued to use the property in exactly the same manner as he had before these transactions were arranged and carried out. This indicates a lack of any business purpose, which we believe is implicitly required by section 162(a).⁴²

From the foregoing it is clear the court was concerned with the substance of the transaction rather than the form. It noted that the taxpayer, in substance, retained control of the property. Also, the taxpayer failed to show that there was a business purpose connected with the transaction.

In affirming the tax court's decision in *Van Zandt*, the Court of Appeals for the Fifth Circuit also noted there was no business purpose involved, saying:

As we should be careful lest our ruling circumscribe the flexibility which the law—even income tax law—accords to businessmen in de-

termining what is good business purpose, we emphasize the proposition that the result ultimately depends on the factual evaluation of the particular case. Here, factors such as the short term of the trust, reversion to the settlors, predetermination of the right to possession of the property and the like, while perfectly permissible so far as taxability of the trust and the settlors goes, bear heavily on the element of business purpose. In this light, and the significant differences we point out here, we regard our holding as consistent with *Skemp v. Commissioner*, 7th Cir., 1948, 168 F.2d 598, 48-1 USTC 9300.⁴³

In *Alden B. Oakes v. Commissioner*,⁴⁴ the tax court upheld the taxpayer's right to a rental deduction. The taxpayers, an Ohio doctor and his wife, owned property upon which was located the building in which the taxpayer conducted his medical practice. The taxpayers created a Clifford type trust with a bank as trustee for their four children. Subsequently, the trustee leased the building to the doctor for a term of 11 years at an annual rental of \$1,500.00. In addition, the lessee was to pay all utilities, insurance, taxes, repairs and maintenance. On April 28, 1959, the doctor conveyed his interest in the property to his wife, her heirs and assigns. The deed also specified that he was relinquishing any remainder interest in the property held in the Clifford trust. On May 5, 1959, the mother was appointed guardian of her children.

The tax court found that the amounts paid for rentals were reasonable and allowed a deduction of the expenses. The court said:

Again, as in *I. L. Van Vandt . . .* we have before us that narrow question of rental deductions, and not to whom trust income is taxable. Petitioners contend that the rental payments made to the trust during the years in issue fall squarely within the provisions of section 162(a)(3) and, therefore, are deductible as ordinary and necessary expenses paid in carrying on Alden Oakes' medical practice. They rely on such decisions as *Skemp v. Commissioner . . .* Respondent relying on the *Van Zandt* case argues that the rental payments made to the trust do not constitute ordinary and necessary business expenses for several reasons, namely: (1) The transfer of the real property to the trust merely resulted in a reallocation of income among the family members because Alden Oakes did not divest himself of control and ownership so as to warrant an allowance of the claimed rental deduction; (2) Alden Oakes retained the prohibited 'equity' in the property under section 162(a)(3); and (3) He initiated the whole transaction merely to reduce his taxes, thus serving no business purpose but only the creation of artificial rentals.

While the line of demarcation might be thin within the *Skemp*, *Brown* and *Felix* cases on one side and *Van Zandt* on the other, a difference nevertheless exists and we have recognized it. One of the pivotal factors is the actual independence of the trustee. Here, unlike *Van Zandt* where control over the trusts was always in the hands of the doctor as sole trustee, the control and ownership passed from petitioners to the Security Central National Bank, an independent trustee. Certainly this is strongly indicative of the bona fides of the transfer. Indeed, in other cases upholding the leaseback deduction, the 'independent' trustees have consisted of the donor's attorney, *Brown v. Commissioner*, supra, as well as his wife, father, and accountant, *John T. Potter*, supra. We think petitioners have brought themselves within the ambit of our decision in *Albert T. Felix*, supra, where we said (p. 804):

"In the instant proceeding, the petitioners, by their trust deed, irrevocably divested themselves of the property

⁴³*Van Zandt*, supra note 40, at 444.

transferred to the trust created for the benefit of their children. The trustee was a corporate trustee, and we find substantial evidence to justify the inference that the trustee did act independently and in the best interests of the beneficiaries of the trust. We think the respondent places undue emphasis upon the exculpatory provisions of the trust instrument. Such a provision is not uncommon where the trustee is not confined to legal investments but is given broad powers of investment in the administration of the trust. We hold that the trust was valid and is to be recognized as such. . . ."

Still another distinguishing factor in this case, which we have taken into consideration in weighing the bona fides of the transfer of the real property to the trust, is that Alden Oakes has relinquished, rather than retained, his reversionary interest.

We do not agree with respondent's second contention that Alden Oakes retained a prohibited "equity" in the property conveyed to the trust. Section 162(a)(3) provides that rentals are deductible only when paid for use of property "to which the taxpayer has not taken or is not taking title or in which he has no equity." In legal parlance one has an "equity" in property where he has a right to redemption, a reversionary interest, a right to specific performance, or in general any right respecting property which traditionally would have been enforceable by means of an equitable remedy. Oakes relinquished his reversionary (future) interest in the trust on April 28, 1959. Clearly he had no "equity" in the property after that date and during most of the time covered by the years in issue * * *.

Irrespective of what we said regarding business purpose in our Van Zandt opinion, we think that where, as here, a grantor gives business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary for us to inquire as to whether there was a business reason for making the gift. Admittedly, there were none. Under such circumstances, the test of business necessity should be made by viewing the situation as it exists after the gift is made. At that point, since Alden Oakes needed a building for practicing medicine, he agreed to rent the property from the trustee for a reasonable amount. Consequently, we believe there is a sound basis for holding that the rent paid by Oakes was in terms of section 162, both "ordinary and necessary" and "required to be made as a condition of continued use * * * of property."⁴⁵

The Government filed an appeal of the Oakes decision to the Court of Appeals for the Sixth Circuit, but later moved for dismissal of the appeal. It would seem that the Government's appeal would not have been meritorious in view of the *Skemp* and *Brown* decisions, because Dr. Oakes went the extra step and obtain the services of an independent trustee. In addition, he legally disclaimed any interest in the remainder of the property after expiration of the Clifford trust. Dr. Van Zandt, on the other hand, attempted a short cut by naming himself as trustee, and lost. It is submitted that the *Oakes* and *Van Zandt* decisions are excellent illustrations of the proper and improper methods of accomplishing a family leaseback transaction.

OTHER LEASEBACK EXAMPLES

It is well known that most of the major chain department stores for several years have been engaging in sale and leaseback transactions. A long term lease from a nationwide chain of stores is generally sufficient for a purchaser to obtain funds with which to acquire the prop-

erty which has been built to specifications of the seller-lessee. The net rental realized by the lessor is generally higher than he would realize from a mortgage earning income on the unpaid balance. Furthermore, an investor in such a leaseback transaction may have the advantage of appreciation of property values.

Another area in which leasebacks have some popularity is the use of a pension or profit sharing plan to purchase property which is then leased to the corporation creating the plan. Many advantages can be obtained from such an arrangement, and abuses of this practice led Congress to the adoption of Section 514 of the Internal Revenue Code of 1954. Section 514 covers the taxation of non-related business income and applies to both charitable organizations and pension and profit sharing trusts. The provisions of Section 514 should be thoroughly understood before a pension or profit sharing trust is allowed to acquire property for leaseback purposes.

CONCLUSION

It is hoped that this article will serve to remind the practitioner of the necessity for laying a proper foundation to support any leaseback arrangement. The tests of business purpose, fair market value, reasonableness of rental, and length of term of the lease should afford the working tools necessary to adequately weigh whether a proposed leaseback arrangement will withstand an attack by the Internal Revenue Service. A leaseback arrangement entered into after careful planning and preparation, and followed by a strict compliance with the terms of the leasing agreement, will afford the taxpayer the advantages he seeks.

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