May v. Commissioner, 76 T. C. 7 (1981)

Rent payments to a trust in a gift-leaseback arrangement are deductible as ordinary and necessary business expenses if the grantor has effectively relinquished control over the property.

Summary

In May v. Commissioner, the Tax Court allowed Dr. Lewis May to deduct rent payments made to a trust established for his children's benefit. The Mays transferred their medical building to an irrevocable trust, with Dr. May and a friend as co-trustees, and Dr. May continued to use the building for his practice, paying rent to the trust. The key issue was whether these payments were deductible under IRC Section 162(a). The court, relying on the Mathews criteria, determined that the transfer was valid, the rent was reasonable, and Dr. May had relinquished sufficient control over the property, thus allowing the deduction.

Facts

In 1971, Dr. Lewis May and his wife transferred their medical building to an irrevocable trust for their children's benefit, with Dr. May and Harlos Gross as co-trustees. Dr. May continued to use the building for his medical practice, paying $1,000 monthly rent to the trust. The trust paid the mortgage on the property, and the rent was considered reasonable. The IRS disallowed the rent deduction, arguing the transfer was not valid and Dr. May retained control over the property.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Mays' 1973 tax return due to the disallowed rent deduction. The Mays petitioned the U. S. Tax Court, which held in their favor, allowing the deduction. The decision was based on the court's interpretation of the Mathews criteria for gift-leaseback arrangements.

Issue(s)

1. Whether the rent payments made by Dr. May to the trust in 1973 were ordinary and necessary business expenses under IRC Section 162(a).

Holding

1. Yes, because the payments satisfied the Mathews criteria: the transfer to the trust was valid, the rent was reasonable, the lease had a business purpose, and Dr. May did not retain a disqualifying equity in the property.

Court's Reasoning

The court applied the Mathews criteria to assess the deductibility of the rent

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payments. It found that the transfer of the medical building to the trust was valid under California law, as evidenced by the trust instrument. The rent was stipulated to be reasonable, and the leaseback had a bona fide business purpose as Dr. May needed the property for his medical practice. The court determined that Dr. May did not retain substantially the same control over the property post-transfer, as evidenced by the presence of an independent co-trustee, Harlos Gross, who monitored the trust's operations. The court rejected the IRS's arguments regarding the lack of a written lease and Dr. May's control, emphasizing that the trust's operation showed sufficient independence. The majority opinion was supported by a concurrence, which argued for a broader interpretation of the independence requirement, and dissents, which focused on the necessity of a written lease and the independence of the co-trustee.

Practical Implications

This decision clarifies the criteria for deducting rent in gift-leaseback transactions, emphasizing the importance of the grantor relinquishing control over the property. Practitioners should ensure that such arrangements include an independent trustee and that the rent is reasonable. The case also highlights the significance of the trust's operational independence from the grantor. Subsequent cases have applied or distinguished this ruling based on the degree of control retained by the grantor and the independence of the trustee. For business planning, this decision supports the use of gift-leaseback arrangements as a legitimate tax strategy when structured properly.

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