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# Income Tax Consequences of Intra-Family Use of Transfer-Leasebacks, Private Annuities and Installment Sales

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# INCOME TAX CONSEQUENCES OF INTRA-FAMILY USE OF TRANSFER-LEASEBACKS, PRIVATE ANNUITIES AND INSTALLMENT SALES

By BARBARA B. HIPPLE

I have been asked to speak today on the general subject of transferring property between family members through the use of private annuities, installment sales, or transfers followed by leasebacks, any one of which might be chosen by the transferor in hopes of obtaining income tax advantages. Obviously, any transfer of property between family members, whether by one of these or by some other method, cannot be undertaken without considering the whole panoply of taxes; estate tax and gift tax as well as income tax. Consequently, the entire, complex interrelationship between income, estate and gift tax consequences to both the transferor and the transferee must be traced before choosing to avail oneself of any of these methods of transfer. Therefore, while my focus today is on the current income tax developments in the use of these three different transfer methods, the estate and gift tax consequences of all of them will also be considered in order to keep the usefulness and drawbacks of each of these devices in proper perspective.

Although transfers between family members may occur for a variety of reasons and can involve all kinds of property, I would like to focus my discussion on a hypothetical typical of one of the more common situations in which these methods of transfer could be considered for use. The hypothetical has the following basic facts:

> The taxpayer, age 67, is the sole proprietor of a small but successful business, worth approximately $1 million. His total investment in this business, net of depreciation, is $250,000 which leaves him with a net potential gain of $750,000. The single most valuable business asset is the land, improved by a building in which the business is conducted. He purchased the property some years ago for $100,000. Due to its prime central location, it is now worth approximately $700,000. This taxpayer is interested in retiring, and has two sons, willing to take over the business but unable to purchase the business directly because of their own limited financial resources. The taxpayer does not want to pay any income tax on the potential gain from either the sale of the business or the land and building if he can avoid it, but he is also not particularly interested in paying any gift tax on the property and, of course, he would also like to avoid any estate taxes at death.

Although this hypothetical is dramatically oversimplified from the planning perspective, it is realistic to the extent that the taxpayer would like to find some way to transfer the property to his two sons without a reduction in income after the transfer, to avoid all income tax as a result of the transfer, to avoid any gift tax on the transfer, and to have nothing left in his estate on which estate tax can be assessed when he dies. Now, let's consider the three different transfer methods to see how close we can come to satisfying these obviously impossible goals.

We will consider first the private annuity transaction. By way of introduction, let me briefly review how the basic annuity rules work. Section 72 of the Internal Revenue Code deals generally with the tax consequences of an annuity. Even though the Code and Regulations do not define an annuity in precise terms, it has long been recognized that a private arrangement between individuals can constitute an annuity within the meaning of Section 72 just as the more traditional commercial annuity is subject to Section 72. The approach of Section 72 is to permit the person who receives the annuity (the taxpayer in the hypothetical), to recover his investment in the annuity contract on a ratable basis over the period of the annuity payments. Of course, this is done on the basis of the calculation of an exclusion ratio, which is the "investment in the contract" divided by the estimated return to the annuitant over the life of the annuity. This exclusion ratio is then applied to each annuity payment received by the annuitant during his life, or the term of years if that is what he bargained for. If the annuitant has a life annuity, the exclusion ratio is applied to each payment regardless of whether he actually lives for a period which is longer or shorter than his life expectancy as calculated in the actuarial tables used to determine the expected return on the contract.

If an individual were to take a substantial amount of cash and transfer it to another family member in return for an annuity which has a present value equal to the cash transferred, the transaction might appear to have been neutral for both estate and gift tax purposes. The transferor merely replaced one asset, the cash, with another equally valuable asset, the annuity promise. This conclusion, however, is, not completely accurate. When the transferor dies after the purchase of the annuity, Section 2039, which deals with the inclusion of annuities in the gross estate of a decedent, would provide that nothing be included in the taxpayer's estate as a result of his right to receive the life annuity payments if he was the only annuitant, although if he had died owning the cash, it would be included in his estate under Section 2033. Also, to the extent that the annuity payments themselves were expended by the transferor for his living expenses, the effect of the transaction would be to remove the original asset from the transferor's estate at no gift tax cost, and to replace it with a "wasting" asset, that is, one which was not included in the estate for estate tax purposes and was used by the transferor during life, as, and to the extent, he received payments. Furthermore, if the value of the right to receive annuity payments at the time of the transfer equalled or exceeded the value of the property transferred, the transferor would not have made a gift, so there would be no gift tax due.

Given these substantial potential estate and gift tax benefits, surely there must be an income tax drawback which tends to limit use of this kind of transaction. Surprisingly enough there is no major income tax disadvantage, because the property used to purchase the private annuity would represent the investment in the contract and could be recovered by the transferor tax-free. In effect, the only income tax cost would be the income tax, at the transferor's marginal tax rates, on the taxable portion of each annuity payment. What may prevent to some degree the more widespread use of this device is not the prospect of adverse income tax consequences, but rather the practical problem of having one family member dependent upon receiving payments from another family member for a long and somewhat unpredictable period of time, as would be the case with a life annuity.

Another deterrent to widespread use of the family annuity is the slightly more complex problem which arises when the transferor uses appreciated property to purchase an unsecured private annuity, such as our hypothetical taxpayer's transfer of the business itself, or the major asset of the business. If we assume that our taxpayer transfers the business itself in return for a promised annuity of $100,000 a year from his two sons, what income tax consequences can be anticipated? Unfortunately, the answer to that question is not completely clear. The taxpayer has transferred an asset, worth $1 million, in which he had an original investment of only $250,000, in return for a private annuity promise of $100,000 a year, which, under the tables provided in Treasury Regulations Section 20.2031-10(f), has a value of $757,630. The Service has attempted to resolve all the income, estate and gift tax consequences which follow from this transaction in Revenue Ruling 69-74. Applying that Ruling to the facts of our hypothetical would dictate the following results:

(1) Because the $1 million value of the property transferred exceeds the present fair market value of the annuity promise, ($757,630), a gift of $242,370 has been made to the transferees at the time of the annuity purchase.

(2) The taxpayer's "investment in the contract", for purposes of determining the exclusion ratio under Section 72, is the basis of the property transferred, or in our hypothetical, $250,000 rather than the $1 million fair market value of the property transferred. Had the $1 million fair market value of the property been used as the investment in the contract the exclusion ratio would have been four times greater than the exclusion ratio which results from using the $250,000 adjusted basis.

(3) Since the property the taxpayer transferred in exchange for the annuity had appreciated in value, the difference between the basis of the property, $250,000, and the present fair market value of the con-

sideration received, $757,630, is realized gain of $507,630. Under the Ruling, this gain can be spread over the 13.8 life expectancy of the taxpayer, computed according to the life expectancy tables used to determine the expected return on the contract for Section 72 purposes.

The question has been raised from time to time whether Revenue Ruling 69-74 is entirely correct in its treatment of the tax consequences of private annuities. Revenue Ruling 69-74 does represent a departure by the Service from its previous Ruling under the 1939 Code equivalent of Section 72. Under Revenue Ruling 239, issued in 1953, the Service took the position that the investment in the contract was the fair market value of the property transferred, even when appreciated property was used to purchase the annuity. Thus the ordinary income portion of the annuity, determined by applying a fixed 3 percent rate of return to the investment in the contract, was measured by the value of the property, and not the basis of the property. That ruling also held that the open transaction concept of *Burnet* v. *Logan* applied, in part, to the sale of property in return for an annuity promise, which meant that the other 97 percent of the annuity payments first represented a return of basis in the property transferred and thereafter were capital gain until the fair market value of the property at the time of transfer was fully recovered. Thereafter the entire annuity payments were taxed as ordinary income. Revenue Ruling 69-74 was a major departure from this treatment of private annuities in two important respects. First, it reduced the investment in the contract from the value of the property to its basis. Second, it required that the gain inherent in the transferred property be recognized ratably over the period of the life expectancy of the annuitant rather than recognized only after the basis of the property had been fully recovered. Prior to the promulgation of Revenue Ruling 69-74, an unsuccessful attempt had been made to add a Section 1241 to the 1954 Code at the time that the 1954 Code was adopted, the effect of which would have been to close an annuity transaction such as this at the time of the transfer, causing the entire amount of the gain on the transfer to be recognized immediately. The legislative history conclusively shows that Congress, in rejecting the adoption of that section, considered that such treatment would be a dramatic departure from existing law, presumably referring to Revenue Ruling 239. It is interesting to note that as late as 1963, the Service was unsuccessfully attempting to secure legislation effecting a compromise between the open and closed transaction treatment of gain by means of the technique they eventually followed in Revenue Ruling 69-74. The Service's present position, reflected in Revenue Ruling 69-74, that the investment in the contract is the basis of the property and not its fair market value, is inconsistent with Treasury Regulations Section 1.1011-2(c), Example 8, which was adopted in October of 1972, three years after the promulgation of Revenue Ruling 69-74. This Regulation provides that, in the case of the transfer of property to a charitable beneficiary in return for a life annuity, the investment in the contract, under Section 72, is the fair market value of the property, rather than its adjusted basis.

Although there is substantial opinion that Revenue Ruling 69-74 is incorrect in measuring the investment in the contract by basis rather than fair market value of the transferred property, no litigation has tested this aspect of the Ruling in an unsecured private annuity situation, although language in *212 Corporation* seems to suggest fair market value is the proper measure.

The leading case dealing with Revenue Ruling 69-74 and its effect on the private annuity transaction area is *Estate of Lloyd Bell.* In the *Bell* case, the Tax Court essentially adopted the rationale of the ruling, except that it held that the entire amount of the gain realized on the transfer of appreciated property in return for a private annuity should be recognized at the time of the transaction. Thus, with respect to recognition of gain, it adopted the approach of the unsuccessfully proposed Section 1241. Arguably, the basis for the Tax Court's departure in this decision from Revenue Ruling 69-74 was that the private annuity in question was fully secured by the property transferred whereas the annuity in revenue Ruling 69-74 was unsecured. The *Bell* approach was followed in a recent case, *212 Corporation* v. *Commissioner,* 70 T.C. No. 77, which also involved a fully secured annuity promise.

In *Fehrs Finance Company* v. *Commissioner,* the Eighth Circuit affirmed and accepted the reasoning of the Tax Court, which distinguished the *Bell* case and held that a transfer of property in return for an unsecured private annuity did not cause the entire realized gain to be recognized in the year of transfer. However, it is not clear from that opinion whether Revenue Ruling 69-74 which spreads the gain ratably over the life expectancy of the annuitant, or whether the open transaction doctrine which defers the gain until the full basis has been recovered, was considered the proper approach. The Court merely noted that the gain did not have to be reported in the year of the transfer due to the uncertainty of payment. However, by citing two earlier decisions, *J. Darsie Lloyd* and *Commissioner* v. *Kahn's Estate,* both of which had applied the open transaction doctrine, the Eighth Circuit seems to have reaffirmed the open transaction doctrine and rejected the position taken in Revenue Ruling 69-74.

Consequently, although the private annuity purchased with appreciated property offers potentially large advantages for income, estate and gift tax purposes, the present unsettled state of the law in this area, as a result of Revenue Ruling 69-74 and the *Bell* case, limits the desirability of using this device.

An interesting issue related to the question of when the gain on the transaction is to be recognized if it is not recognized entirely in the year of the transfer, is what happens if the annuitant, who has transferred the appreciated property, dies before the entire realized gain has been recognized. Neither Revenue Ruling 69-74 nor the cases deal with this question. If our taxpayer transferred his property worth $1 million to his two sons in return for a life annuity of $100,000 a year and then died four years later having received $400,000 in total annuity payments, the entire balance of the gain would never be recognized under either the open transaction doctrine or the ratable recovery rule of Revenue Ruling 69-74. The net effect would be that he would have effectively transferred property worth $1 million, paid at the outset a gift tax on approximately $240,000, and totally avoided tax on a substantial portion of the gain. However, the benefit of this avoidance of the gain may be mitigated somewhat by the Service's approach to the basis of the property in the hands of the transferee (the obligor on the annuity) in Revenue Ruling 55-119. According to this Ruling, the transferee would receive a lower basis, reflective of the amount actually paid on the annuity, which would cause the unrecognized gain to be taxed eventually to the transferee when he makes a disposition of the property.

The second intra-family transfer to be considered is the installment sale, the income tax consequences of which are governed by Section 453. Section 453 permits the taxpayer to elect to spread the gain realized on the disposition of certain kinds of property over the period of the installment payments, rather than having the full realized gain taxed in the year of the sale. In our hypothetical situation, the use of a Section 453 installment election offers several distinct tax benefits. It permits the present transfer of the assets for full consideration, thereby eliminating any possibility that the asset itself will be included in the estate of the transferor, even if he dies within three years of the date of the transfer. It also keeps the asset within the family group while permitting the original owner to liquidate his investment to obtain retirement funds or funds to be expended during the transferor's lifetime for any other purpose. It provides the transferee with a stepped-up basis equal to the full purchase price, but does not require that the transferee pay the full purchase price immediately. Instead, the installment sale permits the purchase price to be funded by future income from the property itself, if it is income producing property. Of course, one of the major advantages, from an income and estate tax savings perspective, is that both the future income and the future appreciation in value of the property are shifted from the transferor who is likely to be in a relatively high income tax bracket to the transferee who is likely to be in a relatively low income tax bracket.

An important concern with installment sales of property is the need to structure the transaction in such a way that it will clearly qualify as an installment sale under Section 453. Obviously, if the stock is to be sold directly to another family member, no particular problems would exist in qualifying for an installment sale, although the transferor would then have to rely on the family member's ability to pay the installments. However, one situation where this can be a problem is when the asset to be disposed of is stock, when that stock is to be redeemed by the corporation or the corporation is to be liquidated. This would commonly occur when an individual who is a principal in a family corporation is about to retire and his interest is to be liquidated so that control of the corporation can pass to other family members. With a stock redemption or liquidation, however, there is no possibility of electing Section 453 treatment because the redemption or liquidation will not create installment payments. To qualify for a redemption or liquidation, and at the same time obtain the benefit of the installment gain reporting election, attempts have been made to interpose an artificial intermediary between the original owner of the property and the corporation. A successful example of this is found in the Fifth Circuit's decision in the *Rushing* case in which the two shareholders of a corporation decided to sell all the assets of the corporation and then to liquidate it. Because a sale of all of the assets followed by a complete liquidation of the corporation would result in capital gains to the two shareholders which could not be deferred on the installment basis, they created two irrevocable trusts just before the end of the 12-month sale period of Section 337 and sold their stock to these trusts on the installment basis. The independent trustee of these trusts paid for the stock with a small down payment and secured the payment of future installments by the trusts assets, including the stock. Then the trustee, as the sole shareholder, completed the liquidation of the corporation without, of course, having to recognize additional gain. The Service attempted to argue that the effect of the transaction was a liquidation by the two individual shareholders followed by their contribution of the net proceeds to the trusts. Under this approach, the shareholders would each have been forced to recognize one-half of the total gain in the year of the sale. The Fifth Circuit upheld the installment gain election because the corporate trustee was totally independent, and, therefore, the two individual taxpayers did not have any control over the proceeds of the liquidation or the decision whether or not to liquidate, nor did they receive any direct economic benefit from the proceeds of the liquidation.

Although, on the authority of *Rushing,* the use of this kind of device for the purpose of obtaining installment sale treatment should be successful, a number of decisions in a related area involving the interposition of an installment sale to a charitable organization between the seller and the ultimate purchaser who is unwilling to buy on an installment basis in which the Courts have reached the opposite conclusion, and the Service's announcement in Revenue Ruling 73-157 that it considered the *Rushing* decision to be incorrect, have caused use of the installment sale for intra-family transfers to often be limited to only the direct transfer situations. However, the Tax Court's recent decision in *William D. Pityo,* which reaffirmed the *Rushing* decision, has renewed interest in use of an intermediary to structure an installment transaction where the intermediary otherwise would not be necessary. Although it did not deal with the liquidation of a corporation, the essential facts of the transaction in *Pityo* were otherwise very similar to the facts in *Rushing*. The taxpayer owned a substantial block of publicly traded stock, which represented over 90 percent of his total wealth. To overcome a serious liquidity problem and, at the same time, to minimize his immediate income tax liability for the capital gains which would be realized on the sale of the stock, the taxpayer created several irrevocable trusts with other property and named a bank as trustee of all of them. He then sold his stock to the trusts in return for long-term installment notes. The trustee almost immediately thereafter sold a substantial block of the stock outright. Mr. Pityo elected Section 453 treatment for his sale to the trust. The Service disallowed that election on the ground that the trustee's sale of the stock shortly after Mr. Pityo's transfer to the trust should be attributed to Mr. Pityo. If the trustee's sale of the stock were attributed to him, then the proceeds he would have been treated as having received in the year of the transaction, including the trust's sale proceeds, would have exceeded 30 percent of the installment sale price and barred a Section 453 election. Applying the *Rushing* rationale, the Court concluded that the taxpayer had neither control over, nor received economic benefit from, the sale of the stock by the trustee. Again, major emphasis was placed on the trustee's independence in deciding whether or not to sell the stock and how the sale proceeds should be used.

There is still some uncertainty about when the courts would recognize that a true *Rushing*-type situation had been created rather than a "sham" intermediary set up merely for the purpose of qualifying the sale for installment treatment. In both *Rushing* and *Pityo*, it was considered important that the trusts had some assets prior to its entering into the installment sale, other than those sold it on an installment basis. Obviously, serious consideration should be given to structuring a *Rushing*-type installment sale transaction in an appropriate case, particularly if the taxpayer resides within the jurisdiction of the Fifth Circuit.

Comparing an installment sale with a transfer in exchange for a private annuity, the installment sale has a similar economic effect to a sale for a joint and survivor annuity, although it eliminates the potential immediate recognition of gain that could result from use of the private annuity transaction under the rationale of *Bell's Estate* and *212 Corporation*, at least where the annuity is secured by the property transferred. Securing the installment sale notes by the property transferred does not defeat the installment election. On the other hand, the estate tax advantages of the private annuity may be greater than those than can be obtained by use of the installment sale. While nothing would be included in the estate of the annuitant if there is no survivor annuity and if the annuity payments have been spent as they have been received, the present value of the right to receive future installments is an asset in the estate of the installment transferor and the actual post-death installment payments would be income in respect of a decedent.

Something that has been seldom tried but has been successful has been to combine the income tax benefits of the installment sale with the estate tax benefits of the private annuity. This is done by structuring a proper installment sale which qualifies for Section 453 treatment and then providing that any installments remaining due at the death of the transferor are to be forgiven, as in *Ruby Louise Cain*, 37 T.C. 185 (1961), *acq*. 1962-2 C.B. 4. The transferor receives the estate tax benefit of a private life annuity because nothing is included in his estate if he dies before all payments are made. Yet he avoids the confusion that currently exists with regard to the income tax consequences of the private annuity transaction. This kind of transaction apparently provides the best of both worlds—something that always makes tax lawyers nervous! It should be noted that the *Cain* case did not deal with the potential problem that the "forgiveness of payments which would be owned after death" could cause price itself for sale to be uncertain.

The third and final intrafamily transfer method to be considered is the one which seems to be generating the most current litigation: the transfer-leaseback transaction. A transfer of property followed by a leaseback of that same property to the transferor is designed almost entirely to take advantage of potential income tax savings. The income tax benefit intended to be accomplished is the diversion of a portion of the transferor's income to the transferee, who is usually in a lower income tax bracket.

This diversion is accomplished by an income tax rental deduction under Section 162(a)(3), which allows a business deduction for rental payments required to be made as a condition to the continued use or possession of property to which the taxpayer has not taken or is not taking title or in which he has no equity. The current transfer-leaseback controversy revolves around the leaseback of property used in his trade or business to the transferor after he has transferred that property either to a trust established primarily to receive it or to another family member. The Service has attacked these transfer-leaseback transactions as shams motivated entirely by tax avoidance and has sought to disallow the deduction for rent on a variety of theories. When the Service has been successful in having the rent deduction disallowed, the continuing payments required under the lease could be treated as a series of gifts to the transferee. Disallowance of the rent deduction would have no effect on the original transfer which, if it had been by gift may have caused gift tax, and if it had been by sale, may have caused income tax on the recognized gain. If, in our hypothetical situation, the land and building are transferred to the taxpayer's sons by gift, the taxpayer would incur substantial gift taxes of roughly $200,000 assuming that there had been no prior gifts and no gift splitting-election. I am also assuming, somewhat unrealistically, that he is willing to transfer such a major asset and incur a large gift tax now. If the land and building were sold to the sons either outright, through financing arranged by the sons who would use the property as collateral, or through an installment sale, a gain of $600,000 will be recognized by our taxpayer. Then, if the lease is entered into with the sons at the assumed fair rental value of $5,000 a month, our taxpayer would obtain an income tax deduction of $60,000 a year which would shelter other income and reduce his tax liability proportionately, depending upon his marginal income tax rate. Assuming his sons are in a lower effective rate bracket, overall family tax savings will result from diverting $60,000 of income to them annually. However, if the deduction is disallowed, the gift tax or the capital gains tax will have been incurred and cannot be undone and the $60,000 annual payments will continue to go to the sons during the period of the lease and would be treated either as income to them, although the taxpayer would receive no deduction, or more likely, as additional gifts from the taxpayer. If the transaction were then reversed by reconveyance to the taxpayer, the sons would each incur gift tax if the retransfer were by gift. If the retransfer were accomplished by sale, no additional tax should result unless the property had increased in value between the time when the sons received it and retransferred it. Although the transfer-leaseback arrangement has been used by taxpayers for a considerable period of time, the current controversy over these transactions can be traced to the 1948 decision in *Skemp* v. *Commissioner*, which was quickly followed by *Brown* v. *Commissioner*. In each of these cases a doctor-transferor placed his medical building in an irrevocable trust for a fixed term and simultaneously executed a lease with the trustee, the terms of which were substantially similar to the relevent terms of the trust. The Service disallowed the rent deduction on the ground that the rent was not "required", but in each case, the Service's position was reversed on the basis that the transferor was legally bound by the lease agreement to make the rent payments and the independent trustee was legally bound to collect those payments, despite the voluntary creation of both the trust and the rental obligation. However, in *Van Zandt* v. *Commissioner*, the Fifth Circuit later refused to allow the rent deduction when a doctor had created a Clifford Trust for a term of ten years and two months, named himself as trustee, retained a reversion in the property and set up the lease arrangement in such a way that, as trustee, he had no function other than to collect the rent for the benefit of the trust beneficiaries. The Court concluded that there was no business purpose for the transaction as a whole and that the transaction was structured solely because of tax avoidance motives and therefore, it disallowed the claimed rent deduction. Immediately following the *Van Zandt* decision, a rent deduction was allowed in *Alden B. Oakes* where an independent trustee was named in a transfer-leaseback transaction otherwise very similar to the transaction in *Van Zandt*.

Following these cases, the two crucial factors which the courts considered in determining the validity of rent deductions following a transfer-leaseback were the independence of the transferee and the existence of a reversionary interest in the transferor. More recently, however, as a result of *Perry v. U.S.* in which the Fourth Circuit refused to allow a rent deduction to a doctor who had transferred his medical building to a bank as trustee of a Clifford Trust in which the transferor had retained a reversionary interest, the critical factors have become less clear. The disallowance of the rent deduction in *Perry* was based solely on the ground that no business purpose had been shown for the entire transaction. According to the Fourth Circuit, the independence of the trustee was not crucial, because the entire transaction lacked business purpose. The Court did not specifically consider whether the existence of a reversion in the transferor was itself a prohibited "equity" in the transferred property, which would also have required disallowance of the rent deduction. Then, in the *Matthews* case, the Fifth Circuit disallowed a rent deduction, in a situation similar to *Perry*, on the somewhat different ground that the transaction, as a whole, lacked "economic reality". It would appear that "economic reality" and "business purpose" are phrases describing essentially the same test. However, a "business purpose" without "economic reality" will not satisfy the *Matthews* standard. The Fifth Circuit in *Matthews* also noted that independence of the trustee could not, by itself, supply "economic reality".

As a result of the *Perry* and *Matthews* decisions, the general guidelines that had been relied upon in the transfer-leaseback area, particularly where a trust is used, have become less definite. A business purpose for the lease itself and independence of the trustee, previously thought to be the crucial factors, have definitely become less important and, at least in the Fifth Circuit, probably nothing more than threshold considerations. The economic reality of the transaction or the business purpose for the entire transaction, which are apparently the important factors now, are virtually impossible to define with any degree of precision. Finally, it is not clear whether a reversionary interest in the transferor will disqualify the rent deduction because the transferor has retained an equity interest in the transferred property.

The decisions since *Perry* and *Matthews* have done very little to clear up the confusion in this area. Thus, for example, in *Richard A. Serbousek*, the Tax Court rejected the Service's attempt to apply the *Matthews* "economic reality" test to the transfer of a medical building by two doctors to an independent trustee of a trust in which they did not retain any reversionary interest. The medical building was leased back on the day following the transfer in a "negotiated" lease with the trustee. Rather than follow the appellate decision in *Matthews*, the Tax Court turned to its own *Matthews* decision, which had set out four tests the Tax Court considered determinative on the issue of the bona fides of the lease agreement. Those tests were: (1) whether the transferor had retained substantially the same control over the property after the transfer as before the transfer, a test which is easily satisfied, if a trust is used, by the independence of the trustee and the fact that the trustee has fiduciary duties; (2) whether the leaseback was in writing and required a reasonable rental, a requirement has been met in virtually every transfer-leaseback case; (3) whether the leaseback itself had a business purpose, as distinguished from whether there was a business purpose for the entire transaction, a test which is nearly always satisfied by the fact that the property transferred is an integral part of the business of the transferor; and (4) whether the taxpayer had a disqualifying equity in the transferred property. Considering the *Serbousek* case in light of these requirements, the Tax Court upheld the claimed rental deduction on facts virtually identical to those presented in *Matthews*. Again in *Richard R. Quinlivan,* the Tax Court applied the four tests set out in its own *Matthews* decision and upheld a rental deduction. In particular the Court again concluded that the business purpose test was satisfied if there was a business purpose for the lease itself without regard to whether there was a business purpose for the transfer-leaseback transaction as a whole. The most interesting aspect of *Quinlivan,* and one which has generally been overlooked, relates to the Court's handling of the transferor's reversionary interest in the trust in light of the fourth factor: whether the taxpayer has a disqualifying equity interest. On this issue, the Court made the following cryptic comment:

> With respect to the fourth requirement in *Matthews* we cannot agree with respondent's contention that petitioners possessed an equitable interest or "equity" in the realty within the meaning of section 162(a)(3). Briefly stated, petitioners' reversionary interest was not derived from the lease or the lessor and would only become possessory after the termination of the trusts. Therefore, such interest is not within the prohibition of section 162(a)(3).

The recent Supreme Court decision in *Frank Lyon Company* v. *U.S.*, has not by itself had any clear effect on the intra-family transfer-leaseback area. *Lyon* involved a three party commercial transfer-leaseback. The Court upheld the leaseback arrangement in view of the independence of the parties involved, the assumption of the risk by the taxpayer holding the property, and the substantial business reasons for the transaction, concluding that the transaction was consistent with objective economic realities, a statement reminiscent of the Fifth Circuit decision in *Matthews*. However, the Court went on to note that, if the lessor retains "significant and genuine attributes of a lessor, then the lease form will govern for tax purposes". Since *Lyon* dealt with a commercial transaction and was clearly not based on the intra-family transfer-leaseback cases, its effect on that area is uncertain. Two subsequent decisions, both of which involve commercial, non-family transactions, have been of no further help. In *Preston W. Carroll,* the Court relied on the economic reality test of the Fifth Circuit and expressly distinguished the intra-family transfer-leaseback cases as inapplicable to a commercial leaseback transaction. In *T. Wayne Davis,* the Court again found economic reality in a lease arrangement between related corporations in a case very similar to the facts of *Lyon,* without making any reference to the intra-family transfer-leaseback area.

Undoubtedly, the intra-family transfer-leaseback area will at some point be considered by the Supreme Court in order to resolve the somewhat conflicting views of the Tax Court, the Fifth Circuit, and the Fourth Circuit. In the meantime, the decision whether to use a transfer-leaseback and if so, how best to structure the transaction for minimum tax exposure must continue to be made by tax planners. At a minimum, the four Tax Court *Matthews* factors should be met. This would require that there be a business purpose for the lease, an independent trustee or other transferee, an attempt to set a fair rental value in the written lease and no retention of any interest in the property by the transferor. In addition, the lease portion of the transaction should not be prearranged and must be negotiated after the transfer.

## Conclusion

The uncertainties with regard to the tax consequences of all three of these arrangements (the private annuity, the installment sale, and the transfer-leaseback) raise the question why anyone would attempt to use one of these transactions or recommend its use by a client. However, there is sufficient guidance from the cases that have been decided with regard to all of these kinds of transactions to at least anticipate the maximum tax exposure, weigh the substantial benefits that may be gained by use of one or more of these transactions, and determine whether the risks involved are worth it for your particular client. Until such time as the law in these three areas becomes more certain, however, we should not be overquick to counsel a client to utilize these devices.