Trust and Leaseback Can Be Implemented With Care

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In years past, there were many techniques in estate planning that could be utilized to reduce or eliminate taxes, such as Clifford trusts, Crown loans, grantor retained income trusts, trust and leaseback transactions and estate freeze devices including buy/sell agreements, all of which have either been curtailed or eliminated as a result of acts of Congress, the judiciary and the Department of the Treasury including the Internal Revenue Service, whose actions have restricted or eliminated the techniques. What these and other techniques had in common is that they were implemented largely to reduce the impact of income, gift and estate taxes on the wealth of a family.

One planning tool that remains viable in certain circumstances is the trust and leaseback arrangement. The total tax liability of a family can be reduced with a properly designed and executed trust and leaseback transaction. This is very often accomplished by shifting income from a parent to his or her children. The trust and leaseback technique often contemplates a gift of business assets from a parent to a trust for the benefit of his children. After the gift, the trust leases the business assets to the parent and the parent pays rent for the use of those assets. A variation on the technique is in the leaseback portion of the transaction. Specifically, the trust leases the assets not to the parent but to a business entity which needs to use those assets. In contrast to a transaction in which the parent and the trust are the only two parties, the variation includes three parties, the parent, the trust and the parent’s business entity.

For example, assume that a very successful doctor with an extensive medical practice generates large patient fee income. He may have a large investment portfolio and may own a building and other business assets. The doctor’s tax problem is that, because he generates a large income, he is taxed at a high income tax bracket. Further, if the doctor owns the office building and other business assets, he may not have sufficient income tax deductions to minimize his income tax. It is true that the owner of a building and/or business assets incur deductible expenses associated with those assets, and depreciation deductions may be available. However, those tax deductions may not be as large as rent expense would be if someone other than the doctor owned the assets and leased them to the doctor for use in his medical practice. The rent payments, of course, would constitute taxable income to the lessor of the assets.

The doctor would like to transfer the assets, to the extent possible, to his children, whose income is presumably taxed at a lower bracket than the doctor’s. In analyzing the total income taxes,

the planner must consider the “kiddie tax” rules, which require that the unearned income of a child under the age of eighteen, which under a recent tax law change is a new age for tax years beginning in 2006, will be subject to tax at the parent’s highest income tax rate. Assuming a child is over age eighteen, these tax rules do not apply and the child’s own tax rate will be used to compute his own income tax. With the doctor’s increased deductions lowering his income taxable at his high tax rate and the children’s increased income taxable at the children’s lower tax rate, the arrangement reduces the total income tax of the whole family.

The transfer of the assets to the children may be subject to gift tax, and thus determining the proper transfer method will depend on a number of factors including but not limited to the doctor’s desire to make a gift or to effect a sale of the assets to the children or some combination of both, the doctor’s remaining gift tax exclusion amount which is currently $1,000,000, the doctor’s income tax basis in the assets and the expected income tax benefit to be realized after the transaction. While the exclusion amounts for gift and estate tax are no as longer unified as they had been, the use of any gift tax exclusion amount reduces the estate tax exclusion amount, currently $2,000,000. Accordingly, if the doctor makes a $900,000 gift, he would have $1,100,000 remaining to use in computing his estate tax. In addition to considering the gift tax, using this technique affects the estate tax of the doctor, which effect is primarily that the value of the gift is frozen and no additional inclusion of value in the estate is required.

It cannot be understated that to implement the trust and leaseback technique improperly will have disastrous consequences—the rent paid to the children for the use of the assets will be treated as gifts by the doctor and no income tax deduction will be available to the doctor for the leasing of property. As explained below, the technique must be designed and executed with extreme care.

Structure

The structure of the transaction is very important to the Internal Revenue Service’s acceptance of the transaction. Compliance with the spirit of the tax laws lies at the heart of obtaining the best tax results. The focus of Internal Revenue Service scrutiny has been on the rent payments the parent pays to the trust after the transfer and the circumstances surrounding those rent payments. The IRS has inquired about how much rent the trust charges the parent, whether there was an agreement relating to the rent payment prior to the transfer of the assets to the trust, and whether there is a written lease for reasonable rent.

There is some good news from the IRS: the Service has stated that it will not contest the deductibility of a reasonable rent paid on a three party gift and leaseback in which the lessee is a

regular corporation rather than a partnership or s corporation. 1984-1 CB 1, acquiescing to Lerner v. Comm'r, 71 TC 290 (1978). The reasoning here is that the regular corporation is a separate taxable entity from the parent which does not flow its income and deductions through to its owners.

Other features of the plan must be present if the transaction is to be respected. For example, the donor must relinquish at least some control over the property after the transfer to the trust. This includes the ability to rent the property as the trustee determines. It is imperative that an independent trustee, and not the donor, manages the property from the moment the property is contributed to the trust. When the donor arranges a lease with the trust, and then makes his gift to the trust, knowing that there is no question that he will continue to use the property gifted to the trust, the donor has not properly relinquished control over the property. To permit the donor's retention of such control is likely to subject the transaction to IRS challenge.

The donor's arrangement stands on more solid ground when the donor gifts property to the trust, and then leases only a portion of the property that he gifted to the trust. Thus, the trustee is managing the property which is leased to the donor as well as an unrelated third party. Assuming the trustee is the person arranging for these leases, this is a strong feature to show that the donor has relinquished control over the property.

Another feature to a well-designed trust and leaseback is that the donor does not retain any equity interest in the property after the gift. The trust language in some early plans provided for the reversion of the property to the donor after a certain period of time. Those plans were the subject of IRS scrutiny and federal court litigation and cannot be used. Any reversion or other equity interest in the property will be viewed unfavorably since such an interest evidences an intent to retain the benefits of the rent payments the donor so creatively has paid in trust.

Finally, the transaction must have a valid business purpose. There is a split in the circuits regarding whether the business purpose test applies to both the gift and the leaseback or only to the leaseback. In the Fourth and Fifth circuits, the gift must have a valid business purpose as well as the leaseback. This creates quite an obstacle for the donor, since a gift is not usually known for its business purpose. However, the desire to protect assets may be enough to show the proper purpose.

While the rent is central to the plan because of the income shifting potential, there is also an opportunity to transfer appreciating assets to the trust. If the transaction is executed properly, these assets will not be subject to estate tax in the parent's estate. Thus, the amount reported in gifts will be used for transfer tax purposes, and the appreciation after the transfer will not be

subject to gift tax or estate tax.

This favorable tax treatment does not come without some disadvantages. First, when the parent shifts the income to the children because he pays rent for the use of the property, if the property is depreciable, the parent no longer is entitled to depreciation deductions on the property. This may reduce the benefit to be gained by creating this arrangement. Second, for the year of transfer there may gift tax due or the donor may use some or all of his applicable exclusion amount. The value of the property to be gifted must be measured against the available gift tax exclusion.

Two party transactions are more risky than three party transactions, especially in the Fourth and Fifth federal circuits. See Perry v. United States, 520 F2d 235 (4th Cir. 1975), cert. denied, 423 US 1052 (1976), Mathews v. Comm'r, 520 F2d 323 (5th Cir. 1975), cert. denied, 424 US 967 (1976), Van Zandt v. Comm'r, 341 F2d 440 (5th Cir. 1964), cert. denied, 382 US 814 (1964). In those circuits, the transactions which involved only the donor making a gift to a trust, with the donor leasing back the property directly from the trust, were undone. This undoing completely destroys the tax benefits expected to be gained by creating this arrangement in the first place. The rent payments are deemed to be gifts by the donor, and thus, no income tax deduction is available to the donor for rent payments. Thus, no income is shifted, and further, the donor is making substantial gifts to the trust beneficiaries. The need for a third party lessee is great, since the alternative is costly. The trustee should negotiate a new written lease with a third party lessee which is not a flowthrough entity.

In order to avoid a step transaction characterization, the donor may wish to gift money rather than property into the trust. If the trust then purchases property, this goes even further to establish that the donor relinquished control over the assets gifted to the trust. The trustee then negotiates a lease with the donor or an entity. A variation of this example is that the trust can finance the entire purchase on terms agreed to by the lender and the trustee, or perhaps more likely, a combination of a gift in trust of money and the trust acquiring its own financing may be possible and desired.

There are some other concerns to address. Many commentators indicate that the key to the maximum total tax savings is to shift the income to the children so that it will be taxed at the lower tax rates. However, a grantor trust may provide reduced total taxes in the long term. The savings will not be in the income tax area: the income received by the trust will be taxed to the donor, yielding no income tax savings at all. In addition, the donor will pay the income tax due on the trust's income from his own assets. The trust will not be diminished. The trust can be written to treat the donor's tax payments as the payment of the donor's own tax liability, and

thus the payment is not considered a gift subject to gift tax. Since the donor is paying income for the trust's assets, his own personal assets will be diminished without a transfer tax cost. At his death, he presumably will own less property. The tax savings will be in estate tax on the donor's death, which is procured by the gift tax-free payments of income tax paid by donor. The gift and estate tax savings must be compared with the income tax savings lost by creating a grantor trust.

Conclusion

A trust and leaseback transaction can produce marked tax savings for the entire family involved. As we discussed above, the rules governing the creation and operation of the transaction must be followed, or the family risks losing the benefits they have sought to obtain.

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