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Recent Decisions

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INCOME TAX: THE FAMILY TRUST: *VAN ZANDT v. COMMISSIONER* (5th Cir., 1965)

Van Zandt v. Commissioner,[1] a recent decision handed down by the Fifth Circuit Court of Appeals, raises interesting questions as to the efficacy of the family trust and lease-back arrangement as a tax-saving device. In the *Van Zandt* case the circuit court upheld a tax court decision[2] which denied the petitioners the right to deduct from their gross income rental payments made by Dr. Van Zandt for the use of certain medical buildings and equipment. Dr. Van Zandt claimed the deductions as "ordinary and necessary expenses . . . in carrying on . . . business."[3] The deductions claimed by Van Zandt were for payments made to two irrevocable, ten year reversionary trusts and "contained the minimum requirements under the pertinent federal statutes which would prevent income of the trusts from being the income of the donors."[4]

Van Zandt created the trusts for the benefit of his children and named himself as trustee. Approximately one month after creation of the trusts Van Zandt transferred real and personal property owned and used by him in his medical practice to the trusts. On the same day the settlor, acting in his capacity as trustee, executed and delivered to himself "two documents, each styled lease . . . one covering the premises . . . the other covering certain . . . equipment."[5] Thereafter, Van Zandt paid the trust the sums of $4,800 in 1958, and $6,204.30 in 1959 for rent, repairs and insurance.

Had the Commissioner allowed the deductions, the advantage to Van Zandt is obvious. His gross income would be reduced by the amount paid to the trust for rent, repairs, and insurance, and the income would be shifted, by virtue of the trusts, to beneficiaries in a lower tax bracket. The Commissioner disallowed the claim on the

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[1] 341 F.2d 440 (5th Cir. 1965).

[2] I. L. Van Zandt, 40 T.C. 824 (1963).

[3] Int. Rev. Code of 1954, § 162(a). The text of the applicable section of the code is as follows: "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."

[4] 341 F.2d 440, 441 (5th Cir. 1965). See Int. Rev. Code of 1954 §§ 671-78.

[5] 40 T.C. at 828.

basis that "he continued to use the property in exactly the same manner as he had before these transactions were arranged . . . this indicates *lack of any business purpose* . . ."[6] as is implicitly required by section 162(a) of the Internal Revenue Code of 1954. Dr. Van Zandt contended his claim fell within the provisions of Internal Revenue Code Sec. 162(a)(3).[7] To support this contention Van Zandt relied on a line of cases beginning with *Skemp v. Commissioner*[8] which have upheld as deductible similar rental payments in connection with trust and lease-back arrangements. An analysis of these and other cases may be helpful in evaluating the decision handed down by the circuit court.

SKEMP CASE

In *Skemp* a practicing physician transferred a two-story brick building, in which he was one of the tenants, to an irrevocable trust created for the benefit of his wife and children.[9] Unlike the Van Zandt trust where the settlor effectively retained some control over the property by naming himself as trustee,[10] the Skemp trust instrument named the La Crosse Trust Company as sole trustee.[11] Skemp retained no control over the trust except that he could rent "all or any part of the real estate in this trust at a rental to be determined by the trustee."[12]

In disallowing the rental deduction the Tax Court held that Skemp did not part with a present interest in the property upon execution of the trust and lease instruments.[13] Relying on *Johnson v. Commissioner*[14] the court held that the rental payments were gratuitous.

In *Johnson* the taxpayer borrowed $400,000 from a bank and gave his wife a check for the same amount. The wife deposited the check in her account and then transferred these funds in trust to an independent trustee. One of the provisions in the trust instrument required the trustee to loan money to her husband upon application by him for such loan. Five days after creation of the trust the

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[6] *Id.* at 831. (Emphasis added.)

[7] *Supra* note 3.

[8] 168 F.2d 598 (7th Cir. 1948), *reversing* 8 T.C. 415 (1947); Brown v. Commissioner, 180 F.2d 926 (3d Cir. 1950), *reversing* 12 T.C. 1095 (1949); A. T. Felix, 21 T.C. 803 (1954).

[9] A. A. Skemp, 8 T.C. 415 (1947).

[10] 40 T.C. at 825.

[11] 8 T.C. at 416.

[12] *Id.* at 418.

[13] *Id.* at 420.

[14] 86 F.2d 710 (2d Cir. 1936).

husband borrowed the $400,000 from the trust at 6% interest. The court held for the Commissioner and disallowed his claim for a deduction of $24,000 for interest payments, indicating that "the question is always whether the transaction under scrutiny is in reality what it appears to be in form."[15]

In the *Johnson* case Mr. Johnson never lost control of his gift. Everything he did was a part of the same transaction. Both the settlor (his wife) and the trustee were under a duty to return his gift upon his application for a loan.[16] In *Skemp* the Tax Court found the amount of rent to be paid into the trust by Dr. Skemp was in reality established by Skemp and not the trustee. The court further held that, had he chosen to do so, Dr. Skemp could have reserved a lease with no rent payable. As a result, the rent payments were held to be gratuities and, like the interest charges in Johnson, were disallowed.[17]

On appeal the seventh circuit court found that the facts in *Johnson* were clearly distinguishable from those in *Skemp*, and the decision of the Tax Court was reversed.[18] In upholding the deduction for rent the court found that the trust and lease-back arrangement was a transaction "of substance" whereas the Johnson transaction was a "formal sham."[19] The court pointed out that under the trust arrangement the settlor was legally obligated to pay the monthly rental sums to the trust and, therefore, the payments were not gratuities.[20]

HALL CASE

In *Hall v. United States*[21] petitioners transferred medical buildings owned by them to an independent trustee for the benefit of their children. The trust was irrevocable for a ten-year period and thereafter revocable. The instrument also provided that the grantors might modify or amend the agreement after the ten-year period had elapsed. It provided, further, that the grantors had the power, during the minority of the beneficiaries to approve and settle the accounts of the trustee.

Petitioners relied on *Skemp* and *Brown v. Commissioner*[22] but

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15 *Id.* at 712.
16 *Id.* at 712-13.
17 8 T.C. at 421.
18 Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948).
19 *Id.* at 600.
20 *Id.* at 599.
21 208 F. Supp. 584 (1962).
22 180 F.2d 926 (3d Cir. 1950), *reversing* 12 T.C. 1095 (1949). The third circuit court held rents and royalties paid to two irrevocable trusts created for the benefit

after admitting the similarity, the court distinguished the cases on the basis that in *Skemp* and *Brown* "the corpus of the trust estate became the property of beneficiaries upon the termination of the trust,"[23] and that the trustee was not in reality an independent trustee, since "it can hardly be said that a trustee is wholly independent or has full freedom of action when the grantors had their reversionary interest and also the right to settle its accounts."[24]

In effect, *Hall* was distinguished from *Skemp* and *Brown* on two grounds: (1) settlors retained a degree of control over the corpus of the trust and (2) the settlors retained a reversionary interest in the trust.

Business Purpose Test

It is interesting to note that the Tax Court in *Van Zandt* alluded to the independence of the trustee as the determinative factor in the *Skemp* and *Brown* cases.[25] The court did not mention the reversionary nature of the trust as did the district court in *Hall*; instead they proceeded to attack the transaction on the basis that "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."[26]

The Tax Court reasoning found support in the Fifth Circuit, although the language in the decision of that court is not entirely clear as to what may or may not be considered an ordinary and necessary business expense.

In rendering their opinion the court took only two cases into consideration, the *Skemp* case, relied on by petitioners and *Armston v. Commissioner*,[27] relied on by the Government. The circuit court recognized the similarity of the facts in *Skemp* and *Van Zandt* with the notable exception that the trust term in *Skemp* was for a twenty-year period and Dr. Skemp retained no reversionary interest in the trust.[28] These two factors alone would seem to be enough to put the *Van Zandt* case within the ambit of the district court decision in the *Hall* case, at least to the extent that the Court in that case disallowed the deduction on the basis of the reversionary interest re-

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of the taxpayer's children were deductible as business expenses where the lease-back arrangement was voluntarily prearranged by the taxpayer.

[23] 208 F. Supp. at 588.

[24] *Ibid.*

[25] 40 T.C. at 830.

[26] *Id.* at 830.

[27] 188 F.2d 531 (5th Cir. 1951), *affirming* 12 T.C. 539.

[28] 341 F.2d 440, 441.

tained by the settlors. The circuit court made a further distinction, however, and pointed out that in *Skemp* "the property transferred contained considerably more space than was rented back to the doctor for his use. Thus, there may have been a proper business purpose of conveying the property to the trustees for management . . . ."[29]

The test adopted by the circuit court appears to be that the deduction must rest upon a necessary and proper business purpose. In *Van Zandt* the court adopted the Government's view that the deduction was not a necessary business expense. In the language of the court "the fact remains that there was no real business purpose served by this intricate transaction. The only thing accomplished was to funnel family income to children in a way that allowed a reduction to the payor and taxation to the recipient at reduced rates."[30] This reasoning by the circuit court is in conformity with that of the court in *Armston* where it was held the sale and lease-back of heavy equipment, owned and used by a corporation, to the wife of the principal share-holder of the corporation, must be disregarded for tax purposes in that "the only logical motive and purpose of the arrangement under consideration was the creation of rentals, which would form the basis for a substantial tax reduction. . . ."[31]

CONCLUSION

In analyzing the effect of the *Van Zandt* decision it is difficult to determine under what conditions a lease back of business property would result in a permissible deduction of rent as a necessary business expense. In the language of the court "the result ultimately depends on the factual evaluation of the particular case;" and, "factors such as the short term of the trust, reversion to the settlors, predetermination of the right to possession of the property . . . bears heavily on the element of business purpose."[32] This language seems to indicate that the standard is arbitrary and implies that most prearranged transfers and lease-backs will not meet the business purpose test.

A recent law review article which deals with the problem in detail criticizes the position taken by the Tax Court in *Van Zandt*.[33] The author of the article feels "where a grantor gives business

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[29] *Ibid.*
[30] *Ibid.*
[31] 188 F.2d at 533.
[32] 341 F.2d 440, 444.
[33] 52 CALIF. L. REV. 968-77.