Rent Determination and Its Tax Treatment

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RENT DETERMINATION AND ITS TAX TREATMENT

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Payments between stockholders and corporations and by lessees to third persons, leases with options to buy and lease-back arrangements involve possibilities of tax avoidance. Professor Rusoff examines the relevance of the substance over form, step-transaction and business purpose doctrines to these and other situations.

The tax treatment of a number of situations depends on whether an item is rent or something else. Some of these situations involve possibilities of tax avoidance. Therefore, the writer will discuss the relevance of various doctrines, such as that preferring substance over form, the business purpose test, and the step-transaction doctrine, which appear commonly in discussions of tax avoidance. The doctrine preferring substance over form seems to be basic, since its point is merely that a transaction which appears to be of one type and to qualify for a particular type of tax treatment may in reality be something else. This doctrine has become commonplace; the difficult problem is deciding what is the real character of the transaction. It may or may not be the same as its form. The other doctrines should be employed to ascertain whether the form and substance of a given transaction are the same. The step-transaction doctrine may be applied, for example, to conclude that what is in form several transactions is in substance one, or vice versa. The business purpose test may be used to find that acts in the form of a reorganization are not such in substance.

The application of these doctrines is not simple. Some criteria are necessary to decide when they should be used. Generally, it appears that the step-transaction doctrine applies if, and only if, the parties would not have entered into the earlier steps without the later ones. The business purpose test is properly applicable where the language of the statute, or at least the aim behind the enactment of the statute,

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4. One writer concludes that no general principles run consistently through the tax avoidance decisions and that the only useful approach is to look for patterns in particular areas. Rice, Judicial Techniques in Combating Tax Avoidance, 51 Mich. L. Rev. 1021, 1051-52 (1953). The present writer suggests that it may still be useful to try to formulate general principles which the courts should follow.
makes a business purpose essential. Thus, it applies under the reorganization provisions because they were enacted to permit a change in the form of carrying on a business without tax liability.\(^6\) It should apply when the question is whether an expenditure involved a “business” expense.\(^7\) These situations may be contrasted with situations in which there is no manifest intent of Congress to limit a tax advantage to commercial transactions. For example, interest paid on a real debt seems properly deductible, regardless of the purpose of the transaction.\(^8\)

The writer does not maintain that reference to these approaches can make the decision of tax avoidance cases simple. Such cases call for a judgment as to what the parties to a transaction or Congress had in mind. One intangible involved is a tendency of the courts to construe an ambiguous statute against the taxpayer when his chief purpose was tax avoidance.\(^9\) When questions of fact are involved, courts use rules as to burden of proof to get judges or juries off the fence in doubtful cases; in the decision of a difficult question of law, a value judgment, such as a feeling that attempts at tax avoidance should be frustrated, is likely to be used for the same purpose. We seem to be dealing, ultimately, with attitudes as to how economic rewards should be distributed, or to what extent a citizen’s “take-home pay” should depend on the adaptability of his affairs to tax avoidance. In such a situation, reaching agreement is inevitably difficult.

I. PAYMENTS BY LESSEE TO THIRD PERSONS AS TAXABLE INCOME TO LESSOR

The problem of whether payments by a lessee to third persons is taxable income to the lessor arose largely in connection with long-term leases of property of railroads and telegraph companies made in the latter part of the nineteenth century. Many such leases provided that the lessee should pay the lessor’s taxes, interest on the bonds of the

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lessor, and certain amounts to the stockholders of the lessor. Some provided that the lessee should pay amounts due on the principal of a debt of the lessor secured by the leased property. The purpose of these provisions was to avoid office expenses, not taxes.  

Payments to Stockholders

In the light of the history of the interpretation of our income tax statutes, it now seems obvious that generally payments by a lessee to the stockholders of the lessor will and should be taxed to the lessor. A contrary result, if applied consistently, would permit corporations to divert various types of income, not merely rent, to stockholders, so as to avoid the corporate income tax. This possibility of avoidance was seen in early litigation dealing with the problem. It was held, moreover, under both the Corporation Tax Act of 1909 and the Income Tax Act of 1913, that such payments were includible in the income of the lessor. The courts thought that the payment was made for the use of the corporate property and to the stockholders because of their status as such. Consequently, the question of whether the lessee paid the money to the stockholders directly or only indirectly through the corporation was found to be only a matter of method, not substance.

Although this holding seems theoretically sound, it raised practical problems as to how the tax could be collected. The lessor was unlikely to have money to pay the tax. As will appear below, the courts found legal difficulties in the way of collecting the tax from the lessee or the stockholders of the lessor. The existence of these difficulties led to some doubt as to the soundness of the original decisions. Ultimately, however, the Supreme Court upheld those decisions.

Between the early and late decisions, there is an interesting change in arguments. At first, the taxpayers argued that these transactions involved an assignment of future rents from the lessor to its stockholders. This argument was rejected on the ground that the payments were to be

16. United States v. Western Union Tel. Co., 50 F.2d 102, 103 (2d Cir. 1931).
made to those persons who should be registered stockholders when the installments become due. When the problem finally reached the Supreme Court, *Lucas v. Earl* had been decided, and therefore it was argued for the Government that the transaction involved an anticipatory assignment of income, with the assignor remaining liable for the tax.

In connection with long-term leases of railroads, the lessee often bought enough of the stock of the lessor to gain control. This raised the problem of whether the lessor was taxable on amounts payable, under the lease, by the lessee to itself as a stockholder of the lessor. Although the lessee typically did not in form make such payments, the lessor was held taxable on the amounts that might have been paid. In a case involving the liability of a lessee-stockholder as a transferee of the lessor, the Second Circuit treated the obligation of the lessee as suspended in respect to those shares of the lessor which it held. Later, however, the same court distinguished that decision on the ground that it did not relate to the problem of the liability of the lessor.

There has been a district court decision that, if the lease provides that the lessee shall make no payments with respect to the stock of the lessor held by the lessee, no income is imputed to the lessor, except as to payments the lessee makes to other stockholders. The rationalization for this decision was that the provision which measured the rent payable by reference to the outstanding stock expressly excluded stock owned by the lessee. *Gold & Stock Tel. Co. v. Commissioner* was one of the leading cases taxing the lessor on amounts which the lessee did not pay with respect to stock of the lessor which it owned. The lease in that case did not expressly exclude such stock, and the court there had said, "Rent accrued to it [the lessee] as a stockholder of the cor-

20. By the time of the decision in United States v. Joliet & C.R.R., 315 U.S. 44 (1942), regulations supporting the tax had long been operative, and the Court made use of that fact. Id. at 47. Treas. Reg. 33, art. 50 (1914), was followed in Treas. Reg. 74, art. 70 (1928).
23. Western Union Tel. Co. v. Commissioner, 68 F.2d 16 (2d Cir. 1933), cert. denied, 292 U.S. 636 (1934).
poration and, whether it chose to pay it to itself or not, its rights were as truly worked out through the corporation as those of the other stockholders.27

On the basis of whether a right to payment exists in form, *Louisville, H. & St. L. Ry. v. United States*23 is consistent with the cases taxing the lessor on payments which the lessee failed to make to itself. It does seem curious that this difference in form should affect the substantive result. There is, however, other authority consistent with this result. The most similar case is *Reynard Corp.*29 There the Board of Tax Appeals held that, although a stockholder realized taxable income to the extent of the rental value of a residence which belonged to the corporation and which he occupied without rent, the corporation did not realize any income from the transaction. The same result appears to follow in the case of bargain sales by corporations to their stockholders. The bargain element may be a dividend to the stockholders,30 but the corporation does not realize income through the distribution of a dividend in kind, at least when it is not satisfying a dividend declared in terms of a fixed sum of money.31

In *58th St. Plaza Theatre, Inc.*,32 the Tax Court and the Court of Appeals for the Second Circuit held that a family corporation which sublet property to a stockholder at a low rental was taxable on income realized by the stockholder from operation of the property. The only advantage in the sublease was the possibility of avoiding taxes, especially the excess profits tax on the corporation. Both courts emphasized the lack of any business purpose for the transaction.

Although there seems to be ample authority for use of the business purpose doctrine in settling a question of allocation of income,33 it is difficult to accept here. We are not dealing with a statute which offers a tax advantage only to business transactions, either expressly or by implication. We are dealing simply with this question: whose income was it? The substance over form doctrine does seem properly applicable. If the sublease was flimsy in terms or was disregarded by the parties, the court might say it was a sham and therefore to be dis-

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27. Id. at 468.
28. 20 F. Supp. 483 (W.D. Ky. 1937), appeal dismissed per curiam, 97 F.2d 1017 (6th Cir. 1939).
29. 30 B.T.A. 451 (1934).
32. 16 T.C. 469 (1951), aff'd, 195 F.2d 724 (2d Cir.), cert. denied, 344 U.S. 320 (1952).
regarded, and the lack of a business purpose might raise suspicion that the lease was not real. Here, however, there was no express finding that the sublease was a sham, but merely a quotation in the Second Circuit's opinion listing a number of epithets, including that of "sham."

The situation is difficult. A court may justifiably suspect that, because of the relationship of the parties and the lack of a business purpose for their transaction, they will disregard its form whenever that is advantageous. Yet the transaction may look normal in form and there may be no evidence that the parties will not abide by it. If the court ignores the form of the transaction, it is in effect saying that the Government may disregard the form of any transaction entered by related parties without a business purpose. It seems that this position involves a broad general policy which should be adopted, if at all, by Congress and not by the courts. Because the question is one of allocation of income and might arise under varied types of facts, it may be more difficult to deal with by statute than other questions. For example, it may have been much easier to draft a statute denying a deduction for a loss incurred on a transaction between related parties, but, if the present problem is serious enough to demand action, perhaps a broadening of Section 482 of the Internal Revenue Code of 1954 would be satisfactory.

The fact that the 58th St. Plaza Theatre, Inc. case is more recent and of higher authority than the Louisville case may raise a question as to whether any reliance can still be placed on the earlier case. It seems, however, that the effect of the 58th St. Plaza Theatre case will probably be narrow, in respect to realization of income by the lessor. Even if the opinion is questionable, the atmosphere was bad for the taxpayer, because of the closely held character of the sublessor and the lack of business advantage in the sublease. Also, the general principle, as discussed above, is that a corporation does not realize income from the extension of a bargain to its shareholders. Hence, it is submitted that the Louisville case is reasonably reliable where there is a lease for a business purpose, with the lessee being one of the unrelated stockholders of the lessor.

It may be wise for the lessor and lessee to agree that the lessee shall make no payments in respect to stock of the lessor owned by the lessee. The difficulty is that even if the result of the Louisville case as to the lessor's tax liability is accepted, awkward tax problems may arise in respect to the lessee. There is authority for taxing a stockholder on the bargain element in purchases and leases from a corporation.

34. 195 F.2d at 725.
35. See note 32 supra and accompanying text.
36. Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942); V. U. Young, 5 T.C. 1251 (1945); Treas. Reg. § 1.301-1(j) (1955); Bittker, Federal Income Taxation of
The theory on which a shareholder is taxed on the bargain element in a lease is not so clear. As early as 1934, the Board of Tax Appeals took the position, in Charles A. Frueauf,23 that the shareholder was either receiving compensation for services or "income received from any source whatever."24 Reference to the quoted language was necessary in the Frueauf case because the stockholder rendered no substantial services to the corporation and the corporation apparently had no earnings. Therefore, the case could hardly involve either compensation for services or a dividend. In the Reynard case, the stockholder rendered services and was held to have received additional compensation to the extent of the rental value of the residence he used. There the court argued that taxability to the stockholder should not hinge on whether the corporation had earnings.

It might be best to treat the question partly as one of fact, so that the excess of rental value over rent paid will be compensation for services to the extent that such excess, plus other compensation, is not unreasonable for the services rendered. In other cases, the excess would be a dividend, to the extent of available earnings and profits. This is consistent with the present approach of the Internal Revenue Service.25 Earnings and profits seem to include only those available because of other corporate transactions, since generally a corporate lessor does not realize income on the making of a lease with a stockholder at a low rental.

Payments to Creditors

Payments by a lessee to creditors of the lessor, such as tax collectors or bondholders, have been taxed to the lessor. The principle is that payment to a creditor of a taxpayer in discharge of the taxpayer's obligation is the same as payment to the taxpayer.31

Corporations and Shareholders 135 (1959). Under Int. Rev. Code of 1954, § 301, and the related regulations, Treas. Reg. § 1.301-1(a)-(I), the amount taxed to a corporate stockholder is subject to special rules but the general principle remains.


38. Supra note 37, at 450.

39. Ibid.


So, payments by the lessee of interest to the lessor’s bondholders are taxable income to the lessor.\textsuperscript{42} Taxability to the lessor of such payments has not been litigated very seriously, because the lessor can balance the inclusion by a deduction for interest.\textsuperscript{43}

The same result has been reached when the lessee has paid the principal amount due on a debt of the lessor.\textsuperscript{44} The lessor has not been relieved of tax liability by the fact that he was not personally liable for the debt but merely holding property subject to it.\textsuperscript{45} The reason seems to be that a person owning property by which a debt is secured must, as a practical matter, treat the debt as his own, at least so long as the property is worth more than the amount of the debt.\textsuperscript{46}

Considerable litigation has arisen in cases in which the creditor of the lessor, paid by the lessee, has been the federal government. A motive to litigate has been supplied by the fact that the lessor cannot deduct its own federal taxes, in contrast with payments of interest to its creditors. It is now clear that the lessor realizes taxable income from the lessee’s payment of its federal income taxes.\textsuperscript{47} This result is based on the long-standing regulations and practice of the Treasury Department, as well as the authority of Old Colony Trust Co. v. Commissioner.\textsuperscript{48} Income is realized, not in the year for which the tax is assessed,\textsuperscript{49} but in the year in which the tax becomes due and is paid.\textsuperscript{50}

In resisting the asserted liability, taxpayers argued that their leases would require the lessee to pay the lessor’s tax on the amount of the initial tax payment made by the lessee, that therefore calculation of the lessor’s total tax liability would require the use of algebraic formulae.


\textsuperscript{43} Int. Rev. Code of 1954, § 163(a).


\textsuperscript{45} Ethel S. Amey, supra note 44.

\textsuperscript{46} For this approach see Crane v. Commissioner, 331 U.S. 1 (1947). The matter has been previously discussed by this writer. Rusoff, The Federal Income Tax Consequences of Transactions Relating to Mortgages on Land, 4 Buffalo L. Rev. 198 (1954).


\textsuperscript{48} 279 U.S. 716 (1929).

\textsuperscript{49} Norwich & W.R.R., 2 B.T.A. 215 (1925).

and that "algebraic formulae are not lightly to be imputed to legislators." The courts rejected this argument. In the cases being considered, the Government had not asserted any claim to a tax except upon the initial tax paid by the lessee. The Government had not required the use of any algebraic formulae. Furthermore, it was said that, if the use of such formulae became necessary, it would be due to the contract made by the lessor and lessee, not to the act of Congress.

Apparently, the Government continued its practice of claiming a tax only upon the initial tax paid by the lessee until 1952. Under that practice, no use of algebraic formulae was necessary. In 1952, however, the Government ruled that the total of the income taxes of the lessor paid by the lessee was taxable income of the lessor. Before the adoption of provisions for declaration of estimated tax and current payment of installments of such tax, this ruling would not have required the use of algebraic formulae. There would have been a pyramiding of the amount of the tax paid by the lessee, if the lease required the lessee to pay all of the income taxes of the lessor. The total would not, however, have been all taxable income of the lessor for one year. The initial tax would have been income for the year when it was due and payable; the tax on the initial tax would have been due and payable in the following year and therefore would have been income of the lessor for that later year. Since the adoption of the Internal Revenue Code of 1954, however, corporations whose tax for a year can reasonably be expected to exceed $100,000 are required to file declarations of estimated tax in respect to such excess and to pay such estimated tax in installments during the taxable year. For taxable years ending on or after December 31, 1959, one-half of such estimated tax has to be paid currently. In the case of a corporate lessor with enough income to be affected by these sections, computations beyond the scope of simple arithmetic would seem to be necessary to determine the tax to be paid.

That the tax of corporate lessors with annual income tax liability of over $100,000 would have to be computed by the use of higher mathematics doesn't seem distressing, since such firms must normally have their returns prepared by skilled accountants. A more serious objection

to the Government's ruling of 1952 is that it taxes the lessor beyond the benefit it receives from the provision that the lessee shall pay the lessor's income taxes. Such a provision does benefit the lessor, however, to the extent of the initial tax, which the lessor would otherwise have had to pay. Thus, it may be fair to treat that initial tax as taxable income of the lessor and subject to an additional tax. Apart from such a provision, however, the lessor would not have been liable for the additional tax, so that it would be more reasonable not to treat that additional tax as also being taxable income of the lessor.68

Construction of a lease to determine the extent of the lessee's duty to pay the lessor's taxes has also given rise to problems. The question of whether the lessee is obligated to pay income taxes of the lessor depends on the intention of the parties and thus upon the rulings of state courts in determining that intention.69 New York has held, for example, that a provision that the lessee should pay all taxes levied on the leased property or on the lessor "by reason of its ownership thereof" did not impose liability to pay the income taxes of the lessor.60 If the parties misjudge the liability of the lessee and it pays taxes of the lessor when there is no obligation to do so, those taxes are includible in the gross income of the lessor, under the doctrine of taxing amounts received under a claim of right.61

The 1954 Code provides limited relief when a lessee pays his lessor's income taxes. Section 110 provides that if a corporate lessee pays the federal income tax of a corporate lessor on the rentals, the payment is not includible in the gross income of the lessor.62 This section applies only if the lease was entered into before January 1, 1954, or was renewed or continued after that date pursuant to an option contained in a lease before that date. If the section applies, the lessee may not deduct any payments.

The motive for the adoption of section 110 was seemingly a desire to avoid unexpected hardship on the lessee. The Senate committee report stated that the lessee is required to pay not only the original tax of the lessor but also the tax on the first tax and so on in pyramidical fashion, with the result that the lessee sometimes pays more in taxes than its taxable income and thus realizes no tax benefit from its deduction for rent paid or accrued.63

II. COLLECTION OF TAXES ASSESSED AGAINST THE LESSOR BECAUSE OF PAYMENTS BY THE LESSEE TO OTHERS

The Government’s success in treating payments made to others by a lessee as income to the lessor would be empty if it could not collect taxes on such payments. Under the typical long-term lease raising this problem, the lessor has controlled no assets which it could use to pay the taxes. Presumably, its reversion is worthless. Thus, sale of the reversion would produce little or nothing for the Government. The problem, then, has been to reach the payments made by the lessee, in the hands of either the lessee or the recipients.

It appears that the Government first tried suing the lessee to impress a lien on amounts which the lessee was obligated to pay to the stockholders of the lessor. This effort failed. In 1931, the Second Circuit held that such an action could not be maintained. The court reasoned that the statute providing a lien for taxes did not apply to a debt and that the Government’s rights against the lessee were not greater than those of the lessor, it being unable to prevent the lessee from making payments directly to the stockholders of the lessor. The court also said that the provision rendering a fiduciary liable for debts due the United States from the person for whom he acts, if he pays any other debts before those due to the United States, creates no lien and does not apply to one who is a debtor rather than a fiduciary.

The next round of the struggle involved an attempt to assert transferee liability against the lessor’s stockholders under what is now section 6901(a)(1)(A)(i). In 1933, the Second Circuit decided this matter against the Government. The rationale of its decision was as follows: (1) The liability of a shareholder as a transferee is a matter of local law, since the statute purports only to provide a method of enforcing a liability existing under local law rather than to create a new liability. (2) Under local law, liability hinges on the existence of a transfer by one who is insolvent. (3) Here the transfer to the stockholders occurred in 1890, when the lease was made, either through an assignment of future rents or through the making of a third-party beneficiary contract. (4) There was no evidence that the lessor was insol-

65. United States v. Western Union Tel. Co., 50 F.2d 102 (2d Cir. 1931).
vent in 1890 and it had no liability in 1890 for the taxes involved in this litigation.\textsuperscript{70}

The turning point in the Government's struggle to collect the lessor's income taxes on payments made by the lessee to the shareholders of the lessor was \textit{United States v. Joliet & C.R.R.},\textsuperscript{71} which held a corporate lessor taxable on amounts paid by the lessee to both the Government and the stockholders. In \textit{United States v. Morris & E.R.R.}\textsuperscript{72} and \textit{United States v. Warren R.R.},\textsuperscript{73} the Court of Appeals for the Second Circuit interpreted this decision as based on the notion that the corporate lessor constructively receives the payments made by the lessee to the stockholders and, in effect, then transfers them to the stockholders as current annual dividends. The stockholders were considered to have derived their rights from their status as stockholders.

The Second Circuit further held in the \textit{Morris} and \textit{Warren} cases that there were two remedies available to the Government. It held that the lessee can be enjoined from making payments to the stockholders of the lessor until the United States has had an opportunity to levy thereon to satisfy the income tax liability of the lessor. It also held that the lessee can be ordered to pay to the District Director of Internal Revenue the amount levied on from time to time, which may be necessary to satisfy the liability of the lessor.\textsuperscript{74} Since the Second Circuit now took the position that the lessor constructively received the annual payments from the lessee and transferred them to its stockholders, it also treated each payment as a fraudulent conveyance which could be set aside in equity. Consequently, the lessor's stockholders could be reached as transferees, even under the earlier decisions that the liability of a transferee depends on state law.\textsuperscript{75} The remedy of injunction and collection from the lessee

\textsuperscript{70.} In this and the succeeding cases in the Second Circuit involving the problem of collecting the tax, Judge Learned Hand maintained that the corporate lessor and its stockholders are not distinct for the purposes of the current litigation, while his colleagues took the contrary view. Nevertheless, they agreed in the result.

\textsuperscript{71.} 315 U.S. 44 (1942).
\textsuperscript{72.} 135 F.2d 711 (2d Cir.), cert. denied, 320 U.S. 754 (1943).
\textsuperscript{73.} 127 F.2d 134 (2d Cir. 1942).
\textsuperscript{74.} In Warren, the court said that there can be a lien on a debt. Id. at 137-38.
\textsuperscript{75.} This result apparently will not be upset by the recent decisions on the liability of a beneficiary of an insurance policy for income taxes of the insured, as a transferee. United States v. Bess, 357 U.S. 51 (1958); Commissioner v. Stern, 357 U.S. 39 (1958). Those cases seem to hinge on variable local rules as to the rights of creditors of an insured to proceeds of his insurance and on facts showing whether the Government has established a lien during the lifetime of the decedent. Here, however, the lessor's stockholders are treated as transferees each year, as a matter of federal law. 9 Mertens, Federal Income Taxation § 53.41 n.32 (Zimet rev. 1958). The lessor has no assets, except the reversion, so that each payment to its stockholders would be a fraudulent transfer under principles generally accepted by state courts as to creditors' rights.
appears to be more fair, since in an action against a stockholder as a transferee the whole tax may be collected from less than all of the stockholders. Because of the possible hardship in an action against a transferee, a state court of New York also has held that the lessee may be ordered to pay the tax liability of the lessor before making any distribution to the stockholders of the lessor.\(^7\)

Under the 1954 Code, another procedure may be available to the Government. It has been suggested that the phrase "or obligated with respect to" in section 6332(a)\(^7\) imposes on a debtor the duty to pay the debt to the District Director on demand, without distraint and sale of the debt or an action to enforce a lien against the debt.\(^8\)

### III. WHETHER PAYMENTS BY A STOCKHOLDER ARE RENT OR CONTRIBUTIONS TO CAPITAL

When a stockholder uses corporate property and makes payments to the corporation, a question may arise as to whether the payments are rent or contributions to capital. Rent, of course, may be deductible by the stockholder and is includible in gross income by the corporation; contributions to capital are not deductible by the stockholder or taxable to the corporation.

There are different situations in which this problem can arise. If a lessee-stockholder pays an excessive rent to his corporation, the excess over a reasonable rent should be treated as a contribution to capital. The statute does not expressly limit the deduction for rent to a reasonable amount, but it permits the deduction only of "payments required to be made."\(^9\) The excess over a reasonable rental may be treated as not "required" and as amounting to something other than rent.\(^9\)

This question may also arise if stockholders use property of a corporation and make payments to the corporation which the corporation uses to retire its debt or preferred stock held by others. Such use of the payments increases the value of the interests of the stockholders in the corporation, which gives rise to an initial reaction that the payments should be treated as contributions to capital. That result, however, does not necessarily follow. Generally, the character of a payment is not determined by the use to which it is put by the payee. It is easy to

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78. 3 Rabkin & Johnson, Federal Income, Gift and Estate Taxation § 73.02(6) (1956).
conceive a case in which a stockholder makes a payment which is clearly an income item to the corporation, such as rent, payment for services rendered or the purchase price of goods sold. In such a case, it would make no difference that the corporation in fact used the payment to reduce its debts or to retire stock held by others. The opposite is also true, i.e., a payment by a stockholder may be a contribution to capital, although it is used to meet an operating expense of the corporation.\textsuperscript{81} Suppose the stockholder makes the payment pursuant to an agreement that the corporation will use the payment to retire its debt or stock held by others. Does the factor of prearrangement give more weight to the character of the use? In Paducah & Ill. R.R.,\textsuperscript{82} the Board of Tax Appeals treated such prearrangement as decisive and held that the payments so used were contributions to capital, not income to the corporation. In later cases involving such a factor, the Board reached a contrary conclusion.\textsuperscript{83}

So, the factor of prearranged use has not been treated as conclusive. What weight should it have? The answer to this question should be attempted in the light of another: What is the basic test of whether a payment is rent or a contribution to capital? Probably an appellate court would say that it is the intention of the parties. Such a test is said to govern in distinguishing a loan from a contribution to capital.\textsuperscript{84} Ascertaining the intent of the parties may be difficult, and a trial court may have to decide, not what they actually intended, but what reasonable and realistic persons in the same situation should have thought they were doing, had they considered the matter. The finding of fact and opinion of the trial court may be worded in terms of actual intent, but it is likely to be an intent constructed by the trial court on the basis of the actions of the parties, the objective manifestations of their intent. Thus, the court is not actually ascertaining intent but determining what the parties "really" did.\textsuperscript{85}

On the basis of this test of constructive intent, what is the significance of a prearranged agreement that the corporation is to retire its debt or preferred stock? If the stockholder has paid a reasonable rent for his use of the corporate facilities, any additional amount he pays to be used to retire corporate debt or stock held by others should probably be

\textsuperscript{81} See Rittenberg v. United States, 267 F.2d 605 (5th Cir. 1959), cert. denied, 361 U.S. 931 (1960).


\textsuperscript{83} Terminal Realty Corp., 32 B.T.A. 623, nonacq., XIV-2 Cum. Bull. 43 (1935); Nowland Realty Co., 18 B.T.A. 405 (1929), aff'd, 47 F.2d 1018 (7th Cir. 1931).

\textsuperscript{84} 2 Rabkin & Johnson, Federal Income, Estate and Gift Taxation \S 35.08(1) (1954).

\textsuperscript{85} An example of the process to which the writer refers may be found in the discussion of Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952), infra at 233.
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The issue of additional stock should be substantial evidence that the parties' actual intent was to make a contribution to capital; the lack of such an issue, however, may be neutral as to actual intent and therefore should not preclude a finding that a contribution to capital was made, at least if the payment to the corporation exceeded a reasonable rental for the property used. The regulations indicate that there can be a contribution to capital without an issue of additional stock.63

The Board has emphasized the parties' description of payments as rent.60 Their words are, of course, evidence of what they say their intention is, but they do not prove conclusively their actual intention. In the cases cited,69 the words used by the parties were relied on in imposing a burden on the taxpayer. This is consistent with the approach of Higgins v. Smith,70 where the Supreme Court indicated that the form adopted by a taxpayer may bind him more tightly than the Government. There, however, the Court was dealing with the form of business organization, not the mere use of a name for a payment. Also, there have been

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88. Treas. Reg. § 1.61-12(a) (1957); Treas. Reg. § 1.113-1 (1956).
90. See note 89 supra and accompanying text.
91. 303 U.S. 473, 477 (1940).
cases in which the label used by a taxpayer has been disregarded to his tax advantage. Thus, it seems that this is a minor factor.

A more significant factor should be whether the payments are apportioned to the stockholder’s use of the corporate facilities or to its ownership of stock. Oddly, however, in the two cases in which this factor might be found, the one in which payments were apportioned to use held that they were contributions to capital, and the one in which they were apportioned to stockholders treated them as rental income. These results seem directly contrary to the natural inference of intent. The conclusion seems to be that the Board has attached less importance to the apportionment of payments than to the issue of additional stock and the parties’ choice of language. This may have been proper when the payments were apportioned to use and additional stock was issued, as in Paducah & Ill. R.R., but it seems to have been wrong when the payments were apportioned to stockholdings and no additional stock was issued, as in Terminal Realty Corp., since the lack of an issue of additional stock seems to be at most a weak factor.

The cases dealing with the problem of whether a payment is rent or a contribution to capital do not seem, then, to make a rational pattern. The difficulty may arise from the fact that few cases have dealt with the problem, and this in turn may result from the double-edged nature of the situation. A tax advantage to the taxpayer or the commissioner is usually balanced by a tax disadvantage on the same side, so that the incentive to raise or litigate an issue in this area is relatively slight.

IV. WHETHER PAYMENTS BY A CORPORATION ARE RENT OR DIVIDENDS

The problem here arises from a situation which is the reverse of that discussed in the preceding section. A stockholder leases property to a corporation. The question is whether “rent” paid by the corporation is excessive and, in substance, partly a dividend, not deductible by the corporation. The courts have said that an excessive payment is neither

92. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939). In fact, in the first case dealing with the problem before us, the Board of Tax Appeals held that a payment received by the taxpayer was partly a contribution to capital, not includible in gross income, although it appeared that the amount in question, used for a sinking fund, might come from sums referred to as “rentals.” Paducah & Ill. R.R., 2 B.T.A. 1001, 1004-05 (1925), acq., V-1 Cum. Bull. 4 (1926). The reference was not prominent, and the Board, in later distinguishing this case, said that the payments had not been called rental. Terminal Realty Corp., 32 B.T.A. 623, 632, nonacq., XIV-2 Cum. Bull. 43 (1935).
97. For a discussion of this point see notes 86-88 supra and accompanying text.
an ordinary and necessary business expense nor an amount required to be paid as a condition to the continued use of the property. Consequently the principal question is one of fact as to whether the payment was excessive. In some cases, the lessor is not a stockholder but a friend or member of his family. A purpose of avoiding taxes is generally apparent in such cases, and the courts emphasize it in their opinions.

Here the business purpose doctrine seems appropriate, since the concepts used in section 162(a)(3) call for consideration of the taxpayer's motive. For example, a question arises as to whether an excessive expenditure made to avoid taxes is "ordinary" in the sense of being common among businessmen. If it is, it does not appear to be "necessary" or helpful to the business. Nor would it be "required," since the payer presumably could obtain the use of other facilities for a reasonable rent: the amount that would have to be paid for similar facilities in an arm's length transaction is strong evidence of whether a given rent is reasonable. Furthermore, the concepts "ordinary," "necessary" and "required" have an indefinite quality which facilitates giving weight to tax avoidance motives.

V. WHETHER A TRANSACTION IS A LEASE WITH OPTION TO BUY OR A SALE

Many cases deal with the question of whether a transaction constituted a lease with an option to buy or a sale. This question involves two tax problems. Has a taxpayer paid rentals, which he can deduct currently, or the purchase price of property, which he can deduct, if at all, through depreciation? Has a taxpayer received rentals, which are taxable as ordinary income, or proceeds from the sale of property, which are taxable as ordinary income, or proceeds from the sale of property,
which may be taxed only to the extent of his gain and perhaps only at capital gains rates?

Section 162(a)(3) of the Internal Revenue Code deals with the above question. It provides: "(a) In general.—There shall be allowed as a deduction . . . (3) rentals . . . of property to which the taxpayer has not taken or is not taking title or in which he has no equity." This language relates only to the deductions of the payer. The problem as to the payee's income is whether it is rental income, taxed at ordinary rates under section 61(a)(5), or gain from the sale of property, subject to sections 61(a)(2) or (3) as well as section 1001, and perhaps section 1201 and sections dealing with capital gains. Only section 162(a)(3) contains any express language helpful in distinguishing rental income from gain from the sale of property. Consequently, the cases rely on the issues raised under section 162(a)(3), whether the taxpayer is the payer or the payee, and they cite cases dealing with either party interchangeably.

The question that arises generally is whether a transaction which is in the form of a lease with an option to buy is in substance a sale. As usual, the cases indicate that substance governs rather than form, if they are not the same. One difficulty is that the form may receive some weight in the determination of the substance, but the courts have not agreed as to the amount of that weight. The Tax Court has said that the words used by the party have some significance but are not controlling. The Court of Appeals for the Ninth Circuit has stated that the fact the parties used the form and terminology of a lease is of no

108. Abramson v. United States, 133 F. Supp. 677 (S.D. Iowa 1955), has been cited as holding that the form of a lease governs. Friedman, Lease or Purchase of Equipment: Sale and Leaseback, N.Y.U. 14th Inst. on Fed. Tax. 1427, 1442 (Sellin ed. 1956). It is submitted, however, that Abramson, supra, merely held that nothing in the evidence showed that the substance of the transaction varied from its form.
The position of the Tax Court seems more sound. Since the courts always describe the form of the transaction in their findings of fact, they must be taking such into account in determining the intent of the parties. Probably, however, they give it little weight if the other facts belie it.

In this area, it seems proper to suspect that the substance of a transaction may be different from its form, and therefore little weight should be given to the form if such suspicion is right. A lease with an option to buy has tax advantages for the buyer not present in an ordinary purchase, so that the buyer has a strong incentive to cast a purchase in the form of a lease even though he expects to buy. For the seller, a lease with an option to buy may not be as desirable for tax purposes as a sale. Yet it seems that sellers frequently are willing to disguise a sale as a lease with an option to buy, in order to enable buyers to seek their own tax advantages. Cases exist in which there was no reasonable probability that the lessee-buyer would not exercise his option. With an option to buy, the parties are not accepting any of the disadvantages which go with a real lease. In such cases, it is submitted that the court should be free to apply the substance over form doctrine and treat the transaction as a sale.

Assuming that substance governs, what criteria determine the substance? Although the Tax Court at first said that the intention of the parties is decisive, it later said it did not matter. The Tax Court developed an “economic test,” which has been stated as follows:

Cases like this, where payments at the time they are made have dual potentialities, i.e., they may turn out to be payments of purchase price or rent for the use of property, have always been difficult to catalogue for income tax purposes. A fixed rule for guidance of taxpayers and the Commissioner is highly desirable, and it is also desirable that the rule, whatever it is, be as fair as possible, both to the tax-

111. Haggard v. Commissioner, 241 F.2d 283, 289 (9th Cir. 1956).
112. The buyer will want the price divided into high rental payments and a low option price. If the form of the transaction is not attacked successfully, he will be able to deduct the rentals currently and from ordinary income. In return for this present advantage, he will have to accept later disadvantages, such as lower deductions for depreciation, based on the low option price, and a larger gain on resale. The sting of these disadvantages may not be great, for they are delayed. The property may only have been partly depreciable, however, or not at all, and the gain on resale may be capital.
113. Rent is ordinary income to him, whereas gain on an outright sale might be capital. On the other hand, until the option is exercised, a lessor-seller may deduct depreciation, if the property is depreciable in his hands, and, if he is a dealer, his gain on a sale would be ordinary income. If the option price is low in relation to the seller’s basis, he may have an ordinary loss on the sale, even though his gain, if any, might have been capital under Int. Rev. Code of 1954, § 1231.
payers and the tax collector. If payments are large enough to exceed the depreciation and value of the property and thus give the payer an equity in the property, it is less of a distortion of income to regard the payments as purchase price and allow depreciation on the property than to offset the entire payment against the income of one year. The notion that the payer is obtaining an equity in the property and hence may not deduct his payments, if they exceed "depreciation and value of the property," has been frequently used by the Tax Court. The quoted phrase has never been explained by the Tax Court, and its meaning is hopelessly obscure.

The phrase "depreciation and value" has been given four interpretations: (1) Depreciation in value; (2) depreciation and rental value; (3) original value less depreciation; and (4) depreciation and remaining property value. The mere existence of these various interpretations casts doubt on the value of the phrase, and reflection increases that doubt.

The weakness of the first and second interpretations appears if we consider that under a clearly genuine lease the lessor should receive rent exceeding his depreciation. Although one who already owns property may have to accept rent which is less than depreciation, a businessman making a new investment in rental property would be foolish to buy property with a rental value less than its depreciation. Therefore, the first interpretation falls. The second seems irrelevant, since depreciation should be included within rental value; there seems to be no purpose in thinking of depreciation as something to be added to rental value.

To test the third interpretation, figures are necessary. If a $20,000 house with a fifty-year estimated useful life were built on a $2,000 lot, the depreciated value of the property at the end of twenty years, on a straight-line basis, would be $14,000. If the house were rented for $125 a month, the total rent over twenty years would be $30,000, which is substantially greater than the original value less depreciation. It is clear that the rent would have to be $220 a month to make the property attractive as a new, voluntary investment. In twenty years, such rent would total

119. Oesterreich v. Commissioner, 226 F.2d 798, 803 (9th Cir. 1955).
121. For a consideration of whether rental value may be used in some other way in distinguishing between leases and sales, see note 124 infra and accompanying text.
$52,800. For twenty years' rent to total just $14,000, the monthly rent would be $58.33. It is arguable that the figures based on a monthly rent of $125 or more do not show the weakness of the third interpretation, on the ground that most tenants of homes would not sign a twenty-year lease at such rent. It is submitted, however, that many tenants would eagerly sign a twenty-year lease for the hypothetical house at a rent of more than $58.33 a month. Thus, it seems clear that the third interpretation is unsound.

The fourth interpretation is more plausible. Assuming that there is no change in market values, depreciation and remaining property value would be the same as the original cost, $22,000. Monthly rent of $125 for twenty years would total $30,000, but it is arguable that the average tenant of a home does not sign a long-term lease and would not sign a twenty-year lease for such rent. The rent would have to exceed $91.67 a month to total more, in twenty years, than $22,000. A question arises as to whether a tenant would sign a twenty-year lease at a higher rental. Perhaps he wouldn't, but several factors should be remembered. The concern here has been with a return to the landlord which would not induce a person to invest in rental realty. At a more adequate return of one per cent a month, or $220, the total rent for twenty years would be $52,800, an amount far exceeding the original cost. Why would a tenant agree to pay more in rent than the sum for which he could purchase the property? He might do so to make his financial statements look more favorable than if he had purchased subject to a mortgage, to keep the assets that would be necessary for a down payment on a purchase available for another use, to obtain the use of a particular site which is not for sale, or to avoid the problems, risks and expenses inherent in ownership. Also, he may lack cash for a down payment. Therefore, it seems at least doubtful that there is any help in the phrase "depreciation and value" even under the fourth interpretation.

If that phrase is not helpful in applying the economic test, what factors should govern under such a test? It is submitted that the decisive factor is the relationship between the option price and the fair market value of the property as of the time for exercise of the option. A court probably would respect the amount at which the parties might reasonably have estimated such value when they made their agreement. If the option price is unreasonably below the value of the property, as so estimated,

122. This factor may be of less significance than before, as it appears that accountants are tending to insert in a balance sheet a footnote showing liability under a lease. Comment, 66 Yale L.J. 751, 760 (1957).
it seems obvious that the parties expected the "lessee" to exercise it and that the transaction should be treated as a sale.

Payment of rent in excess of rental value has been emphasized.\footnote{124} This appears secondary to the relationship between the option price and the value of the property, for, if the option price is high, the fact that the rent also is high creates no certainty that the "lessee" really intends to buy. A high rent may, however, warn that the option price is probably below the value of the property; typically, when a sale is disguised as a lease with an option to buy, the rent is high and the option price is low.\footnote{125} The "lessee" does not want to pay an amount exceeding the value of the property, and the "lessor" does not want to accept less. Thus, when there is evidence that the rent is abnormally high, the court should test whether the option price is correspondingly low.

Other economic factors which tend to show that a transaction is a sale rather than a lease are inclusion of interest on the unpaid balance in the "rentals,\footnote{126} inclusion of interest in the option price,\footnote{127} credit of rentals against the purchase price,\footnote{128} passage of title, without further payment, on the payment of certain rentals,\footnote{129} payment of insurance premiums by the "lessee,\footnote{130} and deduction of depreciation by the "lessee."\footnote{131}
The economic test developed by the Tax Court was rejected by the Court of Appeals for the Fifth Circuit in *Benton v. Commissioner*.* The court stated that, instead, a “legal” test, based on the intention of the parties, should be used. The Tax Court, in addition to discussing the economic factors, had stated that the parties intended to effect a sale, but it made this statement only in its opinion, without finding such intent as a fact.*

The principle of the *Benton* decision seems undesirable. Determining actual intent is difficult, and requiring trial courts to do it is generally thought to cause confusion and increased litigation. Because of the opportunity for tax avoidance in this area, the form of instruments and the statements of the parties are poor evidence of actual intention. This is a business transaction, and therefore the economic factors are likely to be the most reliable guide to the intention of the parties. If intention is found from such factors, any such finding is likely to be a formality and the *Benton* rule will not have much effect on the decisions.

The reversal of the Tax Court’s decision in the *Benton* case seems to have had largely a formal effect on its later decisions. It has denied deductibility to purported payments of rent in seven cases.* It has decided four cases in favor of the deduction,* but only one was a good case for the Government.* Before the *Benton* decision, the Tax Court did not make express findings of fact as to the parties’ intention. Now it tends to do so.* It seems, however, that the finding is a formality, the basis of which is the economic factors. The following language from a Tax Court opinion should be noted:

133. Even with reference to the economic test, *Benton*, supra note 132, was not a very good case for the Government, because the option price, although below the value of the property when the agreement was made, was not nominal. Further, a drop in value might reasonably have been expected.
135. *Benton*, supra note 132, was not a very good case for the Government, because the option price, although below the value of the property when the agreement was made, was not nominal. Further, a drop in value might reasonably have been expected.
136. *Benton*, supra note 132, was not a very good case for the Government, because the option price, although below the value of the property when the agreement was made, was not nominal. Further, a drop in value might reasonably have been expected.
137. *Benton*, supra note 132, was not a very good case for the Government, because the option price, although below the value of the property when the agreement was made, was not nominal. Further, a drop in value might reasonably have been expected.
Upon consideration of all of the evidence, it is concluded that it was the intention of the parties to the so-called lease agreements ... that the petitioner would acquire an equity ... as the result of making each so-called rental payment, and that petitioner did acquire an equity in each item.

In Benton v. Commissioner ... and in Breece Veneer and Panel Co. v. Commissioner ... the courts took the view that it was error on the part of this Court to give considerable weight to a "purely objective economic test" in determining whether a particular transaction constituted a sale or a lease. In this case, after careful consideration of the entire record and of all of the factors, including the so-called economic factor, we are unable to sustain petitioner's contention that the agreements in question were intended to be, and were in fact, leases.188

The careful and elaborate character of this statement suggests that it was drafted primarily to prevent a reversal.

Most of the appeals in this area have gone to the Court of Appeals for the Ninth Circuit. It has four times denied deductibility of purported rentals139 and twice has held that the "lessor" was entitled to capital gains treatment.140 In all these cases, it has held that a transaction in the form of a lease was really a sale.

The Court of Appeals for the Ninth Circuit purports to follow a test of intention, but it seems to determine intention from economic factors.141 It has cited as authority both the Benton case,142 which rejected the economic test, and the Judson Mills143 and Chicago Stoker Corp.144 decisions, in which the Tax Court developed the economic test.145

This interpretation of the approach of the Ninth Circuit seems supported by a statement of a district court within its jurisdiction. In Elliot v. Robinson,146 a lessor-taxpayer was allowed to treat receipts under a transaction in the form of a lease as the proceeds of a sale. The court said that "the greater weight of authority seems to hold that the parties here intended to enter into an agreement for the sale of the property described therein."147 This statement would be inappropriate

138. Western Contracting Corp., supra note 137, at 384.
139. Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959); Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958); Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956); Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955). In Oesterreich v. Commissioner, supra, both the "lessor" and the "lessee" were parties, so that the denial of deductibility to the "lessee" meant extension of the benefit of capital gain treatment to the "lessor."
140. Robinson v. Elliot, 262 F.2d 383 (9th Cir. 1958); Oesterreich v. Commissioner, supra note 139.
142. 197 F.2d 745 (5th Cir. 1952).
144. 14 T.C. 441 (1950).
145. Oesterreich v. Commissioner, 226 F.2d 798, 801, 802-03 (9th Cir. 1955).
146. 57-2 U.S. Tax Cas. 58063 (D. Mont. 1957), aff'd, 262 F.2d 383 (9th Cir. 1958).
147. Id. at 58065.
if the court were primarily concerned with the subjective, actual intent of the parties.

In discussing the proper test, the Ninth Circuit said:

It seems well settled that calling such a transaction a "lease" does not make it such, if in fact it is something else. To determine just what it is the courts will look to see what the parties intended it to be. The test should not be what the parties call the transaction nor even what they may mistakenly believe to be the name of such transaction. What the parties believe the legal effect of such a transaction to be should be the criterion. If the parties enter into a transaction which they honestly believe to be a lease but which in actuality has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it nor how they treat it on their books. We must look, therefore, to the intent of the parties in terms of what they intended to happen.

The italicized statements above are inconsistent. What the parties intend to be the legal effect of their transaction and what they expect to do may be entirely different. Legally, a "lessee" may be free to exercise an option to buy or not, but the rentals and option price may be so rigged that he cannot afford not to buy. In such a case, the transaction ought to be treated as a sale. Hence, the second test seems to be more sound.

In addition to the Fifth and Ninth Circuits, only two courts of appeals have passed on this question. The Seventh Circuit, in Breece Vence & Panel Co. v. Commissioner, allowed the taxpayer to deduct purported rentals. There the payments were not more than a fair rental, the option price was substantial, and some decline in value might have been expected. The court cited Benton for the proposition that the economic test is only one factor bearing on the intention of the parties, but it was careful to point out that this case might be distinguished from other cases on the basis of that test. In Western Contracting Corp. v. Commissioner, the Court of Appeals for the Eighth Circuit allowed the deduction where there was no express option to buy. There it was customary in the particular industry to give a lessee the privilege of buying, but there was no evidence that the lessee knew of the custom nor any showing that the custom had become an implied term of the contract.

148. Oesterreich v. Commissioner, 226 F.2d 798, 801-02 (9th Cir. 1955). (Emphasis added.)
149. 232 F.2d 319 (7th Cir. 1956).
150. Id. at 323.
151. 271 F.2d 694 (8th Cir. 1959).
152. Id. at 701. The court cited, apparently with approval, Abramson v. United States, 133 F. Supp. 677 (S.D. Iowa 1955), but in effect seems to have overruled it. In Abramson, supra, the taxpayer-lessee bought equipment from its lessor, without any prior agreement giving it an option, and was given credit against the purchase price for rentals already paid. The district court disallowed deduction of rentals so credited, although it found that the lessee had no equity or title in the property when it paid the rentals and spoke with
Perhaps there is less conflict between the Ninth Circuit and the Fifth and Seventh Circuits than may appear. Where the option price was substantial but below the fair market value of the property, the Ninth Circuit has twice denied deductibility of rent.\textsuperscript{153} The Fifth\textsuperscript{154} and Seventh Circuits\textsuperscript{155} have allowed the deduction in such cases. The difference may be in the fact that the cases before the Ninth Circuit involved ranch or farm land, while the Benton case in the Fifth Circuit concerned a taxi business and Breece, in the Seventh Circuit, a factory. If the transaction is concerned with personality or improvements to realty, there is a greater chance that the parties reasonably expected the value of the property to drop by the time for exercise of the option. In such a case, they can plausibly argue that the option price, without the rents, was intended as the purchase price of the property. This emphasizes the point that, when the economic factors are being considered, the market value of the property should be considered on the basis of what the parties, when they made their agreement, might reasonably have expected it to be at the time for exercise of the option. If, in this light, the option price appears nominal, the parties should not expect any court of appeals to accept the form of their agreement as decisive.

It has been thought that greater certainty and fairness might be achieved if some leases with options to buy were treated as involving both sales and leases.\textsuperscript{156} A purported lease with an option to buy would be treated as a sale if title may pass without payment of a substantial option price. If title will pass only on payment of such a price, the transaction would be treated as both a sale and lease, with the purported rent treated as rent to the extent of the fair rental value of the property and the excess treated as part payment on the purchase price of the property. One writer has suggested that the lessor be treated as realizing gain or loss when the option is exercised or when the excess over rental value received exceeds his basis.\textsuperscript{157} To avoid the problem of whether to treat the lessor's income as ordinary income or capital gain if he has disfavor of the Government's attempt to relate the status of the parties at the time of the sale back to the time of the making of the lease. In conjunction with this case, see Earl L. Lester, 32 T.C. 711 (1959), where the taxpayer-lessee, under a lease with an option to buy, was held to receive ordinary income in respect to rent paid before exercise of the option price but credited toward that price.

\textsuperscript{153} Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958); Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956).

\textsuperscript{154} Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952).

\textsuperscript{155} Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956).


\textsuperscript{157} Johnson, op. cit. supra note 156, at 96.
received amounts in excess of his basis, it is suggested that no gain be taxed to the lessor with respect to amounts received in excess of rental value until the option is exercised or expires.\textsuperscript{155} The lessee would realize a loss to the extent of the excess paid over rental value, if he failed to exercise the option.

These proposals raise problems as to depreciation. Several solutions have been suggested, with an apparent preference for apportioning depreciation between the lessee and lessor.\textsuperscript{153} The basis of the lessor would decrease and the basis of the lessee would increase for this and other purposes, through allocation of part of each payment of rent to the purchase price of the property.

Opinions have differed as to whether the change should be effected by decision, regulation or statute.\textsuperscript{163} Since the making of these proposals, the Tax Court and the Ninth Circuit have refused to allow a lessee to allocate part of each payment to purchase price and part to rent and to deduct the latter part.\textsuperscript{161} Under the present statute, these courts were correct, since the deduction for rent is allowed only if the lessee has no title or equity in the property and is not taking title to it.\textsuperscript{162} The change could, of course, be made by statute.

Other writers have proposed that the regulations be amended to restate the economic test, with attention paid to the particular situation in determining reasonable rental and reasonable option price.\textsuperscript{163} The result would be to treat the transaction either as a lease with an option to buy or as a sale, but not as both.

It is submitted that, if substantial hardship arises because of the present state of the law, any change should be made by statute. Regulations restating the economic test would leave the law unsettled until their validity had been litigated; they probably could not validly provide for the treatment of a transaction as both a lease and a sale. A statute such as the one suggested above, however, could bury the test of intention at once and therefore eliminate the present doubts as to the weight to be

\begin{thebibliography}{9}
\bibitem{158} Lulins, op. cit. supra note 156, at 75.
\bibitem{159} Ibid. See Johnson, op. cit. supra note 156, at 96.
\bibitem{160} Johnson, op. cit. supra note 156, at 97; Lulins, op. cit. supra note 156, at 74.
\bibitem{161} Wilshire Holding Corp., 18 CCH Tax Ct. Mem. 62 (1953), rev'd, 262 F.2d 51 (9th Cir. 1958). The Ninth Circuit had earlier suggested the taxpayer's approach, in another stage of the same litigation, when it stated that part of each payment was going toward acquisition of the property. Osterreth v. Commissioner, 226 F.2d 793, 503 (9th Cir. 1955). "Lessees," however, have been allowed to deduct part of each payment as interest on the purchase price. Starr v. Commissioner, 274 F.2d 294 (9th Cir. 1959), reversing 30 T.C. 856 (1958); Wilshire Holding Corp., supra; Schwarz v. United States, 301 U.S. Tax Cas. 76277 (S.D. Tex. 1939).
\bibitem{162} Int. Rev. Code of 1954, § 162(a)(3).
\bibitem{163} Blumenthal & Harrison, The Tax Treatment of the Lease With an Option to Purchase, 32 Texas L. Rev. 839, 870 (1954).
\end{thebibliography}
given the intention of the parties and the factors from which it is to be found. The law seems to be clear enough that, if only a nominal option price is required, the transaction is a sale. A statute could remove any uncertainty concerning what is nominal by treating as a sale any lease with an option to buy at a price less than some stated percentage of the value of the property as of the time for exercise of the option. There would still be uncertainty and a source of litigation in the determination of rental value and fair market value. The statute could, however, protect both the Government and the taxpayer in many cases from the present risk that the payments will be treated wholly as rent or purchase price (apart from the element of interest). The proposed statute would seem to treat all parties fairly; whether it would reduce litigation depends on whether the present source of litigation is doubt as to the legal test or disagreements about rental value and fair market value.

VI. WHETHER IMPROVEMENTS ERECTED BY A LESSEE ARE RENTAL INCOME TO THE LESSOR

The apparent answer to when, if ever, improvements erected by a lessee are rental income to a lessor has changed several times.

In 1917, the Treasury ruled that the value of such improvements is rental income to the lessor at the termination of the lease. In Miller v. Gearin, the Ninth Circuit rejected this ruling, on the ground that the lessor realized income from the improvements, if at all, on their erection, when he received title to them and the value of his property was enhanced.

After Miller v. Gearin, the Treasury amended its regulations to provide that the discounted value of the improvements as of the termination of the lease was income to the lessor in the year of erection and later to permit the lessor to amortize the value of the improvements over the remaining term. The new provisions were approved by a number of decisions of the Board of Tax Appeals. Apparently, the Treasury's

165. 258 Fed. 225 (9th Cir.), cert. denied, 250 U.S. 667 (1919).
166. In Miller v. Gearin, the lease expressly provided that the lessor should get title to all improvements on erection. Id. at 226. However, this does not appear to be an essential condition to the holding. See Lewis v. Pope Estate Co., 116 F.2d 328 (9th Cir. 1940), cert. denied, 314 U.S. 630 (1941). Nor did the Ninth Circuit emphasize the fact that the improvements had been erected before the sixteenth amendment was enacted. Cryan v. Wardell, 263 Fed. 248, 249 (N.D. Cal. 1920), held that any income realized under such facts could not constitutionally be taxed.
theory was that improvements by a lessee which have a life longer than the remaining term are additional rent.

The new provisions were rejected by the Second Circuit in 1935 and by the Supreme Court in 1938. One ground for these decisions was that the value of the improvements was not rent, under a definition of rent as "a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property." In the Supreme Court case, the lessee had no duty to make specific improvements or to make them at any particular time. Another ground for the decisions was a lack of realization, since there was no separation of income from capital.

The regulations also provided that, if the lessor elected to report the value of improvements pro rata over the term of the lease and the lease terminated prematurely, he should report the balance of that value for the year of termination. Therefore, the Government was still maintaining, at least in some cases, that a lessor realized income on termination of a lease because of improvements erected by the lessee. The lower courts uniformly held against the Government, but the Supreme Court held, in Helvering v. Bruun, that income can be so realized. The Court did not discuss the question of whether the value of the improvements could be considered rent, but, by reference to the analogy of exchanges, it rejected for this context the notion that realization of income requires separation of income from capital. The Third Circuit interpreted this decision as rendering it immaterial whether the value of the improvements might be considered rent. Income realized under this decision was ordinary income, not capital gain, since the transaction did not involve a sale or exchange.

169. Hewitt Realty Co. v. Commissioner, 76 F.2d 880 (2d Cir. 1935), reversing 29 B.T.A. 1205 (1934).
171. Id. at 277.
172. Id. at 279; Hewitt Realty Co. v. Commissioner, 76 F.2d 880, 884 (2d Cir. 1935).
174. Commissioner v. Center Inv. Co., 103 F.2d 100 (9th Cir. 1939), rev'd, 367 U.S. 639 (1940); Commissioner v. Wood, 107 F.2d 389 (7th Cir. 1939), rev'd, 367 U.S. 637 (1940); Helvering v. Bruun, 105 F.2d 442 (8th Cir. 1939), rev'd, 369 U.S. 461 (1940); Nicholas v. Fifteenth St. Inv. Co., 105 F.2d 239 (10th Cir. 1939).
175. 369 U.S. 461 (1940).
176. Id. at 469-69.
177. Gowern's Estate v. Commissioner, 119 F.2d 83, 84 (3d Cir. 1941).
Congress was soon urged to overrule the Bruun decision. It was argued that the decision would cause hardship to lessors. Several arguments advanced were: that a lessor might be treated as having realized income, although the value of the improved property might be less than his cost or its value at the commencement of the term; that the tax might be very large in some industries, such as railroads, because most of the improvements would typically have been purchased by the lessee; and that the transaction would not provide the lessor with any cash for paying the tax.\textsuperscript{180} Congress did enact a provision excluding from gross income "income, other than rent, derived by a lessor of real property upon the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee."\textsuperscript{181}

The new statute had both advantages and disadvantages. The lessor obtained the benefit, generally, of receiving property of greater value and earning power than he had before making the lease, without presently paying any tax.\textsuperscript{182} His basis for depreciation and computation of gain or loss on a future sale would not include the value of the improvements.\textsuperscript{183} On the other hand, any such gain might be treated as capital\textsuperscript{184} and, if an individual, he might keep the property until death gave him a stepped-up basis.\textsuperscript{185}

In the new statute, the phrase "other than rent" left open the possibility that the value of improvements might sometimes be taxed as rental income to the lessor. Apparently, Congress assumed that this would be governed by \textit{M. E. Blatt Co. v. United States},\textsuperscript{186} which said that the value of improvements would not be taxed to the lessor on erection unless they were intended as rent. This position has been consistent with that of the Treasury Department.\textsuperscript{187}

There is some uncertainty as to when the value of improvements

\textsuperscript{180} Hearings on Revenue Revision of 1941 Before the Committee on Ways and Means, 77th Cong., 1st Sess. 233 (1941).
\textsuperscript{182} Morehead, Newer Thinking on Real Estate Transactions, N.Y.U. 7th Inst. on Fed. Tax. 1036, 1039 (1949).
\textsuperscript{183} Greenberger, Tax Consequences of Tenant Improvements to Real Estate, N.Y.U. 15th Inst. on Fed. Tax. 351, 353 (Sellin ed. 1957).
\textsuperscript{184} Int. Rev. Code of 1954, § 1231.
\textsuperscript{186} 305 U.S. 267, 277 (1938). See Commissioner v. Cunningham, 258 F.2d 231, 233 (9th Cir. 1958).
will be found to have been intended as rent. When such value has been credited against rent, the lessee has been allowed to deduct the cost and the lessor has been taxed. A jury was allowed to find, however, that the parties did not intend improvements as rent when the lessee was required to pay a percentage rental and also to erect certain improvements at a given cost or pay the deficiency to the lessor. The Internal Revenue Service has ruled that, if a lessee is required to make improvements but not to pay any cash rental, the value of the improvements is rental income of the lessor. However, the Tax Court and the Ninth Circuit have ruled that a lessor, the majority stockholder of a lessee which paid no cash rent, realized no such income from the improvements, on the basis of her testimony that she did not intend to charge rent and that the improvements would be of use only to this particular lessee. It would seem that, if the value of improvements is not meant to be treated as rent, a cash rent should be charged and no credit should be given because of the improvements.

If an improvement is found to be rent, the lessee may have a problem as to when he can deduct its cost. A lessee under a ten-year lease was allowed to deduct in full for the year of construction the cost of improvements which were less than a year's rent; a credit was given under the lease for such cost. It has been argued, however, that a lessee might have to prorate the cost over the remaining term if the cost were high and the term long. Two Tax Court decisions have permitted a lessee to amortize the cost of an improvement over the life of a lease. This result would be consistent with cases holding that lessees could deduct other types of expenditures only over the remaining term of a lease.

VII. PAYMENT BY A LESSEE FOR CANCELLATION OF A LEASE

If a lessee pays a sum to his lessor in consideration of cancellation of the lease, the payment is taxable income to the lessor, on the theory that it is a substitute for rent.\textsuperscript{197} Such income is ordinary, since the lessor has made no sale.\textsuperscript{198} Depending on the accounting method of the taxpayer, the income is taxable to the lessor\textsuperscript{199} and deductible by the lessee\textsuperscript{200} in the year of payment or accrual.

VIII. PAYMENTS UNDER LEASEBACK ARRANGEMENTS

Are payments made under the various types of leasebacks deductible? The statutory question is whether the payments are "ordinary and necessary expenses . . . rentals . . . required . . . as a condition to the . . . use or possession . . . of property . . . ."\textsuperscript{201} There is no answer which covers all types of situations. The statute is inconclusive, if it is possible to read into it the step-transaction doctrine and the business purpose test. The result seems to depend on how clearly a tax avoidance motive appears from the facts and how strongly the court reacts to the existence of that motive.

If a court which feels a strong desire to prevent tax avoidance encounters a leaseback effected primarily to avoid taxes, it can readily disallow deductibility of the rent. It can treat the transfer of legal title from the taxpayer and the leaseback to him as one transaction, under the step-transaction doctrine, and then hold that the "rent" paid is not an "ordinary and necessary expense" or is not "required." The payment could be said to be not "ordinary" on the ground that businessmen do not usually transfer property to others and then pay rent to them when they could continue to use the property without paying rent. It could be held not to be "necessary" because not helpful to a business. Similarly, the payment can be held not "required" if the transaction is viewed as a whole.

On the other hand, a court may consider only the situation existing after the transfer and allow the deduction. Rent is generally an "ordinary and necessary" expense of a business, and usually one who wishes to use property owned by another is "required" to pay rent. Consequently, a court which refuses to apply the step-transaction doctrine

\textsuperscript{197} Hort v. Commissioner, 313 U.S. 28 (1941).
\textsuperscript{198} Int. Rev. Code of 1954, § 1222; Spencer Thorpe, 42 B.T.A. 654 (1940), appeal dismissed per curiam, 121 F.2d 458 (9th Cir. 1941); Walter M. Hort, 39 B.T.A. 922, 926, aff'd per curiam, 112 F.2d 167 (2d Cir. 1940).
\textsuperscript{199} King Varick Corp., 11 P-H B.T.A. Mem. 32 (1942); Treas. Reg. § 1.61-8(b) (1957).
\textsuperscript{200} Cassatt v. Commissioner, 137 F.2d 745 (3d Cir. 1943), affirming 47 B.T.A. 400 (1942); C. Ludwig Baumann & Co., 2 CCH Tax Ct. Mem. 188 (1943).
\textsuperscript{201} Int. Rev. Code of 1954, § 162(a)(3).
will tend to allow the deduction. Without using the step-transaction doctrine, a court can rationally deny the deduction if the relationship of the taxpayer and the lessor is such that the property might easily be transferred back to the taxpayer. In such a situation the payment of rent may not be "required." Similarly, if the rent were unreasonable, the excess over what might be paid a stranger for the use of similar property could be held not "required."

The problem of deducting rentals paid pursuant to transfers and leasebacks between related parties will be considered herein. The litigation concerning the deductibility of rent seems to have involved related parties. There have been tax problems in respect to leasebacks between unrelated parties, but these dealt with recognition of losses.202 Several types of transactions can give rise to our problem. There may be a transfer between members of a family, by sale or by gift directly or in trust. A corporation may transfer property to a shareholder, as a dividend or by a sale.

The most favorable situation for the taxpayer arises if he transfers property in trust and takes a leaseback. Here, the courts have held that he may deduct the "rental" paid to the trust.203 They have ignored the step-transaction doctrine and have viewed the situation only as it appears after the transfer in trust. On the ground that the trustee is independent of the transferor, they have held that the "rental" is "required" and deductible. Some of the cases have also stressed the fact that the taxpayer was paying no more than a reasonable rental to the trust.

The earlier Tax Court decisions had disallowed the deduction, largely on the ground that, under the step-transaction doctrine, the payments were not "required."204 The later Tax Court decisions follow the Seventh and Third Circuits and allow the deduction.205 Recently the Tax Court disallowed the deduction, but the facts were unusual, since the transferor had control over the trustees and power to retake the corpus at will for nothing.

204. Consolidated Apparel Co. v. Commissioner, supra note 203; Albert T. Felix, supra note 203.
205. Helen C. Brown, 12 T.C. 1095 (1949); A. A. Skemp, 8 T.C. 415 (1947).
The Internal Revenue Service still maintains that the payments are not deductible. It argues that the trustee is not really independent when the leaseback is prearranged, as it nearly always will be.\(^{208}\) Thus, a taxpayer who attempts a gift in trust and leaseback may still have to litigate to obtain his deduction.

The cases dealing with a gift not in trust and a leaseback have denied the deduction.\(^{209}\) These cases have been decided on various grounds, such as continued actual control by the donor,\(^{210}\) the payment of unreasonable rent,\(^{211}\) the probability of control of the donee by the donor by reason of the marital relationship,\(^{212}\) and lack of business purpose.\(^{213}\)

Why is there a different result in the cases involving a direct gift from that in the cases of a gift in trust? The answer may lie in a conflict of authority among the circuits. The trust cases have been decided in the Third and Seventh Circuits. Two direct gift cases, *Kirschenmann v. Westover*\(^ {214}\) and *Finley v. Commissioner*,\(^ {216}\) might be distinguished from the trust cases on the ground of special facts: unreasonableness of the "rent" paid in the first case and retained control in the second. *White v. Fitzpatrick*,\(^ {218}\) however, stresses the lack of an independent trustee. Should the lack of a trustee matter? Presumably, the argument is that a trustee has a duty to the beneficiary to make the most profitable use he can of the trust property, that he cannot allow the transferor to have the free use of that property, and that therefore the transferor is "required" to pay rent.\(^ {217}\) This argument is sound, however, only if the trust has minor or unascertained beneficiaries, since adult beneficiaries can waive their rights by consenting to what otherwise would be a breach of trust.\(^ {218}\) Thus, if the direct gift is suspect because of the family re-

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\(^{209}\) Finley v. Commissioner, 255 F.2d 128 (10th Cir. 1958), affirming 27 T.C. 413 (1955); *Kirschenmann v. Westover*, 225 F.2d 69 (9th Cir.), cert. denied, 350 U.S. 834 (1955), affirming 53-1 U.S. Tax Cas. 47173 (S.D. Cal. 1952); White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952); Raymond M. Cassidy, 10 CCH Tax Ct. Mem. 573 (1951), where the point was moot.

\(^{210}\) Finley v. Commissioner, supra note 209.


\(^{212}\) White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952).

\(^{213}\) Kirschenmann v. Westover, 225 F.2d 69 (9th Cir.), cert. denied, 350 U.S. 834 (1955); White v. Fitzpatrick, supra note 212.

\(^{214}\) Note 213 supra.

\(^{215}\) 255 F.2d 128 (10th Cir. 1958), affirming 27 T.C. 413 (1956).

\(^{216}\) 193 F.2d 398 (2d Cir. 1951), cert denied, 343 U.S. 928 (1952).

\(^{217}\) 2 Scott, Trusts ¶ 181 (2d ed. 1956).

\(^{218}\) 2 Scott, op. cit. supra note 217, § 216.
relationship of the donor and donee, so is the gift in trust for the benefit of a member of the donor's immediate family, unless the beneficiary is a minor or unascertained. In most of the trust cases, at least some of the beneficiaries were minors. Thus, the trustees had duties to produce income and could not avoid liability for breach of these duties by obtaining the consent of the beneficiaries. In Consolidated Apparel Co. v. Commissioner, however, the beneficiaries were adults. The factor of intervention of a trustee does not seem, of itself, sufficient to sustain that decision. There was evidence of arm's length negotiations between the trustee and the taxpayer as to the amount of the rent, which the court relied on as showing independence of the trustee.

In the area of corporate distributions with leasebacks, it appears that the taxpayer will have to litigate his right to a deduction for rent at least up to a court of appeals. The Tax Court has disallowed the deduction in the cases brought before it. It has applied the step-transaction doctrine and then, looking at the situation as a whole, has said that there was no corporate business purpose for the transaction and therefore that the payment was not an ordinary and necessary business expense.

At first, the Seventh Circuit, in Ingle Coal Corp. v. Commissioner, followed the Tax Court. There, as part of a tax avoidance plan, a family corporation was liquidated. A lease of coal mining lands was distributed by it to its stockholders and transferred by them to a new corporation, which agreed to pay them a royalty. Deduction of the royalty was disallowed. Using the step-transaction doctrine, the court held that the royalty was not an ordinary and necessary business expense, since the old corporation could have continued to mine, under the lease, without paying royalties. Skemp v. Commissioner was distinguished on the ground that there the taxpayer had transferred the property to an independent trustee and could use the property only by paying rent, while here the stockholders could always terminate the duty of the new corporation to pay rent.

Later, the Seventh Circuit seems to have changed its mind. In Stearns Magnetic Mfg. Co. v. Commissioner, it allowed a corporation to deduct

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220. 207 F.2d 580 (7th Cir. 1953), reversing 17 T.C. 1570 (1952).


222. 174 F.2d 569 (7th Cir. 1949), affirming 10 T.C. 1199 (1948).

223. 168 F.2d 598 (7th Cir. 1948).

royalties paid by it to stockholders for the use of a patent which the corporation had distributed to the stockholders. There was some evidence that the transaction had a business purpose. However, the court expressly rejected reliance on the business purpose test and said that the test was whether the royalties were reasonable. By implication, the court cast aside the step-transaction doctrine and applied the test of whether the payment was "required" only in the light of facts existing after the distribution. The court relied on the Skemp case, which it had distinguished in Ingle Coal Corp., and purported to distinguish the latter case on the ground that there the stockholders were only a conduit of title from one corporation to another, a minor ground mentioned by the court in Ingle Coal Corp. The court also emphasized the apparently immaterial fact that the taxpayer was solvent and that its creditors were not damaged by the distribution of the patent to the stockholders.

No other court of appeals has yet dealt with this problem. The Fifth and Ninth Circuits have, however, ruled on a sale by a corporation to its stockholders followed by a leaseback to the corporation, indicating that they might deny the deduction in the case of a corporate distribution and leaseback. Both cases involved corporations operating in a period of improving business and rising earnings. Neither paid cash dividends. The sale and leaseback transactions were entered into under obviously sham recitals of corporate financial needs or condition. In both cases the Tax Court applied the step-transaction doctrine and denied a deduction for rent. One case was affirmed in a per curiam opinion by the Court of Appeals for the Ninth Circuit; the other was affirmed by the Court of Appeals for the Fifth Circuit on the ground of lack of business purpose.

The attitude expressed in these cases seems contrary to that of the Seventh Circuit in Stearns Magnetic Mfg. Co. The fact that they involved sales to stockholders rather than distributions does not seem to be an adequate basis for a distinction. A distinction might be based on the clear tax avoidance motive and lack of business purpose in the cases which came before the Fifth and Ninth Circuits, although the

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225. W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951).
226. Shaffer Terminals, Inc. v. Commissioner, 194 F.2d 539 (9th Cir. 1952), affirming 16 T.C. 356 (1951).
228. The Tax Court has also denied the deduction in the case of a purported sale and leaseback between related corporations. Riverpoint Lace Works, Inc., 13 CCH Tax. Ct. Mem. 463 (1954). There, so many factors tended to show that the transaction was a sham that the decision does not seriously test the business purpose doctrine, although the court did mention it.
Seventh Circuit expressly refused to rely on the existence of a business purpose. In the future there may be a shift which will bring the various circuits to agreement. The Tax Court has accepted Brown v. Commissioner and the Skemp decisions. This may indicate a trend which the Fifth and Ninth Circuits will follow.

Another question which may arise is whether rent can be deducted pursuant to a sale and leaseback between members of a family. This point has not been litigated and may never be, since the cases involving gifts in trust with a leaseback seem so far to provide a fairly safe cover for tax avoidance. The closest case to this problem was H. W. Findley, a Tax Court memorandum decision, which held that the taxpayer could not be taxed on the income of property which he had sold to other members of his family or to trusts for their benefit. The purchasers had leased the property to third persons and had received in return rental income. The Tax Court relied on the Brown and Skemp cases as to the transaction with the trust and on the fact that the taxpayer had not exercised control over the purchasers.

The present law involving leasebacks between related parties is unsatisfactory. The distinction between transfers in trust and others will not stand examination, except perhaps in the case of trusts with beneficiaries who are minors or are otherwise incompetent. A court can rationally allow or disallow the deduction for rent, depending on the strength of its emotional reaction to tax avoidance possibilities.

It seems that this is a situation which should be considered by Congress. There can be some questions of degree relating to specific sets of fact here, as, for example, in the determination of how much control the transferor retained over the property. A taxpayer who is well-advised, however, can frame a leaseback so that the transferee appears to be independent in making the lease. A court may suspect that the parties have made an arrangement to suit the transferor and that they will remake it if he later so desires, but there may be little evidence on which to base a finding to that effect. Thus, we are dealing basically with a general question of whether the possibility of tax avoidance without a real change in economic circumstances is so bad here that the deduction for rent should be disallowed.

This writer is not fully committed to any specific statutory change. Some inquiry should be made of the extent to which the leaseback is being used to avoid taxes, how it is being so used, and whether its use


is increasing. We should consider also that generally a taxpayer can give away income-producing property without remaining taxable on the income. For example, a doctor owning his building could give it to a member of his family and move his own offices to a building owned by an unrelated party. There is little doubt that he could deduct the rent he paid to the unrelated party and that he would not be taxed on rents received by his donee from tenants of his old building. From this, arguments can be made both ways. It is arguable that the doctor should be allowed to deduct rent paid to a related party, because he could deduct rent he paid to a stranger. Disallowing the deduction for rent paid to a related party may only cause taxpayers more trouble without preventing any tax avoidance. On the other hand, the fact that taxpayers have entered into leasebacks with related parties when the tax results were in some doubt tends to show that they wanted to continue their control over the transferred property and that they thought the transferees would not act adversely to them. Perhaps this suspicion need not be confined to the instances in which the unique character of the property makes it a certainty.\footnote{233. E.g., White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952).}

On the whole, the writer would favor a statute barring the deduction for rent paid to a related party pursuant to a leaseback. The statute might apply only to rent paid under a lease made within a set number of years after the transfer. It could be patterned generally after section 267(a)(1).\footnote{234. Int. Rev. Code of 1954, § 267(a)(1).} Such a statute should be definite enough to avoid raising substantial uncertainty and litigation.

There might be some desire for a more flexible statute, so as to give a deduction for rent to the taxpayer who enters a leaseback transaction for a nontax motive, such as a desire to increase working capital.\footnote{235. The increased working capital would come from a sale preceding the leaseback.} Thus, the proposed statute might make an exception for the taxpayer who proves that the transaction was not entered primarily to avoid income taxes. Such a statute would avoid present uncertainty as to the law in this area relating to tax avoidance motives, but it would raise uncertainties of fact in particular cases, especially since any intelligent taxpayer will give some consideration to the tax aspects of a proposed transaction. It seems doubtful, therefore, that the added flexibility would be worth the price. Greater certainty could be obtained by excepting only leasebacks pursuant to transfers for full consideration in money or money's worth. This would not allow a deduction for rent if the transfer were by gift or corporate distribution, but it might allow a deduction in most of the cases dealing with a nontax motive.
If Congress will not enact a statute dealing with this problem, the courts should reconsider their own position. Congressional refusal to act may be taken as an indication that there is no national policy barring deduction of rent paid pursuant to a leaseback. In that case, the concept of the independence of the trustee should be dropped and the question should be only whether there has been a complete transfer and a payment of no more than a reasonable rent. The step-transaction approach and the business purpose doctrine might be used to justify a close look at the facts bearing on completeness, but, if a complete transfer is found, the deduction should be allowed.

IX. Bonuses

The treatment of bonuses paid by lessees to lessors involves two problems. First, how should the lessor and lessee treat bonuses for tax purposes? Second, how are bonuses distinguished from other payments? Payments which are conceded to be bonuses will be discussed first, in order to show the motives for attempting to disguise the payment of a bonus.

A bonus is a payment made by a lessee to a lessor in addition to regular periodic payments of rent. It is usually paid when the lease is executed or at or near the beginning of the term. The term "advance rental" also is used, although the writer recalls no technical distinction in the cases between "bonuses" and "advance rentals." The latter term could be confined to payments which are to be credited against specific installments of rent to become due in the future. The tax treatment of "bonuses" and "advance rentals" has been the same, however, so that distinguishing them may be unnecessary.\textsuperscript{236}

The tax treatment of bonuses should be compared and contrasted with the tax treatment of ordinary rentals. Rentals paid in the course of business are deductible by the lessee and taxable to the lessor,\textsuperscript{237} at times dependent upon the accounting method of the taxpayer. It should be kept in mind that an accrual method taxpayer generally must include unearned income on receipt.\textsuperscript{238} \textit{Bressner Radio Co. v. Commissioner},\textsuperscript{239} which permitted a television dealer to defer income from service contracts, casts doubt on this principle and may well affect the treatment of advance rentals.

Usually the execution of the lease, the start of the term, and the payment of the advance rental occur in a single taxable year. The pay-

\textsuperscript{236} A distinction may develop if \textit{Bressner Radio, Inc. v. Commissioner}, 267 F.2d 520 (2d Cir. 1959), stands and is extended to landlord-tenant situations.

\textsuperscript{237} Int. Rev. Code of 1954, §§ 61, 162.

\textsuperscript{238} \textit{Automobile Club v. Commissioner}, 353 U.S. 120 (1957), affirming 230 F.2d 555 (6th Cir. 1956), affirming 20 T.C. 1033 (1953); \textit{Automobile Club, Inc.}, 32 T.C. 963 (1959).

\textsuperscript{239} 267 F.2d 520 (2d Cir. 1959), reversing 23 T.C. 378 (1957).
ment is includible by the lessor in that year, regardless of his accounting method. Such would be expected in the case of a cash method lessor. An accrual method lessor might, however, argue reasonably that a bonus is earned over the whole term and should be included ratably over it, or that an advance rental, to be applied to the rent for certain months, should be treated as income for those months. The result has been contrary, although the Tax Court has conceded that taxing the whole of a bonus or advance rental on receipt does not fit good commercial accounting practice. It has relied on precedent and the notion that the Commissioner of Internal Revenue has discretion to determine whether a method of reporting income clearly reflects income. The Supreme Court has said: "Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income." The Internal Revenue Code does not say, however, that the Commissioner has such discretion but only that "if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . ." Hence, it is argued that a court has authority to determine whether the taxpayer's method clearly reflects income and that it need accept the method prescribed by the Commissioner only if it has first determined for itself that the taxpayer's method is faulty. It is argued further that the Supreme Court in fact has decided this question for itself. The Second Circuit did so in the Bressner case.

Occasionally a lease is executed and a bonus or advance rental is paid in one year but the term begins in a later year. Both cash and

240. Treas. Reg. § 1.61-8(b) (1957).
242. Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938); New Capital Hotel, Inc., 28 T.C. 706 (1957), aff'd per curiam, 261 F.2d 437 (6th Cir. 1958); Jack August, 17 T.C. 1165 (1952); C. H. Mead Coal Co., 31 B.T.A. 190 (1934); Sixteenth St. Realty Co., 10 P-H B.T.A. Mem. 1079 (1941); J. S. Garnett Co., 9 P-H B.T.A. Mem. 132 (1940).
248. Berry, op. cit. supra note 247, at 82.
249. Renwick v. United States, 87 F.2d 123 (7th Cir. 1936); Roby Realty Co., 19 B.T.A. 696 (1930), appeal dismissed, 62 F.2d 1079 (8th Cir. 1933), acq., X-2 Cum. Bull. 60 (1931).
accrual method lessors have been taxed for the year of receipt. The Bressner case may establish a contrary doctrine for accrual method taxpayers who can prove when they will earn advance receipts. That case might be distinguished on the ground that there the taxpayer was obligated to furnish future services; a lessor often need furnish none. A lessor must, however, allow the lessee to use the rented property in the future. It is possible to argue that a bonus is paid to compensate the lessor for making the lease and is not payment for the use of the property. The answer seems to be that the lease is of no value to the lessee without such use. It is submitted that bonuses should be treated like any prepaid income which will be earned at ascertainable times in the future.

Here an advance payment might be treated differently from a bonus. If an advance payment is to be applied to rent for a specific part of the term, the lessor might be required to return it as income of that period. This would tend to equalize the income of the lessor. It would place on the Government the risk that the lessor may cease to be financially responsible.

If a lease is executed in one year and an accrual method lessor is to receive a bonus in a later year, when should he return it as income? An accrual method seller has been taxed in the year of sale, although he had no right to immediate payment until a later year. Two circuits have reached a similar result in the case of leases. Other cases have reached a contrary result, based perhaps on peculiar facts.

251. Note the argument in Fifteen Hundred Walnut St. Corp., 25 T.C. 61, 69-69 (1955), aff'd, 237 F.2d 933, 936 (3d Cir. 1956), that the taxpayer-lessee had an obligation to furnish space to a sublessee in the future.
252. A lease stated that an advance payment was fully earned on the making of the agreement and was not to be applied to future rents. Jennings & Co. v. Commissioner, 59 F.2d 32 (9th Cir. 1932), affirming 21 B.T.A. 381 (1930). The parties may have meant only to make clear that the stipulated rental should not be reduced on account of the advance payment.
253. This would apply to bonuses also if the lessor were allowed to prorate them.
255. Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1933), reversing S P-H B.T.A. Mem. 497 (1936); Jennings & Co. v. Commissioner, 59 F.2d 32 (9th Cir. 1932), affirming 21 B.T.A. 381 (1930); United States v. Boston & P.R.R., 37 F.2d 670 (1st Cir. 1930), affirming 31 F.2d 594 (D. Mass. 1929).
256. Fifteen Hundred Walnut St. Corp. v. Commissioner, 237 F.2d 933 (3d Cir. 1956), affirming 25 T.C. 61 (1955) (lessee to apply debt of lessor to rent, if lessor let a subtenant occupy the premises); Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934), reversing 26 B.T.A. 998 (1932) (notes received by lessor not treated as income until payment; no statement about taxpayer's accounting method); C.G. Meaker Co., 16 T.C. 1348 (1951), acq., 1952-1
Although a lessor who receives an advance rental or bonus has been required to include it in gross income not later than the year of receipt, the lessee may not deduct it for the year of payment but only ratably over the term of the lease.²⁵⁷ The basic reasoning here is that the payment is a capital expenditure for an asset, the leasehold interest, which has a life of a number of years. This reasoning has been applied not only to cases in which the lessee makes a single payment of a bonus or advance rental, but also to a case in which the lessee made regular monthly payments and also additional payments spread over only part of the term.²⁵⁸ In another case, the lessee was to make a cash payment in advance and to pay a set sum each year for the first twenty-five years of a ninety-nine-year lease. The same result was reached.²⁵⁹ These cases raise a question as to where the line is drawn between advance payments which must be deducted pro rata over the whole of a term and ordinary rentals which differ for different parts of the term. There has not been sufficient litigation to answer that question.

Considerable litigation deals with the distinction between a bonus or advance rental and a security deposit. The latter is not initially includible in gross income.²⁶⁰ Facts vary so widely that there is no 


²⁵⁸. Southwestern Hotel Co. v. Commissioner, supra note 257.


²⁶⁰. If a lessor is released from an obligation to repay a security deposit, he realizes gross income. Commissioner v. Langwell Real Estate Corp., 47 F.2d 841 (7th Cir. 1931). The amount is the then value of his duty to repay the deposit. Bradford Hotel Operating
general rule for distinguishing between advance rentals and security deposits. The Tax Court has said:

If the sum is received under a present claim of full ownership, subject to the lessor's unfettered control, and is to be applied to the rent for the last year of the term, it is income in the year of receipt even though under certain circumstances a refund may be required. . . .

If, on the other hand, the sum was deposited to secure the lessee's performance under the lease, it is not taxable income even though the fund is deposited with the lessor instead of in escrow and the lessor has temporary use of the money. . . .

In some instances the deposit serves as security for the lessee's performance and, in addition, if any or all of it remains during the final period of the lease, it is to be applied to rent. It then becomes necessary to determine whether the deposit was primarily a security payment or a prepayment of rent. . . . This question of fact is resolved by reference to the intention and acts of the parties ascertained from the lease agreement and the circumstances incident thereto.231

The best approach to this problem is a consideration of individual factors and their effects. An arrangement preventing the lessor from using the funds as his own would surely result in treatment of the funds as a security deposit. The writer has seen no litigated case involving such an arrangement, but a number of cases have indicated that control of the funds by the lessor is a factor leading toward their treatment as an advance rental.262 Likely, the Commissioner has not questioned the treatment of a sum as a security deposit if it was either placed in escrow or required to be kept in a separate account by the lessor.

Requiring the lessor to pay interest to the lessee or to allow him credit against the rent for interest should tend toward treatment of the principal sum as a security deposit, since it shows that the lessor received that sum as a kind of loan. The Fifth Circuit has so held,263 but the Ninth Circuit has treated the principal sum as an advance rental.
explaining the interest away as compensation for advance payment of part of the rent. 264

What is the effect of the existence or absence of a provision that the lessor shall under some circumstances return the sum in question to the lessee? Its lack has been expressly relied on to show that the sum was an advance rental. 265 Other cases in which no such provision appears have reached the same result. 266 Therefore, a court will not usually find a sum to be a security deposit if it is not to be returned.

The existence of a provision for return does not, however, conclusively establish that the sum in question was a security deposit. 267 An explanation of the apparent inconclusiveness of this factor may be that in the cases which treated the sum as rent there was not a provision made in good faith for business reasons for a return in all events in the absence of a default or breach by the lessee. In three cases, there was to be a return only on condemnation or destruction of the property. 268 In a fourth case, part of the advance payment was to be credited to rent and only the excess repaid. 269 In the fifth, the parties first provided clearly for an advance rental and then, to save income taxes for the lessor, executed a second lease which called the same sum a security deposit and required it to be repaid in installments near the end of the term in the same amount as installments of rent. The parties just exchanged checks. 270

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264. Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938).
266. Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943); Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938); Gilken Corp., 10 T.C. 445 (1948), aff'd, 176 F.2d 141 (6th Cir. 1949); contra, Harcum v. United States, 164 F. Supp. 650 (E.D. Va. 1958).
269. Detroit Consol. Theatres, Inc. v. Commissioner, 133 F.2d 200 (6th Cir. 1942), affirming per curiam 10 P-H B.T.A. Mem. 874 (1941).
270. Jack August, 17 T.C. 1165 (1952). In John Mantell, 17 T.C. 1143 (1952), however, a payment was treated as a security deposit despite a correspondence between installments of rent and repayments of the purported deposit.
Usually the parties have tried to combine a security deposit and an advance rental by providing for an advance payment to serve as a security deposit until the last months of the term and then to be applied to the rent. As indicated before, the Tax Court treats the question as one of fact as to the primary intention of the parties and tends to make an express finding of fact.\textsuperscript{271} Most of the cases have concluded that the payment was an advance rental,\textsuperscript{272} but a few have treated it as a security deposit.\textsuperscript{273}

What weight is accorded the language used by the parties? If they use the phrase “advance rental,” the sum in question will probably be treated as such, but their use of the words “security deposit” will not prevent a court from deciding that in substance the sum is an advance rental.\textsuperscript{274} Hence, the label given the payment is only a minor factor. The parties may as well adopt a favorable label, but they should not rely heavily on it.

In brief, how should the parties plan a transaction if they wish it treated as involving a security deposit? They should refer to advance payments as security deposits and, if possible, arrange for their segregation in escrow or a separate account of the lessor. Providing for payment of interest on such payments or credit against rent on account of interest would probably help. The deposit should not be credited against...
rent for the latter part of the term or be repaid in amounts correspond-
ing to the rent. In the absence of default, it should be returned to the
lessee. An escrow or a lien on the property could ensure such return.276
Something less than all this would probably do. It is likely that the
lessee could be allowed to use the deposit, and without interest. How
careful the parties should be depends on the degree of their eagerness
to avoid argument with the Internal Revenue Service.

Attempts have been made to disguise advance rentals as the purchase
price of a building. The owner of improved land purports to sell the
building and then leases the land to the same person. The cases have
uniformly treated the purported sale price as an advance rental.277 It
is ordinary income to the lessor,278 and he cannot deduct a loss on the
purported sale.278 The lessee has been required to write the payment off
over the term of a ninety-nine-year lease rather than over the shorter
remaining life of the building.279 These results seem reasonable, since it
was generally clear that the lessor did not really mean to part with his
interest in the building. There have been provisions that title to the
building should return to the lessor on termination of the lease280 or that
the lessee should insure the building and replace it only with a building
of at least equal value.281 Attempts to make the lease and the sale of
the building appear to be separate transactions have been transparent
and ineffective.282

A related problem involves sums paid by a transferee of a leasehold
interest to his transferor. If the transfer is a sublease, a sum paid at
the time of the transfer is treated as an advance rental and taxable to

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275. A lien was used in Commissioner v. Langwell Real Estate Corp., 47 F.2d 841 (7th
Cir. 1931).
276. Lindley's Trust v. Commissioner, 120 F.2d 998 (8th Cir. 1941); Gates v. Helvering,
69 F.2d 277 (8th Cir. 1934), reversing on other grounds 26 B.T.A. 998 (1932); Crile v.
Commissioner, 55 F.2d 804 (6th Cir. 1932), affirming 18 B.T.A. 588 (1929), cert. denied,
287 U.S. 600 (1932); Coronado Realty Co., 25 B.T.A. 1022 (1931); Minneapolis Syndicate,
277. Lindley's Trust v. Commissioner, supra note 276; Gates v. Helvering, supra note
276; Crile v. Commissioner, supra note 276.
278. Crile v. Commissioner, supra note 276.
280. Lindley's Trust v. Commissioner, 120 F.2d 998 (8th Cir. 1941); Gates v. Helvering,
69 F.2d 277 (8th Cir. 1934); Minneapolis Syndicate, 13 B.T.A. 1303 (1928), acq., VIII-1
281. Lindley's Trust v. Commissioner, supra note 280; Crile v. Commissioner, 55 F.2d
804 (6th Cir. 1932); Minneapolis Syndicate, supra note 280.
282. Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934); Crile v. Commissioner, supra
note 281.
the transferor as ordinary income. The transfer is an assignment, the sum is treated as the sale price of the interest and may result in capital gain or loss, depending on the character of the leasehold and the holding period.

There does not seem to be a substantial need for changes in the law relating to bonuses and advance rentals. In some cases it is difficult to decide whether a payment is an advance rental or a security deposit, but the parties can readily avoid creating such situations. Taxation of an accrual method lessor on bonuses and advance rentals seems inconsistent with accrual accounting, but the lessor has the use of the money, so no hardship appears, apart from progressive rates. The lessee may bear more hardship, since he cannot deduct a bonus or advance rental which he has paid except ratably over the term. The result, however, is consistent with the usual treatment of the purchase of an asset with a life of several years.

CONCLUSION

A number of areas have been surveyed in which there is a problem as to whether a payment is rent includible by a lessor or deductible by a lessee, or something else. In some of these areas there have been substantial opportunities for tax avoidance. The solutions to the problems raised have been and should be various. For example, if a lease requires the lessee to make payments to third persons, the payments generally must be treated as income of the lessor. This result can be reached by applying the judicially developed principle that, if a taxpayer has a right to receive a payment and that payment would be includible in his gross income if he received it himself, it is still includible by him, although he directs it to another. This principle probably should not and need not be enacted into our Internal Revenue Code. It is so much more abstract in its terms than most provisions of the Code that it might seem out of place if enacted. Furthermore, there is no doubt that in general Congress would approve it, despite the exception made in section 110 of the Code.

Another area involving opportunity for tax avoidance is that of leases with options to buy. Here there seems to be no need for a change in the law applicable to cases which clearly fall one way or the other. There appears no uncertainty or injustice in the treatment of such cases. There may, however, be uncertainty and unfairness in the close case, where the rent is somewhat higher than a normal rent and the


option price is somewhat lower than the probable present fair market value of the property. Here a statutory change might be useful, although it would still leave open to litigation questions of rental value and fair market value.

The area of leasebacks between related parties seems most clearly to call for congressional consideration. The courts have made an untenable distinction between transfers to independent trustees and others. There can be a question of fact as to the completeness of a transfer, but the basic question of policy as to deductibility of rent paid pursuant to a transfer and leaseback is clear-cut and calls for a congressional answer.