[Vanderbilt Law Review](https://scholarship.law.vanderbilt.edu/vlr)

Volume 19
Issue 3 *Issue 3 - June 1966*

Article 8

6-1966

The Use of Business Property As Short-Term Trust Corpus

Robert Doty

The Use of Business Property As Short-Term Trust Corpus

I. Introduction—The Planning Problem Presented*

A progressive income tax structure encourages the taxpayer with income above his consumption level to attempt to shift income to other members of his family group where it would be taxed at lower rates. The income which the taxpayer desires to shift may be in the form of compensation for services rendered by the taxpayer or of income from income-producing property owned by him. Attempts to shift compensation for the taxpayer's services are generally frustrated by application of the well-established principle that income is to be taxed to the person who earns it.[1] Income from income-producing property, however, may be shifted by a transfer which renders a person other than the taxpayer the "owner" of income-producing property at the time the income is realized.[2] The donee is taxable on the income under the principle that income from property is to be taxed to the owner of the property.[3] The estate planning uses of the short-term trust to transfer the ownership, and thereby the income, of income-producing property during the years in which a taxpayer's earned income is most substantial are well known.[4]

Prior to 1954, whether the trust was the "owner," for tax purposes, of the property transferred to it was determined on a case by case basis by evaluating the "dominion and control" retained by the grantor over the trust corpus.[5] The uncertainty inherent in this

*This note was awarded first prize in the 1966 Estate Planning Competition sponsored by the First National Bank of Chicago.

1. See, *e.g.*, Helvering v. Eubank, 311 U.S. 122 (1940); Burnet v. Leninger, 285 U.S. 136 (1932); Lucas v. Earl, 281 U.S. 111 (1930).

2. This principle is fully considered in Blair v. Commissioner, 300 U.S. 5 (1936).

3. This rule is a correlative to the principle discussed in the text accompanying note 1 *supra*.

4. Casner, Estate Planning 168-74 (3d ed. 1961). The shifting of income from property for the term of the trust is the objective sought in the use of a short-term trust. The settlor of the short-term trust will be deemed to have made a gift of the interest transferred for federal gift tax purposes. Treas. Reg. § 25.2511-2(g) (1961). Also, the value of the reversionary interest is includible in the settlor's gross estate should he die prior to the expiration of the trust. Treas. Reg. § 20.2031-7 (1963).

Some of the uses of the short-term trust to satisfy family estate planning needs are presented in the following articles: Poindexter, *How a Short-Term Trust Solves Four Typical Family Financial Problems*, 12 J. Taxation 286 (1960); Yohlin, *Assignment and Deflection of Income*, N.Y.U. 20th Inst. on Fed. Tax 147, 151-54 (1962).

5. See, *e.g.*, Harrison v. Schaffner, 312 U.S. 579 (1941); Helvering v. Clifford, 309 U.S. 331 (1939); Blair v. Commissioner, *supra* note 2. In Helvering v. Clifford, *supra*, the Supreme Court made the following observation concerning the determination left to the courts: "The failure of Congress to adopt any such rule of thumb for that type of trust must be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of Section 22(a)." *Id.* at 338.

approach led to the enactment of the "Clifford section"[6] of the Internal Revenue Code of 1954.[7] The legislative intent behind these sections was the enactment of precise standards to determine when a trust was to be considered the "substantial owner" of the trust corpus for income tax purposes.[8] Under the criteria established by Congress, the trust is the owner of the trust corpus (and the income produced thereby taxable to it or to the beneficiaries)[9] if the duration of the trust is at least ten years,[10] if certain prohibited powers over the disposition[11] or the administration[12] of the trust corpus are not retained by the grantor, and if the corpus or income of the trust may not be used for the grantor's benefit.[13]

While sections 671-78 themselves impose no limitations upon the kind of property which may be utilized as trust corpus, the conditions of trust validity outlined above suggest the conclusion that the trust is available only to persons who have accumulated investment property with which they can afford to part for at least ten years.[14] This conclusion, however, would render the short-term trust idea inaccessible to the considerable number of persons whose estate planning needs suggest the use of such a trust and who have accumulated substantial income-producing property, but whose assets are largely vital components of a trade or business.

This article seeks to explore the extent to which the benefits of the short-term trust can be secured for this latter class of persons by utilizing business assets as trust corpus in the following manner: (1) by transferring to the trust specific assets which are leased back by the grantor for continued use in his business; or (2) by transferring to the trust a partnership interest in the grantor's business.

II. The Transfer And Leaseback Arrangement

A. *Planning the Transaction—Formal Aspects and Tax Considerations*

The transfer and leaseback arrangement generally follows one of several basic patterns.[15] The most usual plan is for the taxpayer

6. INT. REV. CODE OF 1954, §§ 671-78.
7. H.R. REP. No. 1337, 83d Cong., 2d Sess. 63 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 86 (1954).
8. *Ibid.*
9. The income taxation of trusts and their beneficiaries is provided for at INT. REV. CODE OF 1954, §§ 641-69.
10. INT. REV. CODE OF 1954, § 673.
11. INT. REV. CODE OF 1954, § 674.
12. INT. REV. CODE OF 1954, § 675.
13. INT. REV. CODE OF 1954, §§ 676-77.
14. See CASNER, *op. cit. supra* note 4, at 172.
15. The illustrations are taken from the facts of cases in which the arrangement has received court approval.

to transfer by gift[16] some form of business property such as machinery or a building and land to a trustee. Thereafter, by prearrangement, the grantor and the trustee enter into an agreement whereby the property is leased back to the grantor.[17] A variation of this plan is for the taxpayer to establish the trust with an initial gift of cash. The cash is then used to purchase assets necessary to the business of the grantor, and the assets are leased by the trustee to the grantor or his controlled corporation.[18] Where the taxpayer's business is conducted in corporate form, another variant of the basic plan may be present. The controlled corporation transfers assets to the taxpayer by sale[19] or by a dividend in kind. The assets are then transferred to a trust created by the taxpayer, and the trustee leases the assets back to the corporation.[20]

The desired tax consequences from the arrangement are that the rentals paid under the lease agreement will be deductible by the grantor (or by his controlled corporation) and the income from the rentals will be taxed to the trust or the beneficiaries. If these consequences are achieved, the grantor's gross income will be reduced and the income of other members of the family group increased by a like amount. The estate planning objective is realized—the utilization of business assets as short-term trust corpus with minimal disruptive effect on the grantor's trade or business.

There are several subsidiary tax considerations in evaluating tax effectiveness of the transfer and leaseback arrangement in a given case: (1) The income-splitting provisions of the Internal Revenue Code eliminate the need for,[21] and sometimes the desirability of,[22] interspousal shifting of income. (2) The higher the taxpayer's tax bracket and the lower that of the trust or its beneficiaries the greater

16. Because of the tax problems attendant to the sale of property between related parties, the sale and leaseback is rarely used to shift income within the family group. See INT. REV. CODE OF 1954, §§ 267, 1239.

17. See, *e.g.*, Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Alden B. Oakes, 44 T.C. 524 (1965).

18. See, *e.g.*, Consolidated Apparel Co. v. Commissioner, 207 F.2d 580 (7th Cir. 1953) (leaseback to controlled corporation); Albert T. Felix, 21 T.C. 794 (1954) (leaseback to grantor).

19. The tax problems attendant to the sale of property between related parties are similarly present in such a transaction between a corporation and its controlling stockholder. See note 16 *supra*. However, the sale and leaseback may be useful to the corporation in meeting other financial problems. See Cary, *Current Tax Problems on Sale, or Gift, and Lease-back Transactions*, *N.Y.U. 9TH INST. ON FED. TAX* 959 (1951); Clark, *Changing Considerations in Sales and Leasebacks*, 42 TAXES 725 (1964); Friedman, *Lease or Purchase of Equipment; Sale and Leaseback*, N.Y.U. 14TH INST. ON FED. TAX 1427 (1956); Lassers, *Does a Lease-Back Save You Money*, 32 TAXES 279 (1954).

20. See, *e.g.*, Commissioner v. Greenspun, 156 F.2d 917 (5th Cir. 1946).

21. INT. REV. CODE OF 1954, § 6013.

22. See CASNER, *op. cit. supra* note 4, at 783-84.

will be the tax savings effected. (3) The transfer of the property will result in the grantor's loss of any depreciation deduction on the asset transferred and an investment credit previously received may have to be recaptured in part.[23] Therefore, non-depreciable property such as land, or property which is substantially depreciated, should be utilized as trust corpus where available.[24] (4) A gift tax will be incurred on the transfer to the trust. However, the specific exemption[25] and the exclusion allowed a husband and wife[26] may render this insignificant.

Should the arrangement be held invalid for tax purposes, the grantor is denied the rental deduction and incurs a gift tax on the transfer to the trust which is measured by the present worth of the right to receive the net rentals from the property during the term of the trust.[27]

B. *Planning the Transaction—The Commissioner's Attack and the Criteria Established by the Courts*

In early cases, the Commissioner attacked the transfer and leaseback arrangement on an "incomplete gift" theory under the doctrine of *Helvering v. Clifford*,[28] emphasizing the dominion and control retained by the grantor.[29] In the more recent cases, however, the Commissioner has changed the form of his argument to include an analysis of the provisions of section 162(a)(3) and the contention that the controls retained by the grantor preclude a rental deduction under these provisions.[30]

The planning trap for the taxpayer in implementing the arrangement has been his assumption that because the rental income is taxed to the trust under sections 671-78, the rental payments are deductible as business expenses. The argument inherent in the taxpayer's assumption may be stated in syllogistic form as follows:

23. Int. Rev. Code of 1954, § 47.

24. The use of the liberal depreciation methods of § 167 (Int. Rev. Code of 1954, § 167) will result in property being substantially depreciated within a few years. The property can then be utilized in a transfer and leaseback arrangement and a substantial rental deduction secured since rentals are related to the fair market value rather than the tax basis of the property rented.

25. Int. Rev. Code of 1954, § 2503(b).

26. Int. Rev. Code of 1954, §§ 2513, 2521.

27. Rev. Rul. 57-315, 1957-2 Cum. Bull. 624.

28. *Supra* note 5.

29. Rev. Rul. 54-9, 1954-1 Cum. Bull. 20. See, *e.g.*, A. A. Skemp, 8 T.C. 415, 420 (1947), *rev'd*, Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948); Johnson v. Commissioner, 86 F.2d 710 (2d Cir. 1936).

30. See, *e.g.*, Alden B. Oakes, *supra* note 17; I. L. Van Zandt, 40 T.C. 824 (1963), *aff'd*, Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965); Hall v. United States, CCH 1962 Stand. Fed. Tax Rep. (62-2 U.S. Tax Cas.) ¶ 9676 (N.O.N.Y. July 30, 1962).

Major Premise: Rental payments required to be made to the owner of property for the continued use of that property in the taxpayer's trade or business are deductible under section 162(a)(3).[31]

Minor Premises: The trustee of a trust which has satisfied sections 671-78 is the owner of the trust property for income tax purposes.

Conclusion: Rental payments required to be made to the trustee of a trust which has satisfied sections 671-78 for the continued use of trust property in the taxpayer's trade or business are deductible under section 162(a)(3).

The argument is sound if the characterization of the trustee as owner of the trust corpus under sections 671-78 is generally a controlling description of his status under the income sections of the Internal Revenue Code. However, the Senate Report, in discussing sections 671-78, states generally that the sections have no application in determining the right of a grantor to rental deductions for payments to a trust under a transfer and leaseback arrangement.[32] This statement was adopted by the Commissioner in the regulations[33] and its principle has found acceptance in the courts.[34]

The right to the rental deduction has been resolved by a consideration of the elements of control retained by the grantor in the particular case.[35] None of the decisions has given general approval or disapproval to the transfer and leaseback arrangement per se. A court's conclusion that a particular leaseback arrangement does or does not "pass muster" is frequently couched in imprecise language which speaks of "economic realities," "shams," or "bona-fide transactions."[36] The conclusion, however, is generally posited on the court's subjective evaluation of a number of factors, no one of which may be described as determinative. These factors are similar to those which were used before the 1954 Code to determine whether income of the trust should be taxed to the grantor. The following discussion seeks to analyze the Commissioner's arguments and the criteria considered relevant by the courts and to discuss their ramifications for the estate planner in planning and drafting a transfer and leaseback arrangement.

31. INT. REV. CODE OF 1954, § 162(a)(3).

32. S. REP. No. 1622, 83d Cong., 2d Sess. 365 (1954).

33. Treas. Reg. § 1.671-1(c) (1956).

34. Van Zandt v. Commissioner, *supra* note 30, at 443.

35. See Irvine K. Furman, 45 P-H TAX CT. REP. & MEM. DEC. ¶ 45.32 (1966), wherein the Tax Court condemned the particular arrangement but concluded as follows: "Our decision should not be construed as holding that we will disregard a trust for Federal income tax purposes in all situations involving transfers in trust and leasebacks. The decided cases reveal the standards to be applied. . . . The instant arrangement simply does not pass muster." *Id.* at 259.

36. See, *e.g.*, Van Zandt v. Commissioner, *supra* note 30 ("no real business purpose"); Commissioner v. Greenspun, *supra* note 20 (arrangement held not to be "mere tax dodging device"); Irvine K. Furman, *supra* note 35 ("lack of economic reality").

1. *Prearrangement.*—In some cases the leaseback of the property transferred to the trust has been required by the terms of the trust instrument.[37] In others the trustee is merely given the power to lease the trust corpus, and prearrangement is implied from the fact that the leaseback follows closely in time the original transfer to the trust.[38] In *Van Zandt v. Commissioner,*[39] the fact that the transfer and leaseback were prearranged steps was given as one reason for denying the rental deduction.[40] However, it has been emphasized in several decisions that a prior agreement to lease standing alone will not defeat the rental deduction.[41]

As a practical matter, there will always be some prearrangement. If, as has been suggested by several writers,[42] prearrangement makes the trustee subservient to the grantor and causes him to act in derogation of his fiduciary duty to the beneficiaries of the trust, then its presence should reflect negatively on the validity of the transaction. It is submitted, however, that prearrangement in this context is more analogous to the settlor's normal specification of the type of investment which the trustee should select.[43]

From the planning standpoint, prearrangement in the form of a specific direction in the trust instrument should generally be unnecessary. The asset has special value to the grantor as a part of his business and he will invariably be willing to pay the trustee the highest reasonable rental for its use.[44] Therefore, observance by the trustee of his fiduciary duty to make the trust property productive[45] should result in the leaseback to the grantor. The grantor might wish to reserve the use of the property for a short period of time during which arm's length negotiation of a lease could be accomplished.[46] A final plaming technique for blunting the Commissioner's argument on

37. See, *e.g.,* Skemp v. Commissioner, *supra* note 29.

38. See, *e.g.,* Alden B. Oakes, *supra* note 17.

39. *Supra* note 30.

40. *Id.* at 444.

41. Consolidated Apparel Co. v. Commissioner, *supra* note 18; Brown v. Commissioner, 180 F.2d 926 (3d Cir. 1950); Alden B. Oakes, *supra* note 17; Albert T. Felix, *supra* note 18.

42. Cary, *supra* note 19, at 976; Kornfield, *A New Look at Famliy-Trust-Leaseback Arrangements,* 104 TRUSTS & ESTATES 1121, 1186 (1965); 51 COLUM. L. REV. 247, 249 (1951).

43. RESTATEMENT (SECOND), TRUSTS § 227 (1959). See also BOGERT, TRUSTS & TRUSTEES § 681 (2d ed. 1960); 3 SCOTT, TRUSTS § 227.14 (2d ed. 1956).

44. His willingness is not diminished by the fact that the lessor is a trustee holding the property for the benefit of other members of his family.

45. RESTATEMENT (SECOND), TRUSTS § 181 (1959). See also BOGART, *op. cit. supra* note 43, § 611; 2 SCOTT, *op. cit. supra* note 43, § 181.

46. For diseussion of this suggestion see Cohen, *Transfers and Leasebacks to Trusts: Tax and Planning Considerations,* 43 VA. L. REV. 31, 45 (1957).

this point is to make the leaseback for a fraction of the term of the trust.[47]

2. *Independence of the Trustee.*—In *Alden B. Oakes,*[48] the most recent decision by the Tax Court upholding the validity of the transfer and leaseback arrangement, the "actual independence" of the trustee was described by the court as "one of the pivotal factors" in its determination.[49] In *I. L. Van Zandt,*[50] the Tax Court had reached a contrary result and distinguished prior cases favorable to the taxpayer on the ground that in those cases "the trustee's independence was the determinative factor."[51] The importance of the interposition of an independent personality is further emphasized by the lack of success which leasebacks directly with family members have encountered.[52]

The court's finding of independence, or the lack of it, in a given case has not turned on the trustee's character as a technically "adverse party,"[53] but, rather, on an examination of the trustee's conduct to determine his "actual independence."[54] Accordingly, if the trustee has independently represented the interests of the trust, it is apparently immaterial that the trustee is related to the grantor[55] or is the attorney who was responsible for suggesting and planning the arrangement.[56]

In addition to supporting the validity of the arrangement, the use of an independent trustee should also avoid a question being raised as to the reasonableness of the rentals agreed upon. A valuation problem in this context would be particularly troublesome since the asset leased has peculiar value to the grantor as a part of his existing business.

47. See Oliver, *Income Tax Aspects of Gifts and Lease-backs of Business Property In Trust,* 51 CORNELL L. Q. 21, 46-47 (1965).

48. *Supra* note 17.

49. *Id.* at 529.

50. *Supra* note 30.

51. *Id.* at 830.

52. See, *e.g.,* White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951); Under v. Campbell, P-H 1961 FED. TAX SERV. (7 Am. Fed. Tax R.2d 547) ¶ 61-376 (N.D. Tex. Nov. 14, 1960); Ernest V. Berry, 23 CCH Tax Ct. Mem. 1077 (1964); Hilda M. Royce, 18 T.C. 761 (1952).

53. See INT. REV. CODE OF 1954, § 672.

54. A finding such as that made by the Tax Court in Albert T. Felix, *supra* note 18, that "we find substantial evideuce to justify the inference that the trustee did act independeutly and in the best interest of the beneficiaries of the trust" is most important.

55. See John T. Potter, 27 T.C. 200 (1956), in which the trustees were the taxpayer's wife, father and accountant.

56. See, *e.g.,* Brown v. Commissioner, 180 F.2d 926 (3d Cir.), *reversing,* Helen C. Brown, 12 T.C. 1095 (1949); Consolidated Apparel Co. v. Commissioner, *supra* note 18.

3. *Taxpayer's Continued Occupancy of the Leased Property.*—One critic of the transfer and leaseback arrangement has described the real issue in such a case to be "whether the grantors may be permitted to consume their cake and have it too."[57] This argument emphasizes the taxpayer's continued physical possession of the property. The argument, however, is not satisfying since it ignores the changes in the taxpayer's legal and economic status effected by the arrangement. After the transfer and leaseback, the taxpayer occupies the property as a lessee and is under a legal obligation to pay rentals to one who is under a fiduciary duty to demand their payment.[58]

4. *Business Purpose.*—Some courts have suggested that the existence of a "business purpose" is an implied condition to the deductibility of the rentals under section 162(a)(3).[59] This requirement has been particularly emphasized in cases involving corporate participation in a transfer and leaseback arrangement.[60]

To state generally that a business purpose is required begs the question. The real question is whether a business purpose is required for the entire arrangement or merely for the leaseback agreement pursuant to which the rental payments are made. Admittedly, the purposes behind the taxpayer's original transfer of the property to the trust are non-business.

The two most recent decisions to consider the business purpose requirement have taken divergent positions. In *Van Zandt v. Commissioner*,[61] the Fifth Circuit, affirming the decision of the Tax Court, denied the claimed rental deduction on the ground that the arrangement, taken as a whole, served "no real business purpose."[62] In *Alden B. Oakes*,[63] however, the Tax Court repudiated the position it had taken in *Van Zandt*[64] and held that a business purpose was needed only for the leaseback under which the rental payments were made.[65]

57. Cary, *supra* note 19, at 976.
58. See RESTATEMENT (SECOND), TRUSTS §§ 170, 181 (1959); BOGERT, *op. cit. supra* note 43, §§ 543, 611; 2 SCOTT, *op. cit. supra* note 43, §§ 170, 181.
59. See, *e.g.*, Limericks, Inc. v. Commissioner, 165 F.2d 483, 484 (5th Cir. 1948). The leading case on the business purpose doctrine is Gregory v. Helvering, 293 U.S. 465 (1935).
60. See Finley v. Commissioner, 255 F.2d 128, 133 (10th Cir. 1958); Consolidated Apparel Co. v. Commissioner, *supra* note 18, at 584; W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951); Ingle Coal Corp. v. Commissioner, 174 F.2d 569 (7th Cir. 1949); Halsam Products Co., 11 CCH Tax Ct. Mem. 87 (1952); Shaffer Terminals, Inc., 16 T.C. 356 (1949), *aff'd*, 194 F.2d 539 (9th Cir. 1952).
61. *Supra* note 30.
62. *Id.* at 444.
63. *Supra* note 17.
64. *Supra* note 30.
65. Alden B. Oakes, *supra* note 17, at 532.

Since, following the transfer to the trust, Dr. Oakes needed a building in which to carry on his medical practice, the lease of such a building from the trustee was for a proper business purpose.

Should a court insist on a showing of a business purpose for the whole arrangement, or did the Tax Court correctly reject this requirement? It might be argued that section 162(a)(3) makes no mention of "business purpose" and for a court to require the same amounts to improper judicial legislation. However, section 162(a)(3) does provide that the payments to be deductible shall be "required to be made . . . for the purposes of the trade or business" of the taxpayer.[66] This language implies a payment made both under compulsion and for a business reason.

It is submitted that this business purpose should be required only for the rental payment and not for antecedent events or circumstances. The requirement that a corporation act with business purpose in both the transfer and the leaseback is not founded on section 162(a)(3) but on the general principle that corporations are business entities and are expected to act for business reasons.[67] Individual decisions, however, are frequently motivated by non-business considerations, and, if one is engaged in a business as a partner or proprietor, his personal decisions will frequently affect the conduct of his trade or business. For example, suppose a taxpayer has 5000 dollars cash in his personal bank account at a time when he needs a new piece of equipment in his business. If the taxpayer decides to use the cash in the purchase of a new pleasure automobile and to rent the needed equipment, the Commissioner would surely not disallow the rental deduction on the ground that there was no business reason for each step in the taxpayer's decision-making process leading to the rental payments. Section 162(a)(3) demands only that a rental payment was required to be made for a business reason and not that it might have been avoided by a different or better exercise of personal or business discretion at some prior point in time.

5. *Reasonableness of the Rentals.*—Where a taxpayer has paid an excessive amount as rent and the facts indicate that a portion of the payment is intended as a dividend or gift, the procedure followed in transactions between unrelated parties is to disallow the deduction for that portion of the payment which is unreasonable.[68] Neverthe-

66. INT. REV. CODE OF 1954, § 162(a)(3).

67. See Froehlich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956, 973 (1964).

68. See, *e.g.*, Limericks, Inc. v. Commissioner, *supra* note 59; Logan Lumber Co., 23 CCH Tax Ct. Mem. 735, 744 (1964); Sam Newman, 10 CCH Tax Ct. Mem. 1107, 1109 (1951); Roland P. Place, 17 T.C. 199, 203 (1951), *aff'd*, Place v. Commissioner, 199 F.2d 373.

less, in the context of a transfer and leaseback arrangement, there is the tendency to consider an unreasonable rent as evidence that the entire transaction is not at arm's length and as grounds for denying the deduction *in toto*.[69] Therefore, the tendency to make rental payments overly generous because they are inuring to the benefit of other members of the lesee's family should be avoided.

6. *Duration and Revocability*.—In *Van Zandt v. Commissioner*,[70] the short-duration of the trust and the existence of a reversionary interest in the grantor supported in part the court's decision denying the rental deduction.[71] The presence of these factors are, however, not alone sufficient to invalidate the transaction.[72] Any other conclusion would preclude the use of the short-term trust in the transfer and leaseback arrangement, and this result has not been suggested by any of the cases. The risks attendant to the arrangement may be minimized by making the term of the trust substantially longer than the minimum ten year period permitted by section 673.[73]

7. *Retained "Equity."*—Section 162(a)(3) allows a rental deduction only where the payments are for the taxpayer's use of that property "in which he has no equity."[74] These words were first used in 1916 and the legislative history is silent as to their intended meaning.[75] They have uniformly been construed as intended to preclude a business expense deduction for payments made by a mortgagor to acquire property, as distinguished from payments made for its continued use.[76] If this traditional interpretation is accurate, then the grantor's interest under a transfer and leaseback arrangement is not a prohibited "equity," for the payments made pursuant to the lease are for the use of the property and in no way add to his ownership interest therein.

69. Kirschenmann v. Westover, 225 F.2d 69, 70 (9th Cir. 1955); Irvine K. Furman, *supra* note 35, at 259.

70. *Supra* note 30.

71. *Id.* at 444. See also Irvine K. Furman, *supra* note 35, at 258.

72. See Alden B. Oakes, 44 T.C. 524 (1965), in which the transaction was upheld although the duration of the trust was ten years with a reversion to the grantor's wife.

73. This planning suggestion is discussed further in Cohen, *supra* note 46, at 44; Oliver, *supra* note 47, at 47.

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

75. H.R. Rep. No. 922, 64th Cong., 1st Sess. (1916); S. Rep. No. 793, 64th Cong., 1st Sess. (1916).

76. 4 Mertens, Federal Income Taxation § 25.108 (3d ed. 1960). See also Union Bag-Camp Corp. v. United States, 325 F.2d 730 (Ct. Cl. 1963); Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Judson Mills, 11 T.C. 25 (1948); Edward E. Haverstick, 13 B.T.A. 837 (1928). In Judson Mills, *supra*, the Tax Court stated the test to be whether the taxpayer was "acquiring something of value, that is, a certain equity in the machines, with each payment made in accordance with the agreement." *Id.* at 32.

In *Alden B. Oakes*,[77] however, the Tax Court defined "equity" broadly to include "a right of 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."[78] The court suggested that had Oakes not conveyed his reversionary interest to his wife the same would have constituted a prohibited "equity" within the meaning of section 162(a)(3).[79] In *Hall v. United States*,[80] an alternate ground for the court's decision denying the rental deduction was that the extensive controls retained by the grantors gave them an "equity" in the property.[81]

In neither case was the discussion of the taxpayer's "equity" essential to the decision, and, it is submitted, when the question is directly presented, the traditional interpretation of the term will be followed. The Tax Court's definition of the term in *Alden B. Oakes*[82] simply proves too much. Every lessee has an "equity" in the leased premises in the sense that he has rights under a valid lease agreement which can be enforced in a court of equity by the remedies of injunction[83] or specific performance.[84] Therefore, the Tax Court's definition would disallow the rental deduction in every case and render section 162(a)(3) illusory.

In conclusion, to be effective for tax purposes the transfer and leaseback must satisfy two tests—(1) the objective standards of sections 671-78 which control the taxation of the rental income, and (2) a variety of subjective criteria established by court decision which determine the grantor's rental deduction. The importance of careful planning and drafting of the various steps in the arrangement to minimize tax exposures has been given repeated emphasis.[85] It is at this stage that a record of arm's length dealing between the grantor and an independent trustee can be developed which should render the arrangement relatively safe from attack.

77. *Supra* note 72.

78. *Id.* at 531.

79. *Ibid.*

80. CCH 1962 STAND. FED. TAX REP. (62-2 U.S. Tax Cas.) ¶ 9676 (N.D.N.Y. July 30, 1962).

81. *Id.* at 85,757.

82. *Supra* note 72.

83. 43 C.J.S. *Injunctions* §§ 53(b), 58 (1945).

84. 81 C.J.S. *Specific Performance* § 63(b) (1953).

85. See Cohen, *supra* note 46; Gibbs, *Income Shifting—Recent Trends in Leaseback Transactions*, 19 Sw. L.J. 273, 275 (1965); Webster, *Transfers to Trusts with Leasebacks—Drafting and Other Suggestions for Trusts and Lease Agreements*, So. CAL. 8TH TAX INST. 319 (1956).

C. *Tax Policy Considerations*

Should a trust's validity under sections 671-78 control both the question of the taxation of income and the deductibility of the rentals under a transfer and leaseback arrangement, or have the courts correctly decided that the allowability of the rental deduction turns on a subjective evaluation of the controls retained by the grantor? It is submitted that the tests set forth in sections 671-78 should be the sole standard of the arrangement's validity for the following reasons: (1) The terms of sections 671-78 suggest they were intended to have application in other parts of the Code and the courts' present approach frustrates this intention; and (2) The courts have failed to draw any meaningful distinction between the question of the person to whom the income is to be taxed and that of the allowability of the rental deduction.

The final provision of section 671 suggests that sections 671-78 are to find general application in other parts of the Code:[86]

> No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) *or any other provision of this title, except as specified in this subpart.*[87] (Emphasis added.)

The denial of the rental deduction under section 162(a)(3) for the reasons given to date by the courts frustrates this policy, for it results in a decrease of trust income and an increase in like amount of the grantor's taxable income "solely on the grounds of his dominion and control over the trust."[88]

Further, under section 675[89] the grantor may deal with the trust corpus or income, or may borrow the same in an arm's length transaction,[90] without being treated as the owner of the trust. If, however, business expenses incurred in connection with such transactions are held non-deductible under other provisions of the Code by reason of the grantor's retained controls over the trust, then sections 675(1) and (2) are rendered illusory and the grantor's taxable income is increased "solely on the grounds of his dominion and control over the trust."[91] A transaction, the validity of which is to be determined

86. INT. REV. CODE OF 1954, § 671.
87. *Ibid.*
88. *Ibid.*
89. INT. REV. CODE OF 1954, § 675(1), (2).
90. The dealing must not be for less than an adequate and full consideration and the power to borrow must not be one without adequate interest or security unless a trustee other than the grantor is authorized generally to make loans to any person without regard to interest or security. *Ibid.*
91. See INT. REV. CODE OF 1954, § 671.

solely by reference to the objective standards of sections 671-78, has been defeated by a reference to criteria of dominion and control expressly rejected by Congress.[92]

Nevertheless, the fact that the trustee is characterized as the "substantial owner" of the trust property for purposes of one part of the Code does not *per se* compel the conclusion that he should be "the owner" for purposes of other sections of the Code where ownership is relevant. The question should always be whether differences or similarities in characterization have a basis in reason and policy.[93] For example, a transfer may be sufficient to make the trustee of a trust the "owner" of trust corpus for purposes of the gift tax, and yet the grantor may remain the "owner" for income and estate tax purposes.[94]

In considering the transfer and leaseback arrangement, the courts have stated that the income and deduction issues are separate and distinct, but they have failed to articulate reasons for the distinction. The grantor's right to a rental deduction has been resolved by the same subjective evaluation of elements of dominion and control to determine ownership as was made prior to 1954 to determine the ownership of trust corpus for purposes of income taxation.[95] The enactment of sections 671-78 indicates Congress' intent that the income tax consequences of transfers in trust should be determined, not by a court's subjective evaluation of the dominion and control retained by the grantor, but by the objective standards statutorily expressed.

If the determination to be made in testing the validity of a transfer and leaseback arrangement is, as the cases to date indicate, one of ownership resulting from dominion and control, then sections 671-78 have enunciated the standards to be applied.[96] However, if there are policies operative under section 162(a)(3) which call for a consideration of other factors, then these have not yet been expressed by the Commissioner or the courts.

92. *Ibid.* See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. 63 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 86 (1954).

93. "The tendency to assume that a word which appears in two or more legal rules, and so in connection with more than one purpose, has and should have precisely the same scope in all of them runs all through legal discussions. It has all the tenacity of original sin and must constantly be guarded against." Cook, The Logical and Legal Bases of Conflict of Laws 159 (1942), as quoted in Cheatham, Conflict of Laws 89 (5th ed. 1964).

94. See Casner, Estate Planning 218-23 (3d ed. 1961).

95. See Froehlich, *supra* note 67, at 968.

96. "Perhaps it would be desirable to protect the revenue by amending § 162(a)(3) to exclude from the business expense deductions now allowed those which become necessary only because of intrafamily gifts of property used, or to be used, in business. But that is a matter to be determined by Congress and, nntil it acts, I think the courts are bound to give effect taxwise to gifts which are fully effective otherwise." White v. Fitzpatrick, *supra* note 52, at 402 (Chase, J., dissenting).

III. The Family Trust Partnership

A. *Planning the Transaction—Formal Aspects and Tax Considerations*

While the matter was surrounded by considerable doubt at common law,[97] the great weight of modern authority is to the effect that a trustee can be a partner, and will be so recognized, for tax purposes.[98] There are, however, several practical difficulties in a trustee's acting as a partner which must be resolved. As a general rule, it is imprudent for a trustee to invest the trust corpus in a trade or business, whether conducted as a proprietorship or partnership.[99] Also, the trustee's entry into a partnership is thought to involve a rather extreme delegation of his fiduciary duty because of the mutual agency relationship of partners.[100] Each of these obstacles, however, can be overcome by an appropriate provision in the trust instrument authorizing the trustee to invest in a partnership.[101]

A more serious objection from the trustee's standpoint is the unlimited liability for partnership obligations to which he would be subjected as a general partner.[102] The gravity of the objection is further emphasized by the fact that general partners are bound by the act of any partner "for apparently carrying on in the usual way the business of the partnership."[103] For this reason, it has been suggested that a well-advised bank, or other corporate trustee, will generally refuse to act as a general partner.[104] Another difficulty for the corporate trustee is that it normally manages investment properties which require a minimum of personal supervision. Serving as a general partner would be a novel and time-consuming task for such a trustee which could pose substantial problems for the corporate trustee as well as for the other partners. Therefore, if a general partnership interest is to be held in trust, the trustee will likely have to

---

97. Bogert, Trusts & Trustees § 112 (2d ed. 1965); 1 Rowley, Partnership § 6.4 (2d ed. 1960).

98. Willis, Handbook of Partnership Taxation 439 (1957). See Miller v. Commissioner, 203 F.2d 350 (6th Cir. 1953); Theodore D. Stern, 15 T.C. 521 (1950); I. W. Frank Trust, 44 B.T.A. 934 (1941); Treas. Reg. § 1.704-1(e)(2)(viii) (1964).

99. Restatement (Second), Trusts § 227, comment *f*. See also Bogert, *op. cit. supra* note 97; 3 Scott, Trusts §§ 227.6, 230.4 (2d ed. 1956).

100. 1 Rowley, Modern Law of Partnership 598 (1916); 3 Stan. L. Rev. 467, 468 (1951).

101. 3 Scott, *op. cit. supra* note 99, §§ 227.6, 230.4.

102. Uniform Partnership Act § 15. See Crane, Partnership § 24 (2d ed. 1952).

103. Uniform Partnership Act §§ 9, 15. The partners are also liable for the tortious act of any partner who at the time was "acting in the ordinary course of the business of the partnership or with the authority of his co-partners." Uniform Partnership Act § 13.

104. See Smith, *Shifting Income Within the Family Group*, 30 Taxes 995, 999 (1952).

be a personal acquaintance of the taxpayer, the taxpayer himself, or one of the existing partners.

A corporate trustee may, however, be willing to serve as a special or limited partner. In one case, for example, the American National Bank and Trust Company of Chicago served as the trustee of limited partnership interests.[105] The limited partner has no powers of management and no personal liability beyond the amount of his stated contribution.[106] He is essentially an investor who receives a share of the partnership profits as the return on his investment.[107]

The following discussion assumes that the foregoing problems of trust and partnership law have been given consideration and that a trustee has been found who is acceptable to the taxpayer and to the other partners, if any, in the partnership.

The taxpayer who wishes to utilize a partnership interest in his business as the corpus of a short-term trust for the benefit of other members of his family may do so by one of two methods. He may transfer an undivided interest in his business to a trustee to constitute the trust corpus,[108] or he may transfer cash to the trustee which the trustee is empowered to invest in the partnership.[109] Following the transfer to the trust, a partnership agreement is generally entered into between the grantor and the trustee. The desired tax consequences from the arrangement are that the trust will be taxed on the share of the partnership income distributed to it.

What are the relevant estate planning considerations in selecting the family trust partnership arrangement generally and in evaluating it vis-a-vis the transfer and leaseback arrangement? Generally, a trust removes many of the uncertainties attendant to partnerships directly with minor children. Absent a trust it must be shown that the minor child is "competent to manage his own property and participate in the partnership activities in accordance with his interest in the property.[110] This test will likely not be met in the case of most minor children, and in other cases will present difficult problems of proof.[111]

105. Leeb v. Jarecki, 156 F. Supp. 6, 8 (N.D. Ill. 1957). See also Edward D. Sultan, 18 T.C. 715, 717 (1952), *aff'd*, 210 F.2d 652 (9th Cir. 1954), wherein a trust company served as trustee.

106. UNIFORM LIMITED PARTNERSHIP ACT §§ 4, 7, 17. See also CRANE, PARTNERSHIP § 24 (2d ed. 1952).

107. *Ibid.*

108. See, *e.g.*, Stanback v. Commissioner, 271 F.2d 514, 515 (4th Cir. 1959); Wilson v. United States, 246 F. Supp. 613, 615 (N.D. Cal. 1965); Dreschler v. United States, 161 F. Supp. 319 (S.D.N.Y. 1958).

109. See, *e.g.*, Miller v. Commissioner, *supra* note 98, at 351; Goldberg v. United States, 152 F. Supp. 259, 261 (E.D.N.Y. 1957).

110. Treas. Reg. § 1.704-1(e)(2)(viii) (1964).

111. See, *e.g.*, Batman v. Commissioner, 189 F.2d 107, 109 (5th Cir. 1951) (partnership with 14 year old son held invalid); Arnold v. Green, 186 F.2d 18, 19 (5th

The family trust partnership arrangement has the following advantages over the transfer and leaseback arrangement: (1) It can be used to a greater extent to interest minor children in the family business. (2) It avoids difficulties in selecting specific assets to be committed to the trust over an extended number of years. This is particularly helpful where a depreciation deduction would be lost or where technological change in an industry is such that equipment might be obsolescent prior to the expiration of the trust terms. (3) It may pose fewer administrative problems since the payments to the trust require only a division of profits at specified times in accordance with percentages provided for in the partnership agreement.

The family trust partnership arrangement, however, is unavailable where the taxpayer is a professional person who is precluded from entering a partnership with non-professional persons, or where the taxpayer's business is one in which capital is not a material income-producing factor.[112]

B. *Planning the Transaction—The Commissioner's Attack and the Criteria Established by the Courts*

In early cases, the same principles were applied to family trust partnership arrangements as were applied to short-term trusts generally.[113] The Commissioner attacked the arrangement under the *Clifford* doctrine by emphasizing the controls retained by the grantor over the partnership interest allegedly transferred to the trust.

However, the decisions by the Supreme Court in *Commissioner v. Tower*[114] and *Commissioner v. Culbertson*[115] announced new standards by which the validity of family partnerships generally were to be tested. In *Commissioner v. Tower*,[116] the Supreme Court promulgated the rule that for husband and wife partnerships to be valid for tax purposes, the wife had to "invest capital originating with her" or "perform vital additional services."[117] In *Commissioner v. Culbertson*,[118] however, the Court altered this view, holding that the ultimate

Cir. 1951) (partnership with four minor daughters upheld); Pflugardt v. United States, 201 F. Supp. 379, 382 (E.D. Wisc. 1962) (partnership with minor children aged 1 to 3½ years held invalid due to children's lack of "maturity or competence."); Finley v. Healy, 187 F. Supp. 434, 438 (D. Mont. 1960) (partnership with four minor children held valid due to evidence of "meticulous conduct of the business").

112. INT. REV. CODE OF 1954 § 704(e)(1).

113. See, *e.g.*, Hash v. Commissioner, 152 F.2d 722 (4th Cir. 1945), *cert. denied*, 328 U.S. 838 (1946); Losh v. Commissioner, 145 F.2d 456 (10th Cir. 1944); Armstrong v. Commissioner, 143 F.2d 700 (10th Cir. 1944); Robert P. Scherer, 3 T.C. 776 (1944).

114. 327 U.S. 280 (1945).

115. 337 U.S. 733 (1949).

116. *Supra* note 114.

117. *Id.* at 290.

118. *Supra* note 115.

test was the presence of a bona fide intent to form a partnership.[119] The original capital and vital services criteria were described as merely indicia of the presence or absence of the requisite intent.[120] Following these decisions, it was held that the family trust partnership to be effective for tax purposes had to satisfy both the *Clifford* doctrine and the recently announced standards for family partnership validity.[121]

In 1951, Congress expressly rejected the original capital and vital services tests in enacting what is now section 704(e) of the Code.[122] To qualify as a family partnership under section 704(e) a business must meet two requirements: (1) capital must be a material income-producing factor;[123] and (2) the partners, other than the donor, must "own" capital interests in the partnership.[124] If these requirements are met, it is irrelevant that a partner's capital was non-original and was received by gift or purchase.[125] Further, the whole arrangement need not be supported by any business purpose.[126] The legislative history and the regulations under section 704(e) clearly indicate that the donee's ownership of the capital interest is to be determined by the Commissioner and the courts on a case by case factual analysis of the "incidents of ownership" retained by the donor and the "dominion and control" exercised by the donee to determine the "bona fides of the particular transaction."[127]

The legislative history of sections 671-78 states the intent that the rules as to family partnerships are not affected by Subpart E, even though a partnership interest is held in trust.[128] This statement has been adopted by the Commissioner in the regulations under section 671.[129]

Therefore, as in the transfer and leaseback arrangement, before a particular type of property can be utilized as short-term trust corpus, the controls retained by the grantor must be measured in light of both the objective standards of sections 671-78 and a set of subjective

119. *Id.* at 742.
120. *Id.* at 745.
121. See, *e.g.*, Stanback v. Robertson, 183 F.2d 889, 893 (4th Cir. 1950); Edward D. Sultan, *supra* note 105, at 725.
122. INT. REV. CODE OF 1954, § 704(e). See H.R. REP. No. 586, 82d Cong., 1st Sess. 32 (1951).
123. INT. REV. CODE OF 1954, § 704 (e)(1).
124. INT. REV. CODE OF 1954, § 704(e)(1).
125. INT. REV. CODE OF 1954, § 704(e)(1).
126. See H. REP. No. 586, 82d Cong., 1st Sess. 33 (1951); Treas. Reg. § 1.704-1(e)(2)(x) (1964).
127. See H. REP. No. 586, 82d Cong., 1st Sess. 32 (1951); Treas. Reg. § 1.704(e)(1)(iii) (1964).
128. S. REP. No. 1622, 83d Cong., 2d Sess. 212 (1954).
129. Treas. Reg. § 1.671-1(c) (1956).

tests judicially established. In this case the subjective standards are those rules of family partnership validity developed under section 704(e).

The following discussion considers certain controls which grantors of short-term trusts typically retain and which are perfectly permissible under sections 671-78, but which may raise a question as to the trust's validity under the subjective rules of family partnership validity.

1. *Independence of the Trustee.*—Under sections 671-78 the grantor of a short-term trust may designate himself or a person amenable to his will as trustee, and, provided certain prohibited powers are not exercisable by the trustee, the grantor will not be regarded as the substantial owner of the trust corpus.[130]

The subjective rules of family partnership validity accord some weight to the trustee's technically independent status in determining whether he is the "real owner" of a partnership interest.[131] Much more important, however, is a finding of the trustee's actual independence based on the conduct of the parties and the provisions of the trust and partnership agreements. The regulations under section 704(e) recognize that the grantor or a person amenable to his will may be the trustee,[132] and the decided cases are to the same effect.[133] A number of cases have sustained the family partnership trust arrangement where the grantor[134] or one related or subordinate to the grantor[135] was the trustee. Similarly, the mere presence of a corporate trustee has not saved an arrangement when the trustee did not independently represent the beneficiaries in the business as fully as

130. INT. REV. CODE OF 1954, §§ 674-77.

131. See Treas. Reg. § 1.704-1(e) (2) (vii) (1964). In the following cases the fact that the trustee was an independent personality was given as one factor in support of the trust's validity: West v. Commissioner, 214 F.2d 300, 302 (5th Cir. 1954); Edward D. Sultan, *supra* note 105, at 725; Louis R. Eisenmann, 17 T.C. 1426, 1433 (1952). In Smith v. Westover, 237 F.2d 201 (9th Cir. 1956), the fact that the grantors served as trustees was given by the court as one reason for holding the arrangement invalid. *Id.* at 203.

132. Treas. Reg. § 1.704-1(e)(2)(vii) (1964).

133. See, *e.g.*, Dreschsler v. United States, *supra* note 108, at 324; Dickstein v. McDonald, 149 F. Supp. 580 (M.D. Pa. 1957); Goldberg v. United States, *supra* note 109.

134. See, *e.g.*, Neil v. Commissioner, 269 F.2d 563 (5th Cir. 1959); Dreschler v. United States, *supra* note 108; Miller v. Commissioner, *supra* note 98; Theodore D. Stern, *supra* note 98; Armstrong v. Commissioner, *supra* note 113.

135. See, *e.g.*, Pike v. United States, 231 F.2d 688 (9th Cir. 1956) (wife trustee for three minor children); Maiatico v. Commissioner, 183 F.2d 836 (D.C. Cir. 1950) (wife trustee for minor children); Broide v. United States, 156 F. Supp. 12 (N.D. Ill. 1957) (sister-in-law of grantor and employee of partnership trustees for minor children); Herbert Shainberg, 12 CCH Tax Ct. Mem. 201 (1953) (grantor's attorney and employee of partnership trustees for minor children).

his partnership status would have permitted.[136]

It is suggested that a stronger case frequently may be presented where the trustee is the grantor or a person amenable to his will, since the existing partners will be less hesitant to have such a person be fully active in the affairs of the partnership.

2. *Duration and Revocability.*—The grantor may retain a reversionary interest in the trust corpus without being treated as the substantial owner of the trust under sections 671-78 provided the interest does not take effect in possession or enjoyment within ten years.[137]

The Commissioner, however, has taken the position in unpublished rulings that such a reversionary interest in the grantor deprives the trustee of the "full and complete ownership" necessary to a valid family partnership.[138] Two writers on the subject have asserted that it is unsafe to transfer a partnership interest to a trust, the corpus of which reverts to the grantor after ten years.[139]

Neither section 704(e) nor sections 671-78 suggest that the existence of a reversionary interest in the grantor will result in the ipso facto invalidation of the arrangement, and the decided cases are to the same effect. In several cases, the absence of a reversionary interest in the grantors is referred to as one relevant factor in holding the trust valid under section 704(e),[140] and, in at least one case, the possibility of a reverter to the grantors has been given as a ground for its invalidity.[141] Nevertheless, in none of the cases has this "incident of ownership" alone been regarded as determinative.

It is submitted that a reversion to the grantor after a period of years is merely one factor to be considered in determining the trustee's "full and complete" ownership. The reversionary interest in the grantor is in derogation of the trustee's ownership of the partnership interest in two respects: (1) it arbitrarily limits the duration of the partnership; and (2) it provides that the partnership interest will vest in another as owner at a given point in time. The setting of an arbitrary limit on the duration of the trust and, therefore, on the

136. See, *e.g.*, Solomon v. Commissioner, 204 F.2d 562 (4th Cir. 1953) (bank and trust company); Stanback v. Robertson, *supra* note 121 (bank and trust company was co-trustee); Feldman v. Commissioner, 186 F.2d 87 (4th Cir. 1950) (independent individual); Leeb v. Jarecki, *supra* note 105 (bank and trust company).

137. INT. REV. CODE OF 1954, § 672.

138. The rulings are discussed in Herzfield, *Grantor of Family Partnership Interest to Clifford Trust Is Taxable, IRS Says*, 15 J. TAXATION 50 (1961).

139. See WILLIS, *op. cit. supra* note 98, at 439; Froehlich, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956, 965 (1964).

140. See, *e.g.*, Miller v. Commissioner, *supra* note 98, at 352; Goldberg v. United States, *supra* note 109, at 264; Thomas H. Brodhead, 18 T.C. 726, 735 (1952).

141. Boyt v. Commissioner, 209 F.2d 839, 844 (8th Cir. 1954).

trustee's participation in the partnership, has never been held to affect the trustee's ownership during the term of the trust. For example, trusts have frequently been held valid even though the trust instrument provided that the trust shall terminate and the corpus be distributed to the beneficiaries at a certain time after the grantor's death,[142] or when the beneficiaries "become of age"[143] or attain a certain age.[144] These decisions would seem to be authority for the proposition that one's ownership of a capital interest in a partnership at a given time is not affected by the fact that another will later become the owner of the same property.

The grantor's reversionary interest should affect partnership validity only where its existence is used by the grantor as leverage to subvert the trustee's full present ownership of the trust corpus. If the trustee independently exercises the rights of one owning a capital interest in partnership, his ownership of the interest should be unaffected by the fact that another, even the grantor, will be the owner of the interest at a future date. In planning the family partnership trust arrangement, the Commissioner's argument on this point might be blunted somewhat by making the term of the trust longer than ten years or by selecting an independent person to act as trustee.

3. *Restrictions on Trustee's Powers.*—If the trustee is an independent personality and a stranger to the business, it is unlikely that either he or the existing partners will favor his assumption of full partnership discretion and authority. The tendency will be to include restrictions on the trustee's powers either in the trust instrument or the partnership agreement. Such limitations may be consistent with the trustee's status as the substantial owner of the trust corpus under sections 671-78, but inconsistent with his full and complete ownership of a capital interest in the partnership under the family partnership rules.

The conclusion as to what restrictions may be imposed on a trustee consistent with the family partnership rules generally turns on the answers to two questions: (1) What type of partner is the trustee under the trust instrument and the partnership agreement? (2) Does the trustee possess and exercise the full powers which a partner of this type normally possesses and exercises under the applicable local law?[145] For example, if the trustee is a limited partner, he will not

142. See, *e.g.*, Thomas H. Brodhead, *supra* note 140; Theodore D. Stern, *supra* note 98.

143. See, *e.g.*, Maiatico v. Commissioner, *supra* note 135; Herbert Shainberg, *supra* note 135.

144. See, *e.g.*, West v. Commissioner, *supra* note 131; Sanford H. Hartman, 43 T.C. 105 (1964); Edward D. Sultan, *supra* note 105.

145. Treas. Reg. § 1.704-1(e)(2) (1964).

be expected to actively participate in the management decisions of the partnership. His activities will be confined to the periodic review of partnership affairs to determine the status of his investment.[146] Further, even though the trustee is a general partner, one of the other general partners may be designated the managing partner, thus relieving the trustee of responsibility for the day to day operation of the business.[147]

A finding that there were significant powers withheld from the trustee which partners of that type can, and generally do, possess is generally fatal to the family trust partnership arrangement. The following holding is illustrative:

> Under Illinois law the limited partners could have been given considerably fuller power of ownership over their investments in the partnership. In the partnership context, a limited partner whose property interest in the partnership originates with a general partner may be regarded as the true owner of that property notwithstanding that the general partner retains substantial powers over it, provided that the powers retained are such as are normally incident to that type of partnership. This proviso is not satisfied by a partnership agreement which places substantial restrictions upon the limited partners' rights to withdraw or assign their interests in the partnership, restrictions which are not normally incident to a limited partnership organized under Illinois law.[148]

In conclusion, the estate planner who is considering the use of a partnership interest as the corpus of a short-term trust must be aware of the two sets of operative standards which the arrangement must satisfy.

C. *Tax Policy Considerations*

The policy question involved is basically the same as that raised in connection with the discussion of the transfer and leaseback arrangement:[149] Should a trustee who is the "substantial owner" of trust corpus under the provisions of sections 671-78 also be considered the "owner" of a capital interest in a partnership under section 704(e) where a partnership interest is utilized as trust corpus? As with the transfer and leaseback arrangement, the ultimate question is stated in terms of ownership under both sections 671-78 and the additional subjective standards applied by the courts to measure the arrange-

146. See Edward D. Sultan, *supra* note 105, where the Tax Court held a family partnership trust arrangement valid even though the grantor retained entire control of the business on the ground that such control was "of no particular significance since limited partners normally have no part in the control or management of the business." *Id.* at 723.

147. See, *e.g.*, Robert P. Scherer, *supra* note 113.

148. Leeb v. Jarecki, *supra* note 105, at 11.

149. See text accompanying notes 86-95 *supra*.

ment's validity under other sections of the Code.

Section 671 enunciates the broad policy that the determination of the trustee's ownership of trust corpus under Subpart E is not to be upset under any other section of the Code on the grounds of the grantor's dominion and control over the trust property.[150]

It was suggested that the subjective criteria applied by the courts to determine the grantor's rental deduction under a transfer and leaseback arrangement were nothing more than a determination of ownership based on dominion and control, and, therefore, needlessly frustrated the intent of Congress in enacting Subpart E.

It is submitted, however, that the subjective tests of family partnership validity, while they may be couched in terms of the trustee's "ownership of a capital interest," are not essentially concerned with determining the trustee's ownership of trust corpus based on an evaluation of the grantor's retained dominion and control. Rather, they are concerned with whether the relationship over a period of time between two personalities—the grantor and the trustee—was that of partnership.

Therefore, the application of the family partnership rules to the short-term trust where a partnership interest is used as trust corpus does not replace or frustrate sections 671-78, but rather applies supplemental standards which are demanded by the terms and policy of section 704(e).[151]

ROBERT DOTY

150. INT. REV. CODE OF 1954, § 671.
151. *Contra*, Herzfield, *supra* note 138.