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THE INCOME TAX CONSEQUENCES OF A GRATUITOUS TRANSFER OF APPRECIATED PROPERTY CONTINGENT UPON THE DONEE’S PROMISE TO PAY THE GIFT TAX

Jeffrey L. Kwall*

X wishes to make a gift of 10,000 shares of Acme Corporation stock to Y. The fair market value of the stock is $2,500,000 and X’s basis in the stock is $500,000.¹ X realizes that when one makes a gift of this magnitude, the donor is required to pay a gift tax. X, however, is unwilling to incur any costs in connection with the gift and therefore proposes that Y agree to pay the gift tax resulting from the transfer. Y suggests that X simply give her the shares and assures X that if he still wants Y to pay the gift tax when the tax is due, she will gladly do so. X trusts Y and her proposal is acceptable to him, but he nevertheless decides to discuss the idea with his tax advisor, Z.

Z informs X that he will be making a serious mistake if he transfers the shares in the absence of an agreement requiring Y to pay the gift tax as a condition to the transfer. Z assures X that he is not questioning Y’s integrity and insists that his only motive for suggesting the conditional transfer is to minimize the tax liability of both X and Y. Z states that if X transfers the shares in the absence of an agreement stipulating that Y will pay the gift tax and Y ultimately does pay the gift tax when due, Y will pay a gift tax of $1,000,000 and X will pay an income tax of $650,000. Alternatively, if Y agrees to pay the resulting gift tax as a condition to the transfer, the transaction can be structured such that Y will pay a gift tax of $700,000 and X will pay no income tax.²

This planning premium has in the past been available to prudent taxpayers. Although the Internal Revenue Service has actively fought this result, reliance on questionable precedent has hampered the courts from mitigating the disparate treatment. As the tax court has stated, “[w]e are not prepared at this time to reexamine an intricate and consistent pattern of


¹ Basis is generally defined as the cost of the property. I.R.C. § 1012 (1976). In this example, value and basis are proportionately allocated among the shares. Thus, the fair market value of each share is $250 and X’s basis in each share is $50.

This article is concerned exclusively with gifts of appreciated property. For an informative discussion contrasting the tax consequences of a gift of appreciated property contingent upon a donee’s agreement to pay the gift tax with a gift of unappreciated property or cash pursuant to such an agreement, see Recent Development, Federal Income Tax—Net Gift Doctrine, 63 CORNELL L. REV. 1074 (1978).

² See notes 4-12 and accompanying text infra for an explanation of these calculations.
decision that has evolved over the years in this field. Things have gone too far by now to wipe the slate clean and start all over again.' A reexamination of the law will reveal that the magnitude of the premium associated with advance planning in this area is unjustified and should not be perpetuated.

**NET GIFT TREATMENT**

To demonstrate why the planning premium associated with a pretransfer agreement is not justified, it is essential to distinguish the gift tax consequences from the income tax consequences of such a transaction. The gift tax treatment of these transfers, although well established, must be explored in order to understand the controversy surrounding the income tax consequences. The gift tax treatment will be illustrated in the context of \( X \)'s gift of stock to \( Y \).

\( Y \) suggested that \( X \) transfer the shares to her without a formal agreement requiring \( Y \) to pay the gift tax. Were the transfer executed in this manner, a gift tax would be imposed on \$2,500,000, the fair market value of the property transferred.\(^4\) When the graduated gift tax rate schedule is applied to a \$2,500,000 gift, the tax due is approximately \$1,000,000.\(^5\) The donor is required to pay this tax.\(^6\) If the donor pays the gift tax, there are no additional tax consequences to the donor upon payment, nor are there any tax consequences to the donee. If, however, the donee rather than the donor pays the gift tax, further tax consequences to the parties will arise at the time the gift tax is paid because the payment of a liability of another gives rise to income to the party whose liability is satisfied pursuant to *Old Col-

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4. I.R.C. § 2501(a) (1976 & Supp. III 1979). The value of a gift for gift tax purposes is the value of the gift on the date the gift is made. *Id.* § 2512(a).

5. The tax is computed by applying the uniform estate and gift tax rate schedule, *id.* § 2001(c), to the aggregate value of all taxable gifts the donor has ever made, including the current gift, and deducting from the tax which would be due on this aggregate amount all gift taxes the donor previously paid. *Id.* § 2502(a).

To simplify the hypothetical, several assumptions have been made. First, it is assumed that \( X \)'s gift to \( Y \) was \( X \)'s first taxable gift. In addition, the hypothetical ignores the unified credit against the gift tax, *id.* § 2505, and the annual exclusion for each donee. *Id.* § 2503(b). It should be noted that for gifts made after December 31, 1981, a modified uniform estate and gift tax rate schedule will apply. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 402, 95 Stat. 172 (to be codified at I.R.C. § 2001).

Therefore, the donor will be deemed to have received income of $1,000,000. Consequently, if Y discharges X's $1,000,000 gift tax liability in the absence of an obligation to do so, X will pay an income tax on the $1,000,000 of approximately $650,000.8

In contrast, if Y agrees to discharge X's gift tax liability as a condition to the gift, the tax consequences to the parties are different from those that result in the absence of such an agreement. When a gift is made contingent upon the donee paying the gift tax, the transfer is treated as a net gift. In other words, the property transferred is valued net of tax for gift tax purposes.9 Thus, if X transfers stock with a fair market value of $2,500,000 contingent upon an agreement that Y will pay the resulting gift tax, the gift is valued for gift tax purposes at $1,800,000 since a gift of this magnitude generates a gift tax liability of approximately $700,000.10 Hence, a lesser gift tax is imposed on a net gift than on a conventional gift which is valued at fair market value for gift tax purposes.11 Despite this disparity in gift tax treatment, the courts and the Service agree that the reduced gift tax resulting from a pretransfer agreement is justified.12 The controversy, instead, relates to the establishment of additional tax consequences resulting from the donee's promise to discharge the donor's gift tax liability and the fulfillment of that promise.

7. 279 U.S. 716 (1929). If the donee's intent in paying the gift tax is gratuitous, it is arguable that this tax payment is a gift. Thus, with respect to this tax payment, the original donee is a donor subject to a gift tax. Cf. Commissioner v. Duberstein, 363 U.S. 278 (1960) (an objective determination of a transferor's intention in making a transfer determines whether that transfer is a gift or income to the transferee).

8. It is assumed that X files a joint return and has no other taxable income in the year in which Y pays X's gift tax. If the gift tax liability is discharged after 1981, the income tax will be less because of the rate reductions of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172 (to be codified as amended in scattered sections of 26 U.S.C.).

9. See Harrison v. Commissioner, 17 T.C. 1350, 1356-57 (1952), acq., 1952-2 C.B. 2. To compute the amount of the gift tax to be deducted from the gross value of the property transferred, the Service acknowledges the following formula:

\[
\text{Tenative Tax} = \frac{\text{True Tax}}{1 + \text{Rate of Tax}}
\]

Rev. Rul. 75-72, 1975-1 C.B. 310.

10. See note 5 supra for the assumptions on which this calculation is based. Although the donee pays the gift tax when the parties structure a net gift transaction, it is the donor's unified credit which is relevant to the computation of the tax. See Rev. Rul. 81-223, 1981-39 I.R.B. 6.

11. A more than proportionate reduction in the gift tax results because of the graduated nature of the gift tax rate schedule. As a result of the graduated schedule, the net gift is taxed at a lesser marginal rate than the marginal rate at which the gross value of the property would have been taxed. See I.R.C. § 2001(c) (1976). Furthermore, once a donor makes a net gift, all of the donor's future gifts will be taxed at a lesser marginal rate than would otherwise apply since the value of all past gifts influences the marginal rate at which future gifts will be taxed. See id. § 2502(a).

12. See note 9 supra.
The tax consequences to the donor associated with the donee's promise and subsequent payment of the gift tax depend upon the theory adopted to justify net gift treatment at the time of the transfer. Net gift treatment has been justified by either a retained interest theory or a part gift/part sale characterization. The retained interest theory was adopted by those courts first authorizing net gift treatment in the case of a gift made contingent upon a donee's agreement to pay the gift tax. In Harrison v. Commissioner, the court stated, "[w]e hold that the amount of the gift tax may be excluded, as a retained interest, from the gross value of the gifts in determining the net value." Shortly thereafter, in Lingo v. Commissioner, the court again allowed net gift treatment when a donee agreed to pay the gift tax. The Lingo court cited Harrison for the proposition that:

since the obligation of the trustee to pay the gift tax was incurred as a condition to the making of a gift, the donor did not intend that the amount of the property necessary for the gift tax liability would be a gift to the trust, and . . . such amount was not effective as property passing from the donor.

The retained interest theory treats the donor as transferring only the value of the property net of tax to the donee. Thus the donor retains an interest in the property transferred, the value of which is equivalent to the donor's gift tax liability. Hence, if Y agrees to pay the gift tax on the shares of stock worth $2,500,000 as a condition of the transfer, this theory treats X as transferring a $1,800,000 interest to Y and retaining a $700,000 interest in the property. Basis is allocated pro rata to the donee's interest and the donor's retained interest. Hence, X's basis in his retained interest is $140,000. Notwithstanding the donee's promise to discharge the donor's

13. 17 T.C.M. (CCH) 1350, 1356 (1952) (emphasis added).
15. Id. at 441.
16. The gift tax due on the net gift is equivalent to the value of the donor's retained interest.
17. The Internal Revenue Code does not explicitly authorize a pro rata allocation of basis under these circumstances. It is, however, generally accepted that when part of a property is sold, a pro rata share of the transferor's basis is allocated to the sale to determine the transferor's taxable gain. The transferor then retains a pro rata share of basis in that portion of the property that was not transferred. See Welsh Homes, Inc. v. Commissioner, 279 F.2d 391, 395 (4th Cir. 1960) (basis allocated between the transferred leasehold and the reversionary interest); Treas. Reg. § 1.61-6(a) (1957). In the case of a gift, the Treasury has implicitly acknowledged that an allocation of basis is appropriate when a donor gratuitously transfers a term interest. Id. § 1.1015-1(b) (1971). No compelling reason exists to limit this pro rata allocation of basis to gratuitous transfers of term interests. Thus, it is arguable that when the retained interest analysis is employed, the donor's basis should be allocated pro rata to the portion of the property transferred and the donor's retained interest.
18. The following equation is used to calculate X's pro rata basis in his retained interest:

\[
\text{Retained Interest (}$700,000) = \frac{\text{Fair Market Value (}$2,500,000)}{\times \text{Basis (}$500,000)} = \text{$140,000.}
\]
gift tax liability, no further tax consequences to the parties result until the donee actually pays the gift tax. The donee’s discharge of the donor’s gift tax liability necessarily entails the disposition of the donor’s retained interest, thereby triggering a realization event on behalf of the donor. Because the surrender of the donor’s retained interest in the property is entwined with the donee’s discharge of the donor’s liability stemming from the earlier net gift transaction, reliance on an Old Colony Trust analysis to attribute income to the donor pursuant to the discharge of the donor’s gift tax liability is precluded. This does not mean, however, that there are no tax consequences associated with the latter transaction although this inference, at least in one instance, has been mistakenly drawn. Rather, when Y pays X’s gift tax, X should be treated as realizing $700,000. Consequently, X should be compelled to recognize a $560,000 gain. The courts, however, have not addressed the tax consequences associated with the disposition of the donor’s retained interest, nor has the Service raised the issue. This explains why Z advised X that Y’s agreement to pay X’s gift tax as a condition to the transfer would result only in the payment of a gift tax on the net gift.

As an alternative to the retained interest theory, the Service has frequently characterized a transfer of appreciated property contingent upon an agreement by the donee to pay the gift tax as a part gift/part sale. A part gift/part sale characterization treats the donee’s promise to pay the gift tax as contemporaneous consideration for the transfer of the gross property by the donor. Thus, if Y agrees to pay X’s gift tax as a condition to the transfer, the Service has argued that X is exchanging $2,500,000 worth of

19. At the time of the transfer, no realization event with respect to the donor’s retained interest occurs.
20. See text accompanying notes 93-99 infra.
21. See note 69 infra.
23. I.R.C. § 1001(b) (1976), provides that the amount realized from the sale or other disposition of property equals the sum of any money received plus the fair market value of any property other than money received in the transaction.
24. X’s $560,000 gain is calculated by deducting his basis in the retained interest ($140,000) from his amount realized ($700,000). Id. § 1001(a), (c) (1976 & Supp. III 1979). Since the Acme Corporation stock is a capital asset, the gain X realizes pursuant to disposition of his retained interest is a capital gain. Id. § 1221 (1976).
stock for $700,000, the value of Y's promise.\textsuperscript{26} Net gift treatment results since only the bargain element of the exchange, $1,800,000, constitutes a gift.\textsuperscript{27} As a result of this gift, X is liable for a $700,000 gift tax.\textsuperscript{28}

In addition to the gift element, however, the presence of contemporaneous consideration triggers an immediate realization event on behalf of X.\textsuperscript{29} Consequently, X realizes $700,000 in the exchange. To the extent that X's amount realized exceeds his total adjusted basis of $500,000 in the property transferred,\textsuperscript{30} X realizes taxable gain.\textsuperscript{31} Hence, in addition to the $700,000 gift tax imposed on the transfer, X must recognize a $200,000 gain at the time of the transfer.\textsuperscript{32} When Y actually discharges X's gift tax liability at a later date, no additional tax consequences to the parties result.

Until recently, no foundation existed upon which the Service could base a compelling argument that a donee's mere promise to discharge the donor's gift tax liability constitutes contemporaneous consideration for an otherwise gratuitous transfer.\textsuperscript{33} Thus, the courts appropriately rejected this theory when the Service advanced it in past cases.\textsuperscript{34} In light of this precedent, Z apparently did not regard the Service's part gift/part sale characterization as a significant threat to his conclusion that a pretransfer agreement between X and Y would limit the tax consequences of the transaction to a gift tax on the net gift.

\section*{THE INCOME TAX CONTROVERSY}

An examination of the evolution of the case law will reveal why uncertainty has developed over the income tax consequences associated with the donee's promise and the ultimate discharge of the donor's gift tax liability.

\textsuperscript{26} The gift tax due on the net gift is equivalent to the value of the donee's contemporaneous consideration.

\textsuperscript{27} The Code provides that when property is transferred for less than full consideration, the amount by which the property's fair market value exceeds this consideration is a gift. I.R.C. § 2512(b) (1976).

\textsuperscript{28} \textit{Id.} §§ 2501(a), 2502(a), 2512(a).

\textsuperscript{29} See note 23 supra.

\textsuperscript{30} The courts and the Service have rejected a pro rata allocation of basis in a part gift/part sale. See, e.g., Fincke v. Commissioner, 39 B.T.A. 510, 515 (1939), \textit{acq.}, I.T. 3335, 1939-2 C.B. 1934; Ltr. Rul. 7752001. It is, however, arguable that this position is inconsistent with I.R.C. § 1011(b) (1976), which provides that a pro rata allocation of basis is appropriate in the case of a bargain sale to a charity.

Although the Service has rejected a pro rata allocation of basis in a part gift/part sale, this does not affect the propriety of allocating basis when the donor is regarded as retaining an interest in the property transferred. See note 17 supra.

\textsuperscript{31} I.R.C. § 1001(a) (1976).

\textsuperscript{32} X's $200,000 gain is computed by deducting his basis in the property ($500,000) from his amount realized ($700,000). \textit{Id.} § 1001(a), (c) (1976 & Supp. III 1979). Since the Acme Corporation stock is a capital asset, the gain X realizes pursuant to the gift/part sale is a capital gain. \textit{Id.} § 1221 (1976).

\textsuperscript{33} For a discussion of recent authority supporting a part gift/part sale argument, see notes 74-80 and accompanying text infra.

\textsuperscript{34} See note 62 infra.
Decisions reviewing the development of the relevant law commence the analysis with Estate of Staley v. Commissioner. Staley involved gifts of stock to a trust for the benefit of the donor's children in consideration for $150,000 to be paid to the donor out of income the transferred assets generated. The donor arranged the transaction in this way because he did not have sufficient funds to pay the gift tax. The court accorded the donor net gift treatment and held that the nature of the donor's retained interest was an income interest. As such, the $150,000 was taxable as ordinary income to the donor upon receipt. Harrison v. Commissioner and Lingo v. Commissioner, which followed Staley, expanded the net gift concept to encompass gifts to a trust when the trustee agreed to pay the gift tax. Although both courts justified net gift treatment on the basis that the donors had retained an interest in the properties transferred, neither opinion indicated that the nature of such interest was regarded by the courts or the parties as an income interest. In addition, neither decision raised the issue of tax consequences to the donor associated with the discharge of the donor's gift tax liability and consequent disposition of the donor's retained interest.

The validity of net gift treatment was virtually assumed when the next case arose in which the donor transferred property to a trust with the trustee agreeing to pay the gift tax. In this decision, Estate of Sheaffer v. Commissioner (Sheaffer I), the trustee paid the $330,000 gift tax with income generated by the trust assets while in the hands of the trustee and with funds borrowed on the security of the trust assets. The Service sought to tax the donor on $255,000 of income generated by the trust assets prior to the close of the tax year in which the gift tax was paid.

35. Hirst v. Commissioner, 63 T.C. 307, 310-14 (1974), aff'd, 572 F.2d 427 (4th Cir. 1978), and Turner v. Commissioner, 49 T.C. 356, 360-64 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), provide the most detailed reviews of prior case law.


37. 47 B.T.A. at 265. The donor had excluded $150,000 from the value of the gifts on his tax return. Although the Service determined a deficiency, the Board of Tax Appeals found that the $150,000 was properly excluded from the value of the gifts. The decision made no further mention of the net gift issue.

38. It is interesting to note that the taxpayer was not arguing that there were no tax consequences associated with the receipt of the $150,000. Instead, the taxpayer argued that the $150,000 constituted a return of capital. 47 B.T.A. at 265. This argument is analogous to a part gift/part sale characterization.

39. 17 T.C.M. (CCH) 1350 (1952).

40. 13 T.C.M. (CCH) 436 (1954).

41. See text accompanying notes 13-14 supra.

42. 37 T.C. 99 (1961), aff'd, 313 F.2d 738 (8th Cir.), cert. denied, 375 U.S. 818 (1963). Sheaffer I is the first of two decisions involving this transaction. See also Estate of Sheaffer v. Commissioner (Sheaffer II), 25 T.C.M. (CCH) 646 (1966) (discussed in text at notes 58-59 infra).

43. The trustee paid the $330,000 gift tax with $190,000 of income the trust corpus had generated and with a $140,000 loan. By the close of the tax year in which the gift tax was paid, the corpus had generated an additional $65,000 of income. 37 T.C. at 103 (1961).
The tax court held that the $255,000 was taxable to the donor as ordinary income based on sections 671 and 677 of the Internal Revenue Code.\textsuperscript{44} Section 677 provides that the grantor of a trust shall be treated as the owner of the trust if the trust's income may be "distributed to the grantor or . . . held or accumulated for future distribution to the grantor" at the discretion of the grantor or of a nonadverse party. Treasury Regulations promulgated under section 677 indicate that the possibility that income the trust generates will be used to discharge a liability of the grantor provides a sufficient nexus for treating the grantor as owning a portion of the trust.\textsuperscript{45} When the grantor is treated under section 677 as the owner of any portion of the trust, section 671 operates to tax the donor on trust income.\textsuperscript{46} Thus, the \textit{Sheaffer I} court, citing \textit{Estate of Staley v. Commissioner},\textsuperscript{47} held that:

We see no material difference in principle between making a gift of stock in trust with a reservation . . . of the first $150,000 of income, which the settlor intended to use to pay his gift taxes directly, as in \textit{Staley}, and, as in the instant case, the making of a gift of stock in trust with a provision in the trust instrument that the trustee is to pay the gift tax. In both cases, income is reserved for the benefit of the donor and, under section 677, is taxable to the donor.\textsuperscript{48}

Although the \textit{Sheaffer I} court relied on \textit{Staley}, it is imperative to draw a distinction between the two cases. In \textit{Staley}, the nature of the interest the donor retained was clearly and exclusively an income interest in the trust; the donor retained the right to $150,000 of income to be generated by the trust assets. The interest the donor retained in \textit{Sheaffer I}, however, was not exclusively and specifically a right to income. The trust agreement in \textit{Sheaffer I} provided that the trustee was authorized to obtain a loan to pay all gift taxes and to pledge the trust's corpus and income to secure this loan.\textsuperscript{49}

\textsuperscript{44} \textit{Id.} at 104.

\textsuperscript{45} Treas. Reg. § 1.677(a)-1(d) (1971), provides that "under section 677 a grantor is, in general, treated as owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both may be applied in discharge of a legal obligation of the grantor. . . ."

\textsuperscript{46} Section 671 of the Internal Revenue Code provides that:

Where it is specified . . . that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account . . . in computing taxable income or credits against the tax of an individual.


\textsuperscript{47} 47 B.T.A. 260 (1942), \textit{aff'd}, 136 F.2d 368 (5th Cir.), \textit{cert. denied}, 320 U.S. 786 (1943). See notes 36-38 and accompanying text \textit{supra}.

\textsuperscript{48} 37 T.C. at 106. Income the corpus generates prior to the discharge of the donor's gift tax liability is taxable to the donor pursuant to I.R.C. §§ 671, 677 (1976), regardless of whether such income is actually used to discharge such liability. Krause \textit{v. Commissioner}, 56 T.C. 1242 (1971), \textit{appearance dismissed nolle pros.}, (6th Cir. 1972).

\textsuperscript{49} Specifically, the trust agreement provided:

The trustee is authorized and agrees to obtain a loan in an amount sufficient to
The language of the trust agreement indicates that the retained interest was not limited to the right to have trust income applied to the payment of the gift tax. Nor does the fact that the donor was taxable on income the corpus generated based on sections 671 and 677 render the retained interest an income interest. The foregoing sections are frequently invoked to attribute capital gains to the settlor of a Clifford Trust\(^9\) when capital assets the trust holds are sold and the trust retains the proceeds.\(^{10}\) Whenever the grantor retains some interest in the trust, sections 671 and 677 will operate to pass through to the grantor those tax events of the trust which could conceivably accrue to the benefit of the grantor. Thus, in *Sheaffer I*, the trust income was taxable to the donor not because of a requirement that the gift tax be paid out of trust income, but because trust income was subject to being used for that purpose until the donor's gift tax liability was satisfied.\(^{12}\)

The limited utility of sections 671 and 677 for the purpose of attributing taxable income to the donor when the trustee agrees to satisfy the donor's gift tax liability became apparent in *Estate of Morgan v. Commissioner.*,\(^{53}\) In *Morgan*, the trustee discharged the donor's entire gift tax liability with borrowed funds before the trust corpus generated any income while in the trustee's hands. The loan was subsequently repaid with income generated by the trust assets. The Service sought to attribute this income to the donor based on sections 671 and 677 apparently arguing that substitution of the trustee's liability for the donor's gift tax liability did not constitute a termination of the donor's retained interest in the property. Thus, not until the trustee's liability was discharged would the donor be insulated from all income generated by the transferred assets. Although the court conceded that, under certain circumstances, the trustee's loan would be

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\(^{9}\) 37 T.C. at 101.

\(^{10}\) In *Helvering v. Clifford*, 309 U.S. 331 (1940), the grantor created a trust for the benefit of his wife. At the end of five years the trust was to terminate with the corpus to revert to the grantor. The grantor also was sole trustee with the power to distribute income to the beneficiary or retain income within the trust. Based on these facts, the Court held that the grantor was the owner of the trust for income tax purposes. *Id.* at 335-37. Under I.R.C. §§ 671-679 (1976 & West Special Supp. 1980), if certain requirements are satisfied a grantor can avoid being taxed on income the trust corpus generates. Trusts which operate in this manner are commonly called Clifford Trusts.


\(^{12}\) As the court stated in *Krause v. Commissioner*, 56 T.C. 1242 (1971), *appeal dismissed nolle pros.*, (6th Cir. 1972), a case involving analogous facts, "[t]rust income is taxable to petitioner not because of any requirement that the gift taxes be paid out of income but because the trust income, within the meaning of § 677, was subject to being used for that purpose at a time when petitioner was personally liable for the tax." 56 T.C. at 1248.

deemed a sham and ignored, the court concluded that such circumstances were not present in Morgan. Therefore, the court held that once the donor’s obligation is satisfied, no grounds remain for attributing future income generated by the transferred property to the donor. The Morgan holding indicates that the Service was proceeding with an inappropriate theory since application of the proceeds of the trustee’s loans to the donor’s gift tax liability constituted a termination of the donor’s retained interest. The decision does not suggest, however, that no tax consequences are associated with termination of the donor’s retained interest.

The Service’s position in Morgan explains why the Service did not attempt to establish tax consequences with respect to that portion of the donor’s gift tax liability that was discharged with proceeds the trustee borrowed in Sheaffer I. As in Morgan, the Service was apparently proceeding in Sheaffer I with the mistaken belief that substitution of the trustee’s liability for the donor’s liability would not preclude attributing to the donor

54. See, e.g., Russell v. Commissioner, 5 T.C. 974 (1945) (loan involving related parties), appeal dismissed, 154 F.2d 829 (1st Cir. 1946).

55. 37 T.C. at 984-85 (citing David Keith, 45 B.T.A. 644 (1941), acq., I.T. 11132, 1942-1 C.B. 101). In Keith, the settlor transferred assets in 1926 to an irrevocable trust subject to an agreement that the trustees pay certain liabilities of the settlor out of the trust estate. The trust agreement authorized the trustees to borrow on the security of the trust estate or to sell portions of the corpus in order to discharge the settlor’s indebtedness. In addition, the trustees were required to deposit in a sinking fund a portion of the income the trust assets generated to discharge the settlor’s indebtedness, to discharge any indebtedness the trustees incurred and to restore the trust estate to its original value if any portion of the corpus was sold to raise proceeds to discharge the settlor’s indebtedness. Between 1926 and 1930 the trustees discharged $232,000 of indebtedness with funds obtained from income, loans secured with trust corpus and the sale of trust corpus. It is unclear whether the trustees discharged all of the settlor’s indebtedness prior to discharging any of their own. By 1930, however, the indebtedness of all parties had been discharged. 45 B.T.A. at 645-46.

The issue in Keith was whether trust income generated after 1930 and deposited in the sinking fund to restore the trust estate to its original value was attributable to the settlor under the predecessor to I.R.C. § 677 (1976). The court held:

[w]hatever may have been said in 1926-1930 as to the propriety of attributing to [settlor] the trust income used to discharge his debts, there is no theory upon which the income of succeeding years may be attributed to him. It was not used for his benefit to discharge any of his obligations. His obligations had been paid in 1930 and no continuing obligation was left upon him.

45 B.T.A. at 646-47 (emphasis added).

It is unclear from the decision whether the Service attributed income to the settlor from 1926 to 1930 and whether all or part of such income was generated subsequent to the discharge of the settlor’s indebtedness. If, in fact, the Service did attribute income to the settlor between 1926 and 1930 that was generated after the substitution of the trustees’ indebtedness for the settlor’s indebtedness, the taxpayer apparently did not challenge the Service for doing so. Instead, the taxpayer challenged the Service only to the extent that it attributed income to the settlor after the trustees’ substituted indebtedness had been discharged. If the foregoing hypothesized events actually transpired, it is rather ironic that the case was ultimately cited in Morgan to preclude the attribution of income to a settlor under circumstances in which the settlor’s gift tax liability was discharged with proceeds from the indebtedness the trustee incurred.

56. See notes 42-43 and accompanying text supra.
trust income generated between the time that the donor's liability was discharged and the trustee's liability was discharged. If this were the case, it would have been logical for the Service to wait until such income was generated and seek to attribute this income to the donor pursuant to sections 671 and 677 rather than attempt to tax the donor on the disposition of the donor's retained interest at the time the donor's gift tax liability was discharged.\footnote{57. The Treasury will raise more revenue if income generated by the trust assets is attributed to the donor as ordinary income since taxing the donor on the disposition of the donor's retained interest often entails recovery of basis and capital gains rates. See notes 23-24 and accompanying text supra.}

That the foregoing is exactly what the Service had in mind at the time of \textit{Sheaffer I} is confirmed by \textit{Estate of Sheaffer v. Commissioner (Sheaffer II)}.\footnote{58. 25 T.C.M. (CCH) 646 (1966).} In \textit{Sheaffer II}, the Service sought to tax the \textit{Sheaffer I} donor under sections 671 and 677 on $72,000 of income the trust generated between the time that the donor's gift tax liability was discharged and the time that the loan proceeds the trustee used to pay the tax were repaid. Naturally, the court held against the Service in light of \textit{Morgan}.\footnote{59. \textit{Id.} at 650-51.} Here again, the holding only indicates that sections 671 and 677 are an inappropriate route to taxation under these circumstances. The decision does not suggest that no tax consequences are associated with the disposition of the donor's retained interest.

In the decade following \textit{Sheaffer II}, the Service frequently was confronted with gifts of appreciated property to trusts and individuals that had agreed to pay the donor's gift tax liability as a condition to the gift. Regardless of the nature of the donee, the donor consistently claimed that the only tax consequences associated with the transfer of property and the discharge of the gift tax liability was a gift tax on the net gift. In the trust cases, taxpayers apparently took notice of \textit{Morgan} and \textit{Sheaffer II} in structuring their transactions. These taxpayers avoided the reach of sections 671 and 677 by ensuring that the gift tax liability was discharged before the trust assets produced income while in the trustee's hands.\footnote{60. \textit{See, e.g.,} Krause v. Commissioner, 56 T.C. 1242 (1971) (trust income generated after the payment of the donor's gift tax was not income of the donor), \textit{appeal dismissed nolle pros.}, (6th Cir. 1972); Estate of Davis v. Commissioner, 30 T.C.M. (CCH) 1363 (1971), \textit{aff'd}, 469 F.2d 694 (5th Cir. 1972) (discharge of the donor's gift tax liability with assets held in a pre-existing trust precluded the Service from attributing income to the donor under I.R.C. §§ 671, 677 (1976)).} With this route to taxation foreclosed, the Service for the first time attempted to tax the donor on the disposition of the donor's retained interest in the property transferred when the trustee discharged the donor's gift tax liability. The courts rejected the Service's theory, however, since the Service was claiming that the nature of the donor's retained interest was an \textit{income} interest.\footnote{61. \textit{See the decision cited in note 60 supra.} These courts were correct in concluding that
In those cases involving the transfer of property to individuals, the Service endeavored to characterize the transaction as a part gift/part sale rather than trying to reconcile the appropriate tax consequences with the retained interest theory.\(^6\) The Service did not contest net gift treatment, but argued that the net gift was incidental to a sale transaction in which the donor realized gain to the extent that the donor's gift tax liability exceeded the donor's basis in the property transferred. The Service, however, departed from a pure part gift/part sale analysis in these cases when it conceded that the donor did not recognize gain until the donee discharged the donor's gift tax liability.\(^6\)^3 The courts rejected the Service's position and held for the taxpayers in these cases.

By the mid-1970's, the Service argued that a gratuitous transfer contingent upon an agreement by the donee to pay the gift tax should be characterized as a part gift/part sale regardless of whether the donee was an individual or a trust.\(^6\)^4 After a series of defeats in the Tax Court in which the Service was apparently advancing some version of its part gift/part sale theory,\(^6\)^5 the Service has recently refrained from characterizing these trans-


\(^6\) A delayed recognition of gain could be reconciled with a part gift/part sale characterization if there were some basis for establishing that, while the realization event occurs at the time of transfer, recognition of gain is delayed until the gift tax is actually paid. No provisions of the Internal Revenue Code, however, lend support to this analysis.

\(^6\) The Service was obviously influenced by its success in characterizing a gift subject to a donee's agreement to pay certain nonrecourse indebtedness of the donor as a part gift/part sale. Johnson v. Commissioner, 59 T.C. 791 (1973), aff'd, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974). The Johnson decision, however, is of limited relevance to a donee's agreement to pay the donor's gift tax liability because the gift tax is a recourse liability. See note 87 and accompanying text infra.

\(^6\) The Service failed to adopt a consistent position as to whether the donor recognized gain at the time of the transfer or at the time the donee discharged the donor's gift tax liability. In several decisions the Service argued in the alternative that gain was recognized either when the donee paid the gift tax or when the donor made the transfer. See, e.g., Bradford v. Commissioner, 70 T.C. 584, 594 (1978), appeal docketed, No. 79-1032 (6th Cir. 1979); Estate of Henry v. Commissioner, 69 T.C. 665, 669 (1978), appeal pending, No. 78-1340 (6th Cir. argued July 16, 1980); Estate of Currey v. Commissioner, 41 T.C.M. (CCH) 800-01 (1981); Benson v. Commissioner, 37 T.C.M. (CCH) 989, 990 (1978), appeal docketed, No. 79-1032 (6th Cir. 1979).

\(^6\) In other cases, the Service argued that the gain should be recognized when the transfer occurred. See, e.g., Davis v. Commissioner, 74 T.C. 881, 906 (1980); Grant v. Commissioner, 39 T.C.M. (CCH) 1088, 1089 (1979), rev'd sub nom., Diedrich v. Commissioner, 643 F.2d 499 (8th Cir.), cert. granted, 50 U.S.L.W. 3216 (U.S. Oct. 5, 1981) (No. 80-2204). In Estate of Weeden v. Commissioner, 39 T.C.M. (CCH) 699, 700 (1979), appeal docketed, No. 80-7127 (9th Cir. 1980), the Service assessed the tax deficiency in the year in which the gift tax was paid. In Diedrich v. Commissioner, 39 T.C.M. (CCH) 433, 434-35 (1979), rev'd, 643 F.2d 499 (8th Cir.), cert. granted, 50 U.S.L.W. 3216 (U.S. Oct. 5, 1981) (No. 80-2204); Owen v. Commissioner, 37 T.C.M. 272, 273 (1978), aff'd, 652 F.2d 1271 (6th Cir. 1981) and McNeice v.
actions as a part gift/part sale. In order to establish income tax consequences to the donor with a part gift/part sale theory, it is essential to demonstrate that a donee's mere promise to discharge the donor's gift tax liability constitutes contemporaneous consideration for the transfer, thus triggering a realization event at the time of the transfer. For some time relevant authority would not facilitate a persuasive argument to this effect. This, however, is no longer the case.

PART GIFT/PART SALE CHARACTERIZATION

The attributes of a part gift/part sale must be explored prior to considering whether a net gift transaction can be characterized as a part gift/part sale. When property that would otherwise be transferred by gift is instead transferred for consideration which is less than the fair market value of the property, a sale element is introduced into the transaction. The transaction is, therefore, characterized as a part gift/part sale. Typically, the consideration the transferee provides is cash or other property. Thus, if Y, the donee in our hypothetical, transferred $700,000 in cash to X as a condition to receiving the property worth $2,500,000, the transaction would be justifiably treated as a part gift/part sale. Net gift treatment appropriately results from this characterization because X makes a gratuitous transfer only to the extent that the fair market value of the property exceeds $700,000. Hence, Y pays for $700,000 of property and receives gratuitously $1,800,000 of property.

A part gift/part sale also would be present if, as a condition to the transfer, the donee remitted funds to a creditor of the donor. When a third party discharges the debtor's recourse liability, the discharge of the liability constitutes consideration and gain is as real as if the money were paid to the debtor and the debtor, in turn, paid the creditor. Thus in the hypothetical, if conditional to the transfer of the shares, Y remitted $700,000 to the government in satisfaction of X's gift tax liability, net gift treatment again would be justified. This treatment is justified because the donee received gratuitously only $1,800,000 worth of property. By paying

Commissioner, 41 T.C.M. (CCH) 969, 970 (1981), the Service's position was unclear because the gift tax was paid in the same year that the transfer occurred.


See, e.g., Blackburn v. Commissioner, 20 T.C. 204, 207 (1953) (the transfer of property for a note which had a face value less than the fair market value of the transferred property was a part gift/part sale); Rogers v. Commissioner, 31 B.T.A. 994, 1002-03 (1935) (the transfer of property for an annuity worth less than the fair market value of the transferred property was a part gift/part sale).

See, e.g., United States v. Hendler, 303 U.S. 564, 566 (1938) (when one corporation which was merging with a second corporation paid the indebtedness of the second corporation, the second corporation received taxable income). When a debtor is personally liable the debt is characterized as a recourse debt. Conversely, a debt is a nonrecourse debt when the debtor is not personally liable for its payment.
the government at the time of the transfer, Y provided contemporaneous consideration for the balance of the property.

Additionally, a part gift/part sale occurs when the donee accepts property subject to a nonrecourse liability. The donor realizes gain pursuant to the transfer of property encumbered with a nonrecourse liability because an obligation that previously would have been satisfied at the donor's expense no longer poses any threat of diminishing the donor's wealth. In addition, net gift treatment is justified because the donee receives gratuitously only the net value of the property. The donee, in effect, pays for the balance by relieving the donor of the obligation that was formerly burdening the donor's wealth.

The foregoing analysis also is applicable to the donee's assumption of a nonrecourse liability burdening the property transferred. The donor's position is the same regardless of whether the donee assumes or takes subject to the nonrecourse liability. With respect to the donee who becomes personally liable, the creditor is provided with additional protection in case the value of the property falls below the value of the liability. The addition of the donee's personal liability, however, has no bearing on that which the donee is receiving gratuitously or that for which the donee is paying.

In contrast to the above transactions, it is more difficult to find contemporaneous consideration and hence a part gift/part sale when the donor transfers property encumbered with a recourse liability. The problem with demonstrating contemporaneous consideration in this situation is that unless the donee assumes the liability and the creditor surrenders its claim against the donor, the transfer of the property does not necessarily shift the burden of the claim to the donee. Because the liability will not necessarily be satisfied at the donee’s expense, it would appear that contemporaneous

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69. It is important to note that the Old Colony Trust analysis, see note 7 and accompanying text supra, is not applicable to a part gift/part sale. The Old Colony Trust analysis is limited to the situation where a third party discharges a taxpayer's liability without receiving anything in return. Thus, the taxpayer receives income equal to the entire amount of the discharged liability. See text accompanying note 21 supra. In contrast, in a part gift/part sale the discharge of the transferor's liability is contemporaneous to a property transfer. The discharge of the liability constitutes consideration the transferor receives in exchange for a complete termination of interest in the property transferred. This exchange element allows the transferor to recover the transferor's basis in the transferred property. See I.R.C. § 1001 (1976 & Supp. III 1979).

70. In a sale, when a buyer takes property subject to a nonrecourse liability, the amount of the liability is included in the seller's consideration. Crane v. Commissioner, 331 U.S. 1, 14 (1947). This principle has been applied in the context of a gift. Estate of Levine v. Commissioner, 634 F.2d 12, 16 (2d Cir. 1980). It should be noted, however, that in Levine the donee also assumed certain recourse liabilities of the donor.

71. See Crane v. Commissioner, 331 U.S. 1 (1947); Johnson v. Commissioner, 59 T.C. 791 (1973), aff’d, 495 F.2d 1079 (6th Cir.) (extension of Crane to gratuitous transfers subject to a nonrecourse liability, at least when the donor receives additional consideration), cert. denied, 419 U.S. 1040 (1974).

72. See text accompanying note 70 supra.
consideration is lacking. Were this the case, the transfer could not properly be characterized as a part gift/part sale.\textsuperscript{73}

Notwithstanding the foregoing analysis, however, case law suggests that the donee's assumption of the donor's recourse liability justifies part gift/part sale treatment. In \textit{Malone v. United States},\textsuperscript{74} state law provided that the assumption of a recourse liability rendered the assuming party primarily liable. Based on this law the district court found that it was sufficiently probable at the time of the transfer that the liability would be satisfied at the donee's expense to regard the assumption as contemporaneous consideration for the transfer.\textsuperscript{75} Similarly, in \textit{Evangelista v. Commissioner},\textsuperscript{76} the court stated that when a trust assumes a recourse liability, the assumption is sufficient to constitute contemporaneous consideration for the transfer.\textsuperscript{77} The court reasoned that it would be highly unlikely that the donor would be required to make payment because the creditor could first attempt to secure payment from the trust assets and income.\textsuperscript{78}

Any lingering doubts with regard to whether the donee's assumption of a recourse liability triggers a realization event were laid to rest with the adop-

\begin{itemize}
\item \textsuperscript{73} Without contemporaneous consideration, no sale element is present. In the absence of a sale element, a part gift/part sale analysis is inapplicable because either the gross value of the property passes gratuitously or the donor retains an interest in the property transferred.
\item \textsuperscript{74} 326 F. Supp. 106 (N.D. Miss. 1971), \textit{aff'd}, 455 F.2d 502 (5th Cir. 1972).
\item \textsuperscript{75} The \textit{Malone} court stated:
\begin{quote}
Granting that the assumption of debt did not constitute either a cancellation or total discharge of [donor's] debt liability, the chances that he would ever have to pay any portion of the debt were remote indeed. For even though the [creditor] under Mississippi law still had the option to proceed against either [donee] or the [donor] if the [debt] installments were not paid, [donor, who would be treated as a surety under state law], would be subrogated to the rights of the [creditor] if he were compelled to pay the [debt] and could thereafter go against both the income [from the property and the property itself] to recoup any amounts he might have paid to the [creditor].
\end{quote}

326 F. Supp. at 111.
\item \textsuperscript{76} 629 F.2d 1218 (7th Cir. 1980).
\item \textsuperscript{77} The court indicated, however, that if it had been proper to characterize the entire transaction as a gift rather than as a taxable disposition, the trust's assumption of the recourse liability might not change this characterization. \textit{Id.} at 1225.
\item \textsuperscript{78} The court stated:
\begin{quote}
After the assumption of the liability the [creditor] would look to whatever income or assets the trust possessed for payment. Only in the event the trust income or assets failed would [transferor] be called on to make payment. The assumption of the liability substantially reduced [transferor's] responsibility on the [debt]; he was no longer primarily liable. A potential situation in which [the transferor] would be called on to make payment is too speculative to defeat the assertion that [transferor] received an economic benefit in the amount of the liability assumed in the year of the transfer. The amount of the liability assumed was an amount realized. . .
\end{quote}
\textit{Id.} The basis on which the court concluded that the transferee became primarily liable for the debt cannot be ascertained from the decision.
tion in 1980 of new Treasury Regulations promulgated under section 1001.79 The regulations provide that the amount realized from a sale, gift, or other disposition of property includes the amount of liability from which the transferor is discharged. In addition, in the case of a recourse liability, a donor will be treated as being discharged from the liability if the donee agrees to pay the liability. The donor is accorded this treatment even if the creditor does not release the donor.80 Based on these regulations, sufficient certainty exists at the time of the transfer that the obligation will be satisfied at the expense of the donee to characterize the transaction as a part gift/part sale.

When a donee merely takes property subject to a recourse liability rather than assuming the liability, contemporaneous consideration is absent. The possibility that the creditor will look to the property transferred for payment rather than to the donor is too remote to constitute contemporaneous consideration. Without contemporaneous consideration, there is no realization event and part gift/part sale treatment is precluded. Under these circumstances, a part gift/part sale characterization cannot be used to justify net gift treatment. If the donor transfers the entire property to the donee for no contemporaneous consideration, the gift must be valued at its gross value. If the liability is subsequently satisfied at the expense of the donee, additional tax consequences will result at that time. The gift tax resulting from the prior transfer, however, will be unaffected.81

It is, of course, arguable that a gift of property subject to a recourse liability is sufficient to constitute contemporaneous consideration because it creates a possibility that the liability will be satisfied at the donee's expense. If the value of the property transferred is substantially in excess of the liability, the donor might refuse to pay and instead convince the creditor to proceed against the property rather than institute collection proceedings against the donor.82 For this theory to be accepted, however, the

80. The new Treasury Regulations provide in pertinent part:
   (1) [T]he amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.
(4) For purposes of this section—

   (i) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);
   (ii) A disposition of property includes a gift of the property . . .

Id.

81. Under an Old Colony Trust analysis, see note 7 and accompanying text supra, income would be attributed to the donor at the time his or her liability was discharged.
82. See, e.g., Mississippi Valley Trust Co. v. Commissioner, 147 F.2d 186, 187-88 (8th Cir. 1945) (donee liable for the unpaid gift tax even though the donor was solvent and the tax had not been assessed against the donor).
holding in *Crane v. Commissioner* must be extended to encompass the transfer of property subject to a recourse liability. Recently, the Second Circuit suggested that it would not necessarily reject such an extension of *Crane*. At the present time, however, no precedent exists which indicates that *Crane* would apply under these circumstances. In this regard, it is significant that the *Malone* court, which applied *Crane* to the assumption of a recourse liability, expressly based its decision on the fact that the donee did not merely accept title subject to the mortgage but rather assumed responsibility for payment of the underlying obligation.

Whether a promise by the donee to discharge the donor's gift tax liability constitutes contemporaneous consideration resulting in a part gift/part sale on which basis net gift treatment can be justified depends, therefore, upon the nature of the gift tax liability and the extent to which the donee is committed to satisfying it. The donor is liable for payment of the gift tax and therefore a gift tax liability is a recourse liability. A donee's agreement to discharge the donor's gift tax liability constitutes an assumption of the liability. This is the case notwithstanding that the government will not hold the donee personally liable for the gift tax unless the donor fails to pay the tax when due. The agreement constitutes an assumption because, as between the donor and the donee, the agreement renders the donee ultimately liable for the donor's gift tax.

In accord with the newly adopted Treasury Regulations, an agreement that the donee will pay the gift tax is sufficient to trigger an immediate realization event. Hence, if the new regulations are acknowledged, an argument that these transactions are properly characterized as a part gift/part sale should prevail.

83. 331 U.S. 1 (1947). See note 70 supra.
84. Estate of Levine v. Commissioner, 634 F.2d 12, 16-17 (2d Cir. 1980).
85. The Service has cited Johnson v. Commissioner, 59 T.C. 791 (1973), aff'd, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), for this proposition. The *Johnson* holding is inapplicable, however, because that case involved a transfer subject to a nonrecourse liability. See note 71 supra.
89. The courts may be reluctant to characterize these transactions as entailing a sale element in view of past decisions indicating that the donor's sole intent is gratuitous since these transactions typically occur between family members. See Estate of Henry v. Commissioner, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir. argued July 16, 1980); Turner v. Commissioner, 49 T.C. 356 (1968), aff'd, 410 F.2d 752 (6th Cir. 1969). If this occurs, then the donor should not be accorded net gift treatment and the payment of the gift tax liability by the donee should be treated as a taxable gift from the donee. In the rare instances in which this gift/gift theory has been raised, it has been flatly rejected. Hirst v. Commissioner, 63 T.C. 307, 315 (1974), aff'd, 572 F.2d 427 (4th Cir. 1978); Recent Development, *Federal Income Tax—Net Gift Doctrine*, 63 CORNELL L. REV. 1074, 1086 n.101 (1978).
As the foregoing discussion indicates, recently adopted Treasury Regulations enable the Service to treat a donor as realizing gain at the time of the transfer of appreciated property contingent upon a donee’s agreement to pay the gift tax. Prior to the adoption of the regulations, the courts did not regard a donee’s promise to pay a donor’s gift tax liability as contemporaneous consideration for a gift of appreciated property. Hence, the Service’s part gift/part sale characterization was rejected and net gift treatment was justified only on the basis of the retained interest analysis. Even when net gift treatment is justified by the retained interest theory, that theory, when carried to its logical conclusion, entails tax consequences in addition to a gift tax on the net gift.

Under the retained interest theory, the donor retains an interest in the property transferred equivalent in value to the gift tax due on the transfer. Thus, no realization event occurs at the time of the transfer. If the transfer is to a trust and the trust assets generate income prior to the time that the trustee discharges the donor’s gift tax liability, then such income is attributable to the donor pursuant to sections 671 and 677 of the Internal Revenue Code. The donor is taxed on this income not because the donor has retained an income interest, but rather, because income the trust assets generate potentially could be applied to the donor’s liability and hence used for the donor’s benefit. Under these circumstances, it is at least arguable that the aggregate income attributed to the donor should not exceed the donor’s gift tax liability and that the donor’s retained interest disappears once this amount of income has been attributed to the donor.

If the foregoing argument is rejected or if the trust assets have generated insufficient income prior to the discharge of the donor’s gift tax liability to eradicate the donor’s retained interest, then the donor’s retained interest is necessarily disposed of at the time that the donee discharges the donor’s gift tax liability. In addition, if the donee is an individual rather than a trust, the donor’s retained interest is disposed of at the time the donee pays the

90. In the remote event that the courts reject the new Treasury Regulations, the Service should be prepared to use the retained interest theory to establish the realization event which these transactions necessarily entail.
91. See notes 62-66 and accompanying text supra.
92. See notes 16-24 and accompanying text supra.
93. See note 16 and accompanying text supra.
94. See notes 44-48 and accompanying text supra.
95. See notes 49-52 and accompanying text supra.
96. Although little precedent exists to support this argument, it seems patently unfair to tax the donor more than once on the same value.
97. There are no analogous provisions to I.R.C. §§ 671, 677 (1976), for individuals. The common law “assignment of income” doctrine might be analogously applied in certain cases. Under the assignment of income theory, an incomplete transfer of income-producing property will not relieve the transferor of tax liability with respect to future income the property generates. See Helvering v. Horst, 311 U.S. 112 (1940).
In all of the foregoing cases, the disposition of the donor’s retained interest is contemporaneous to the donee’s payment of the donor’s gift tax liability. Thus, the donor is transferring the donor’s retained interest in the property for real and contemporaneous consideration at the time that the donee discharges the donor’s gift tax liability. Such a transfer is the essence of a sale or exchange. Therefore, gain must be recognized at the time that the donee pays the donor’s gift tax liability irrespective of the tax consequences associated with the earlier net gift.

In *Hirst v. Commissioner*, the tax court acknowledged that the retained interest analysis logically entails a realization event. Nevertheless, the court chose to ignore this logic and erroneously concluded that precedent prevented it from acknowledging the realization event. The *Hirst* court’s conclusion indicates that it misinterpreted the earlier line of cases. Those cases never explored the income tax consequences associated with the disposition of the donor’s retained interest when the retained interest was not claimed to be an income interest. Thus, even if net gift treatment is justified by the retained interest theory, the courts are not barred from arriving at the analytically correct result that the realization event with respect

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98. Both the retained interest analysis and a part gift/part sale characterization regard the transfer as entailing both a gift and an exchange. Under the retained interest analysis, however, the gift and the exchange do not occur simultaneously. Instead, the exchange occurs after the transfer when the gift tax is paid. See text accompanying notes 16-24 supra.


The donor will prefer a part gift/part sale characterization to the retained interest analysis because the donor’s taxable gain will be smaller if the transaction is characterized as a part gift/part sale. Although the same amount will be realized regardless of which theory is adopted, the donor can offset the amount realized with the donor’s total basis in the transferred property if the transfer is characterized as a part gift/part sale. See note 30 supra. On the other hand, if the transaction is characterized as a net gift followed by a disposition of the donor’s retained interest when the donee pays the gift tax, the donor can only offset the amount realized with a pro rata portion of the donor’s basis in the transferred property. Consequently, the donor must recognize a larger gain than would be recognized in a part gift/part sale transaction. See note 17 supra. The gain will be deferred, however, when the net gift is followed by the disposition of the retained interest. No logical explanation for this difference exists and it could be eliminated by allocating basis in all transactions characterized as a part gift/part sale in the way in which basis is allocated when a bargain sale is made to a charity. See note 30 supra.

100. 63 T.C. 307 (1974), aff’d, 572 F.2d 427 (4th Cir. 1978).

101. The *Hirst* court stated:

The gift tax itself is imposed only upon the “net gift,” i.e., upon the gross amount of the property transferred minus the gift tax paid by the donee. In substance, a portion of the transferred property equal in value to the amount of the gift tax is not treated as having been part of the gift. But surely that portion did not vanish into thin air, and a strong argument can be advanced for the conclusion that it was exchanged for the donee’s payment of the gift tax on the “net gift,” a transaction that may result in the realization of gain or loss depending upon the donor’s basis in the property.

63 T.C. at 315.

102. *Id.*

103. See note 35-64 and accompanying text supra.
to that portion of the property which is not subject to gift tax is not entirely avoided; it is merely delayed until the donee actually pays the donor's gift tax.104

RECENT APPELLATE DEVELOPMENTS

During the past year, two circuit courts of appeals have reviewed Tax Court decisions involving the income tax consequences to the donor pursuant to the transfer of appreciated property contingent upon a donee's agreement to pay the donor's gift tax. In the consolidated Eighth Circuit cases, Diedrich v. Commissioner and Grant v. Commissioner,105 the donors transferred low basis, highly appreciated securities to family members. The gifts were expressly conditioned on the donees' promise to pay all gift taxes arising from the transfers. The Service determined that the transfers resulted in taxable income to the donors in the years in which the transfers occurred to the extent that the gift tax exceeded the donors' total basis in the securities.106 The Tax Court held for the donors.107 The Eighth Circuit reversed, asserting that prior cases were erroneously decided and that when the donees discharged the donors' gift tax liability the benefit conferred resulted in taxable income to the donors.108

The Eighth Circuit's analysis does not clearly indicate on what theory of taxation the Service and the court were relying. By finding that the series of cases rejecting the Service's part gift/part sale characterization was incorrectly decided,109 and by allowing the donors to offset the amount realized with the donors' total basis in the property transferred, the court appeared to be utilizing a part gift/part sale approach.110 The court's decision, however, never mentions the part gift/part sale theory and fails to adopt the retained interest theory. Instead, the court acknowledges an abstract "economic benefit" theory the Service ostensibly advanced.111 The court's analysis implies that the donees were unilaterally thrusting a benefit on the donors when the donees paid the gift tax.112 The foregoing analysis,

104. The magnitude of the donor's gain will vary depending upon which theory the courts adopt. See note 99 supra. Although taxpayers may have interpreted precedent as indicating that these transactions do not entail income tax consequences, this is no excuse for perpetuating the myth. Diedrich v. Commissioner, 643 F.2d 499, 504 (8th Cir.), cert. granted, 50 U.S.L.W. 3216 (U.S. Oct. 5, 1981) (No. 80-2204). But see note 3 and accompanying text supra.
106. In Diedrich, the transfers occurred and the gift tax was paid in the same year. See note 65 supra.
108. 643 F.2d at 504.
109. Id. at 502.
110. See notes 25-32 and accompanying text supra.
111. 643 F.2d at 502.
112. The Diedrich court explicitly relied on Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). See notes 7 & 69 and accompanying text supra. In Old Colony Trust, the third
however, is incongruous with a donor's recovery of basis. If gain is not realized until the gift tax is paid and the donor is permitted to recover basis notwithstanding that the donor previously transferred the property, there must be a means available by which the donor can retain basis. The only conceivable manner in which the donor can retain basis is if the donor is treated as retaining an interest in the property transferred. As was previously indicated, however, the *Diedrich* court failed to adopt the retained interest theory.

In a Sixth Circuit decision, *Owen v. Commissioner*, the donor gratuitously transferred highly appreciated stock to several trusts contingent upon the corporate trustee's payment of the donor's gift tax. The stock was transferred and the gift tax paid during the same taxable year of the donor. The donor did not report any gain from the transfer but the Service determined that the donor realized gain to the extent that the donor's gift tax liability exceeded the donor's basis in the transferred stock. The Tax Court held for the donors and the Sixth Circuit affirmed, indicating precedent dictated its decision.

It is clear that the Service did not advance a part gift/part sale theory of taxation in *Owen*. Instead, the Service argued that the trustee's payment of the gift tax constituted gross income to the donor under section 61 of the Internal Revenue Code, that the discharge of the donor's gift tax liability gave rise to income pursuant to an *Old Colony Trust* analysis, and that the benefit the donor received pursuant to the discharge of the donor's gift tax liability was equivalent to the receipt of gross income pursuant to the *Crane* doctrine. Because the court based its holding on stare decisis it refrained from analyzing the Service's arguments although it did indicate that the Service's position was somewhat persuasive.

Notwithstanding the court's comment as to the persuasiveness of the Service's position, the Service's arguments in *Owen* are technically deficient because they fail to justify why the donor is entitled to recover basis at the time that the donor's gift tax liability is discharged. In order to recover basis at that time, the donor must have retained an interest in the property transferred. The Service's arguments, however, essentially ignored this retained interest.

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party who discharged the taxpayer's liability received nothing from the taxpayer in return. In contrast, an exchange element was present in *Diedrich*.

113. See note 69 supra.

114. See notes 16-24 and accompanying text supra.

115. 652 F.2d 1271 (6th Cir. 1981).


117. 652 F.2d at 1278.

118. Id. at 1277.

119. See note 70 supra.

120. 652 F.2d at 1278.

121. See note 69 and the text accompanying notes 113-14 supra.

122. See notes 16-32 and accompanying text supra.
While neither the Eighth Circuit nor the Sixth Circuit articulated a technically sound theory for establishing the necessary income tax consequences to the donor pursuant to a gift of appreciated property contingent upon a donee’s agreement to pay the gift tax, the disagreement among the circuits resulting from the disposition of those cases has had one positive effect. On October 5, 1981, the United States Supreme Court granted the taxpayer’s petition for a writ of certiorari and will now review the Eighth Circuit’s Diedrich decision. Thus, the long-awaited opportunity to wipe the slate clean and start over again may finally have arrived.

CONCLUSION

When appreciated property is transferred gratuitously contingent upon a donee’s agreement to discharge the donor’s gift tax liability, net gift treatment can be justified either by characterizing the transaction as a part gift/part sale or by employing a retained interest analysis. A part gift/part sale characterization entails, in addition to a gift tax on the net gift, the realization of gain by the donor at the time of the transfer. Gain is recognized to the extent that the gift tax on the net gift exceeds the donor’s entire basis in the property transferred.

Alternatively, if net gift treatment is justified by resort to the retained interest theory, there are still tax consequences in addition to the gift tax on the net gift. The donor realizes gain at the time that the donee discharges the donor’s gift tax liability to the extent that the gift tax on the net gift exceeds that portion of the donor’s basis attributable to the donor’s retained interest in the transferred property. Thus, regardless of how net gift treatment is justified, a gift of appreciated property made pursuant to the donee’s agreement to pay the gift tax entails, in addition to a gift tax on the net gift, a realization event and, therefore, income tax consequences to the donor. The only question is whether that realization event occurs at the time of the transfer or at the time that the donee discharges the donor’s gift tax liability.

Now that the Supreme Court has agreed to rule on whether there are income tax consequences to the donor pursuant to a gift of appreciated property contingent upon an agreement by the donee to pay the gift tax, the uncertainty surrounding this issue should finally be eliminated. As the foregoing discussion indicates, as long as net gift treatment is allowed under these circumstances, there are necessarily income tax consequences to the donor when appreciated property is transferred in this manner. Although some practitioners may mourn any reduction in the planning premium associated with a pretransfer agreement, the certainty resulting from an

124. See note 3 and accompanying text supra.
125. Establishing the realization event will not eliminate entirely the planning premium resulting from a pretransfer agreement. Net gift treatment is unaffected, hence the presence of a pretransfer agreement will result in a lesser gift tax than would otherwise be imposed. See
authoritative, analytically correct decision will enable tax planners to focus more attention on technically sound tax saving strategies.

notes 9-12 and accompanying text supra. In addition, the income tax payable by the donor when the donee pays the gift tax pursuant to a pretransfer agreement will be less than when the donee pays the gift tax in the absence of an obligation to do so because the donor will receive less income, will be entitled to recover basis and may be eligible for capital gains rates if a pretransfer agreement is utilized. Compare notes 4-8 and accompanying text supra with notes 16-32 and accompanying text supra.