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Federal Income Tax-Net Gift Doctrine-No Taxable Income Results from Gift Given Subject to Condition That Donee Pay Gift Tax

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RECENT DEVELOPMENT

Federal Income Tax—Net Gift Doctrine—NO TAXABLE INCOME RESULTS FROM GIFT GIVEN SUBJECT TO CONDITION THAT DONEE PAY GIFT TAX

Hirst v. Commissioner,
572 F.2d 427 (4th Cir. 1978) (en banc)

Edna Bennett Hirst, an eighty-one year old widow, transferred real property worth approximately $400,000 to her son, daughter-in-law, and grandchildren.[1] Unable to afford the resulting gift taxes, Mrs. Hirst made the transfers subject to the condition that her son pay the gift taxes. The Commissioner of Internal Revenue claimed that the transactions resulted in taxable income to Mrs. Hirst. The Fourth Circuit, sitting en banc,[2] disagreed, holding that a donor who gives a gift subject to an agreement that the donee pay the resulting gift tax realizes no income on the transaction.[3] The court relied on *Turner v. Commissioner*,[4] a case that the Sixth Circuit had apparently overruled in *Johnson v. Commissioner*.[5] *Hirst v. Commissioner*[6] thus perpetuates the confusion in the law governing this type of transaction.

I

HISTORY OF THE NET GIFT DOCTRINE

Turner v. Commissioner dealt with the income tax consequences[7]

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[1] Hirst v. Commissioner, 572 F.2d 427, 434-35 (4th Cir. 1978) (en banc) (dissenting opinion, Thomsen, J.).

[2] Originally heard by a three-judge panel, the case was reheard en banc. *Id.* at 434 (dissenting opinion, Winter and Butzner, JJ.).

[3] *Id.* at 431.

[4] 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq.* 1971-2 C.B. 4.

[5] 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974).

[6] 572 F.2d 427 (4th Cir. 1978) (en banc).

[7] Unlike the income tax consequences, the gift tax consequences of net gifts, or gifts in which a donor gives a gift subject to an agreement that the donee pay the resulting gift tax, are well established. Courts have concluded that the net benefit to the donee equals the value of the gift property less the gift tax due; therefore, only the value of the gift exceeding the gift tax paid—the amount given with donative intent—is a taxable gift. *See*

of a gift to an individual[8] subject to a condition that the donee pay the donor's gift tax, a transaction the court labeled a "net gift."[9] Pamela Turner owned 70,902 shares of stock having a cost basis of $3.5203 per share.[10] She wished to give a portion of this stock to her children and grandchildren without incurring a crushing gift tax liability. She transferred 18,980 shares, with a basis of $66,815.29, in nine separate transfers to three individuals and six trusts.[11] Each transferee took his portion of the stock subject to an agreement to pay that part of the donor's gift tax arising from the transfer.[12]

The Commissioner argued that Turner's transfer of stock to each individual subject to agreement that the recipient pay the resulting gift tax was "a part sale and part gift" and, as such, resulted in taxable income to the donor.[13] In a part sale, part gift transaction, the seller-donor transfers property to the buyer-donee in return for payment of an amount less than the market value of the property transferred.[14] To the extent that the donee gives con-

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Harrison v. Commissioner, 17 T.C. 1350, 1357 (1952), *acq.* 1952-2 C.B. 2. The Internal Revenue Service has acquiesced in this view and provided a formula to use in calculating the gift tax due on a net gift. *See* Rev. Rul. 75-72, 1975-1 C.B. 310 (general formula); Rev. Rul. 76-57, 1976-1 C.B. 297 (formula for North Carolina taxpayers); Rev. Rul. 76-104, 1976-1 C.B. 301 (formula for California taxpayers); Rev. Rul. 76-105, 1976-1 C.B. 304 (formula for Virginia taxpayers).

[8] This Note is primarily concerned with transfers to individuals. Where appropriate, the implications for transfers to trusts are noted.

[9] 49 T.C. at 363.

[10] *Id.* at 358.

[11] *See id.*

[12] The agreement stated, *inter alia*:

> We have further been informed that this gift is being made subject to my paying the gift tax on same. This letter can be taken as my acceptance of the proposed condition of the gift, and I agree to accept as my share of the gift tax an amount which is computed by your tax counsel.

Id. The gift taxes due on the nine transfers totaled $172,424.17. *Id.* at 359. With respect to the transfers in trust, a further agreement required that federal gift taxes be paid out of the corpora of the trusts in equal shares without personal liability on the part of the trustees. *Id.* at 358.

[13] *Id.* at 357. The issue in the Tax Court centered on the transfers to individuals. The Commissioner had conceded "that the transfers to the trusts were in no part sales." *Id. See also* note 12 *supra*.

[14] *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162 (defining gain to donor on part sale, part gift); Treas. Reg. § 1.1015-4, T.D. 6693, 1963-2 C.B. 326 (donee's basis after part sale, part gift); *cf.* I.R.C. § 1011-2(b) (part sale, part gift to charitable organization). *See generally* Rogers v. Commissioner, 31 B.T.A. 994 (1935), *rev'd*, 107 F.2d 394 (2d Cir. 1939), *nonacq.* 1939-2 C.B. 64 (donee's basis after part sale, part gift); *see also* Blackburn v. Commissioner, 20 T.C. 204 (1953) (gift tax due on part sale, part gift).

sideration for the transfer of the property, a sale results; to the extent that the value of the property exceeds the consideration received, a gift results. In *Turner*, the Commissioner urged that the payment of a donor's gift tax by the donee supplies partial consideration for the transfer and renders the transaction a part sale, part gift.[15] Consequently, the taxpayer realizes gain to the extent that his gift tax liability exceeds his basis in the property transferred.[16]

The Commissioner's argument did not convince the Tax Court. The court concluded that each transaction was more accurately characterized as a "net gift": a gift of the property less the amount of gift tax due on the transfer.[17] The Sixth Circuit agreed in a per curiam opinion.[18] Under the net gift characterization, the

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[15] 49 T.C. at 357. Under I.R.C. § 2502(d), the donor is primarily liable for the gift tax. I.R.C. § 6324, however, places a lien against the gift property if the tax is not paid on time. Therefore, the donee may in some cases become liable for payment of the tax. Estate of Sheaffer v. Commissioner, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963), held that although the donee may become liable for the tax, timely payment by the donee may result in income to the donor. *Id.* at 740-41.

[16] *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162.

[17] Turner v. Commissioner, 49 T.C. at 363. In making its determination, the Tax Court examined a line of cases dealing with the income tax consequences of a transfer to a trust subject to an agreement by the trustee to pay the donor's gift tax. *See* Estate of Morgan v. Commissioner, 37 T.C. 981 (1962), *aff'd*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963) (no taxable income to settlor when gift tax paid by borrowing money against trust corpus and repaying loan from subsequent trust income); Estate of Sheaffer v. Commissioner, 37 T.C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963) (taxable income to donor when gift tax paid from current trust income); Lingo v. Commissioner, 13 T.C.M. (CCH) 436 (1954) (gift tax excluded from gross value of net gift in computing gift tax); Harrison v. Commissioner, 17 T.C. 1350 (1952), *acq.* 1952-2 C.B. 2 (donor may exclude gift taxes from gross value of gift to determine net value of gift subject to gift tax); Estate of Staley v. Commissioner, 47 B.T.A. 260 (1942), *aff'd*, 136 F.2d 368 (5th Cir.), *cert. denied*, 320 U.S. 786 (1943) (taxable income to donor when he receives fixed amount of trust income with which to pay gift tax).

These cases interpreted I.R.C. § 677, which provides:

(a) General Rule

> The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
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> (1) distributed to the grantor or the grantor's spouse . . . .

None of these cases considered whether the transactions constituted part sales, part gifts; rather, they focused on the degree of interest retained by the settlor where the trust instrument provided that the trust would pay the gift tax. Nevertheless, from this treatment of transfers to trusts, the Tax Court in *Turner* concluded that a net gift to an individual was not a part sale, part gift and thus resulted in no taxable income to the donor. 49 T.C. at 362.

[18] Turner v. Commissioner, 410 F.2d 752 (6th Cir. 1969), *aff'g per curiam* 49 T.C. 356 (1968).

donor had given away the stock, retaining an interest sufficient to pay the gift tax due on each transfer.[19] The Tax Court held that the donor could retain this interest and direct the donee to use it to pay the gift tax without the donor realizing any income.[20] The Tax Court failed to recognize, however, that if the donor had physically retained a portion of the property, she could not have used that portion to discharge her gift tax obligation without realizing any appreciation in the value of the retained portion.[21] By neglecting to carry the analysis to its ultimate conclusion, the Tax Court in *Turner* established that net gift transactions are nontaxable events, even when the donor transfers appreciated property.[22]

In *Johnson v. Commissioner*,[23] the Sixth Circuit again confronted an attempt by a donor to make a gift of property while shifting to the donee the burden of the gift tax. The taxpayer first obtained a $200,000 bank loan secured by 50,000 shares of stock.[24] He then established an irrevocable trust with his children as beneficiaries, and transferred to it his rights in the 50,000 shares of stock.[25] The trustee executed a note to the bank, cancelling Johnson's note and secured by the 50,000 shares.[26] At the close of the transaction, the

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[19] 49 T.C. at 363. To illustrate the "net gift" proposition, the court analogized the concept to the transaction in Kruesel v. United States, 12 A.F.T.R.2d 5701 (D. Minn. 1963). In that case, taxpayers owned farm property and a house. They sold the property to a corporation for $225,000, reserving for themselves the rent-free occupancy of the house for their lives plus six months. The court held that the amount realized was $225,000, not $225,000 plus the rental value of the house for their lives. *Id.* at 5705.

[20] 49. T.C. at 363.

[21] If the donor had physically divided the property and retained a portion sufficient to pay the gift tax, she would have had to sell the retained portion, realizing any appreciation in value over her adjusted basis. *See* I.R.C. § 1101(a), *quoted in part in* note 70 *infra*. In *Turner*, where the subject matter of the gift was 18,980 shares of stock, the donor could easily have retained enough shares to pay the gift tax. A physical division of property may not be possible, however, when the property is a single entity, such as an apartment house. *See* note 90 *infra*.

[22] *Turner* involved appreciated property: the donor transferred 18,980 shares, each with a basis of $3.5203, amounting to a total basis of $66,815.29. The gift taxes arising from the transfer amounted to $172,424.17. 49 T.C. at 358-59. Clearly, the market value of the shares at the time of transfer greatly exceeded the donor's basis in the shares.

The Commissioner conceded in *Turner* "that the transfers to the trusts were in no part sales" (*id.* at 357), presumably even if I.R.C. § 677 did not apply (*see* note 17 *supra*). This concession forced the Commissioner to argue that the gifts to the individuals could be distinguished from those to the trusts. The Commissioner failed to persuade the court, however, that the transfers to individuals should be treated differently from the transfers to trusts.

[23] 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974).

[24] *Id.* at 1080. The stock was worth approximately $500,000 at the time. The note was without personal liability. *Id.*

[25] *Id.*

[26] *Id.*

trust contained $500,000 worth of stock encumbered by a $200,000 debt. Johnson had $200,000 in cash and no obligation on the note. He later paid gift taxes of $150,000, leaving him $50,000 in cash.[27]

In the Tax Court,[28] the taxpayer argued that he had made a net gift and therefore, under *Turner*, had no taxable income arising from the transaction. Yet Johnson had neither conditioned the transfer on the recipients' payment of the gift tax, nor retained an interest in the trust corpus. For these reasons and because the loan proceeds exceeded the gift tax liability by $50,000, the court held that a net gift had not occurred.[29] Instead, the Tax Court found that Johnson had entered into a part sale, part gift transaction, resulting in taxable income to the donor.[30]

The Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision, but rejected the part sale, part gift label as conclusory and immaterial.[31] The court discussed two alternative analyses, based on *Crane v. Commissioner*[32] and *Old Colony Trust Co. v. Commissioner*.[33] In *Crane*, the Supreme Court held that the increase in net worth resulting from a cancellation of indebtedness is taxable.[34] Applying *Crane*, the critical factor in the *Johnson* transaction was that Johnson had borrowed money using the stock as collateral before the transfer. As a result, Johnson received something of value when he transferred the stock—the cancellation of the $200,000 debt.[35] Under *Old Colony Trust*, on the other hand, the discharge of a taxpayer's tax liability by a third party is income to the taxpayer.[36] The *Johnson* court equated the $150,000 Johnson used to pay his gift tax with the donee's assumption of that tax.[37]

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[27] *Id.*

[28] Johnson v. Commissioner, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974).

[29] *Id.* at 813.

[30] *Id.* at 808.

[31] "Whether we describe this substance as a 'part sale and part gift' or a 'net gift' has no importance." 495 F.2d at 1083. In fact, *Johnson* looks less like a part sale, part gift transaction than does *Turner*. In *Johnson*, no agreement existed before the transfer that the donee would pay the gift tax; the donee merely received a smaller gift.

[32] 331 U.S. 1 (1947).

[33] 279 U.S. 716 (1929).

[34] 331 U.S. at 14.

[35] "Under Crane v. Commissioner . . . , the taxpayer realized income in the amount or [*sic*] the debt disposed of, regardless of the fact that he was not personally liable on the debt." Johnson v. Commissioner, 495 F.2d at 1083. This analysis will apply only to those net gift transactions where the donor borrows money against the gift property to pay the gift tax.

[36] 279 U.S. at 729.

[37] The donor bears the primary responsibility for the gift tax. *See* note 15 *supra*.

The donor thus realized income in the amount of the gift tax paid.[38]

The *Johnson* court did not choose between these approaches, finding that, under either analysis, the gain on the transaction was the amount realized ($150,000 plus $50,000) less Johnson's basis in the stock ($10,000), or $190,000.[39] Because the gain resulted from an exchange of a capital asset, the *Johnson* court held that the taxpayer was entitled to treat it as a capital gain.[40] Thus, although the court rejected the part sale, part gift label, it arrived at the same result as had the Tax Court.

Johnson did not expressly overrule *Turner*, but purported to confine *Turner* to its facts.[41] Commentators nevertheless viewed *Johnson* as an abrupt departure from the established treatment of net gifts.[42] Furthermore, because the characterization of the transaction in *Johnson* differed so greatly from that in *Turner*, *Johnson* appeared to have completely rejected both the analysis and the outcome of *Turner*.

II

HIRST V. COMMISSIONER

The net gift problem resurfaced in *Hirst v. Commissioner*.[43] The facts of *Hirst* resembled those of *Turner*.[44] The parent taxpayer (Mrs. Hirst) gave her interest in three tracts of unimproved land[45]

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[38] The amount realized would not be ordinary income as in *Old Colony Trust*, but a benefit to the taxpayer that must be construed in the context of the transaction—in the *Johnson* case, an exchange of a capital asset.

[39] 495 F.2d at 1084.

[40] *Id.* The court found that the gain resulted "from the sale or exchange of a capital asset held for more than 6 months." I.R.C. § 1222(3) (amended 1976).

[41] *See* Johnson v. Commissioner, 495 F.2d at 1086.

[42] *See, e.g.*, Note, *Bad News For Net Givers: Donee Payment of Gift Taxes Results in Taxable Income to Donor*, 36 U. PITT. L. REV. 517 (1974). *See generally Net Gifts—A Critical Look at Johnson v. Commissioner*, TAX MNGM'T MEM. (BNA) No. 75-05, Mar. 3, 1975, at 2.

[43] 572 F.2d 427 (4th Cir. 1978) (en banc).

[44] *See id.* at 433 (dissenting opinion, Bryan, J.), 437 (dissenting opinion, Thomsen, J.); text accompanying notes 7-12 *supra*.

[45] Mrs. Hirst owned a one-half interest in three tracts of land; the other half interest in the land was in the donor's husband's estate. The fair market value of the donor's one-half interest greatly exceeded her basis:

	Donor's Adjusted Basis	*Fair Market Value*
Tract 1	$4,654	$291,832.50
Tract 2	3,723	119,404.50
Tract 3	0	33,351.50

572 F.2d at 435 (dissenting opinion, Thomsen, J.).

to her son, his wife, and their children. As part of the transaction, the son agreed to assume Mrs. Hirst's gift tax liability. She calculated the worth of the net gifts by reducing the value of the transferred properties by the amount of gift tax liability on the transfers.[46] Her son paid gift taxes on the net gifts; the gifts totalled $359,118.[47]

The Tax Court[48] found that a realistic solution to the problem in *Hirst* would require the imposition of income taxes on Mrs. Hirst.[49] The court noted that

> [i]n 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" . . . .[50]

Nonetheless, the Tax Court felt constrained by the holding in *Turner* due to the factual similarity of the two cases, and held that Mrs. Hirst was not liable for income taxes on the transaction.[51]

Initially, a panel of the Court of Appeals for the Fourth Circuit disagreed,[52] finding that the transaction did result in taxable gain to Mrs. Hirst.[53] The panel majority reasoned that under *Old Colony Trust*,

> [t]he discharge of a solvent taxpayer's liability is ordinarily regarded as conferring a benefit which may result in income to the taxpayer. . . . The effect of what was done in this case is the same as though the son had paid the money directly to taxpayer and she had used it to discharge her gift tax liabilities.[54]

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[46] "Recognizing that the net amount of gifts and the gift tax itself are mutually dependent variables, taxpayer computed the gift tax in accordance with a formula that was substantially the same as the formula subsequently adopted for use in such situations . . . ." *Id.* at 435 n.1.

[47] *Id.* at 435.

[48] Hirst v. Commissioner, 63 T.C. 307 (1974), *aff'd en banc,* 572 F.2d 427 (4th Cir. 1978).

[49] *Id.* at 315.

[50] *Id.*

[51] "[I]n the absence of any clear-cut overruling of prior law by a Court of Appeals, we are not prepared at this time to reexamine an intricate and consistent pattern of decision that has evolved over the years in this field . . . ." *Id.*

[52] Hirst v. Commissioner, 572 F.2d at 434-40 (dissenting opinion, Thomsen, J.). After the *Hirst* rehearing, Judge Thomsen's panel majority opinion became a dissenting opinion from the en banc majority opinion.

[53] *Id.* at 439-40.

[54] *Id.* at 438.

The court concluded that the payment of the gift taxes was partial consideration for the transfer of the property to the donee, and that Mrs. Hirst therefore realized a capital gain in the amount by which the gift taxes paid exceeded her basis in the property.[55]

Before the court filed its opinions, however, the Fourth Circuit reheard the *Hirst* case, this time sitting en banc.[56] On rehearing, the Fourth Circuit affirmed the Tax Court decision.[57] The majority opinion, written by Chief Judge Haynsworth, relied heavily on *Turner*[58] and distinguished *Johnson*.[59] The majority opinion did not, however, scrutinize *Turner*'s rationale.[60] The court merely found the case before it factually identical to *Turner*; *Johnson*'s limitation of *Turner* to its facts thus did not impede reliance upon the earlier case.[61]

The Fourth Circuit justified its holding in *Hirst* by emphasizing that the transaction was not a sale.[62] The taxpayer did not receive anything of value as a result of the transaction: "[T]here was no economic gain of any kind accruing to her, except release from the normal tax burden of an owner of real estate."[63] The court denied that *Old Colony Trust*[64] compelled a finding that some benefit accrued to Mrs. Hirst from the payment of her gift taxes: "[I]t is no doubt generally true that another's discharge of an obligation is productive of income, but that is not universally the case."[65] Judge Haynsworth did not explain the characteristics of those transactions to which *Old Colony Trust* does not apply. His limited explanation suggests, however, that the payment of the gift taxes by Mrs. Hirst's son should be viewed as a gift from the son to Mrs. Hirst.[66] The evidence does not support this analysis:[67] the payment of the

[55] "In substance, taxpayer received the amount of the gift taxes in exchange for the transfer of the properties." *Id.* at 439.

[56] *See id.* at 434 (dissenting opinion, Winter and Butzner, JJ.).

[57] *Id.* at 431 (majority opinion).

[58] *See* text accompanying notes 7-22 *supra*.

[59] *See* 572 F.2d at 428-31; text accompanying notes 23-42 *supra*.

[60] *See* text accompanying notes 17-22 *supra*.

[61] *See* 572 F.2d at 430.

[62] "The predominant circumstance here is that this taxpayer did not intend to sell anything; she intended only to give her property to her progeny." *Id.*

[63] *Id.*

[64] *See* text accompanying notes 36-38 *supra*.

[65] 572 F.2d at 431.

[66] "For example, where a son has borrowed from a bank and his father pays off the son's loan without discharging any obligation to the son, the payment is not taxable income to the son, but a gift." *Id.*

[67] Judge Thomsen noted: "Taxpayer's argument that the payment of the taxes was a

gift taxes was not spontaneous, but was instead a condition of the receipt of the gift.[68]

Judge Haynsworth noted that Mrs. Hirst was not better off after the transaction than before,[69] implying that she therefore received no income as a result of the transaction. That the taxpayer is not better off after a transaction does not necessarily imply, however, that the transaction generated no taxable income. For example, in an arms-length sale of appreciated property, a taxpayer may receive as consideration an amount equal to the fair market value of the property transferred. In strict economic terms, he is not better off after the transaction; yet clearly the taxpayer has taxable income arising from the transaction.[70] Because the *Hirst* court employed the "gift" paradigm, it failed to recognize the transaction as an appropriate event through which to tax the appreciation in the gift property.[71]

III

SHOULD NET GIFTS RESULT IN TAXABLE INCOME?

A. *The Argument for Taxation of Net Gifts of Appreciated Property*

The courts that have considered the income tax aspects of net gifts to individuals[72] have failed to confront the major issue involved: whether and to what extent the donor must realize appreciation of net gift property.[73] The following three variations on the facts of *Hirst* help to isolate the problem and suggest possible solutions.

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gift back to her is not supported by the facts stipulated by the parties and testified to by the son." *Id.* at 439 n.6 (dissenting opinion).

[68] "All of the transfers were subject to the condition that [the son and daughter-in-law] pay the applicable gift taxes." *Id.* at 435 (dissenting opinion, Thomsen, J.).

[69] *Id.* at 431 (majority opinion).

[70] Section 1001(a) of the Internal Revenue Code provides: "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain . . . ." If, as stipulated, the property has appreciated, its fair market value (the amount realized) will exceed its basis and give rise to income taxable under I.R.C. § 1001(c).

In addition, although Mrs. Hirst did not "better" her position, she was better off than if she had transferred the property but paid the gift taxes herself.

[71] *See* text accompanying notes 95-96 *infra*.

[72] *See* Johnson v. Commissioner, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974); Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq.* 1971-2 C.B. 4.

[73] *Johnson* dealt only tangentially with this issue. *See* Johnson v. Commissioner, 495 F.2d 1079, 1084 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974).

Cash: Donor *A* makes a net gift equal to $400,000 in cash. Donor *A*'s objective is clear: he wants the value of the gift property minus the burden of the gift tax to total $400,000.[74] Donor *B* might structure the transaction differently, retaining an amount sufficient to discharge the gift tax obligation and transferring the remainder to the donee. The gift tax consequences of these two transactions are identical. Under the net gift theory of gift taxation, only the value of Donor *A*'s gift that exceeds the gift tax paid by the donee is a taxable gift.[75] Donor *A* is thus in the same position as Donor *B* who withheld the amount necessary to discharge his gift tax liability.

On the income tax side, Donor *B* has no taxable income as a result of his transfer;[76] nor should Donor *A*. Two reasons argue against Donor *A* incurring income tax liability even though his donee paid the gift tax. First, the two transactions are essentially the same,[77] and similarly situated taxpayers should experience similar income tax consequences.[78] Second, nontaxation of Donor *A* comports with the approach courts have adopted in determining the gift tax consequences of such a transaction: the donor who makes a net gift is treated as if he had retained a portion of the property with which to pay his gift tax.[79] The suggested approach thus results in consistency between the gift tax and income tax systems.[80]

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[74] Frequently, as in the *Hirst* case, the donor makes a net gift because he lacks the liquid assets necessary to pay the gift tax. *See* Hirst v. Commissioner, 572 F.2d 427, 435 (4th Cir. 1978) (en banc).

[75] *See* note 7 *supra*.

[76] *See* I.R.C. § 1001(a), *quoted in part in* note 70 *supra*. The donor's basis in the cash is equal to its face value; the amount realized minus the donor's basis is, therefore, zero.

[77] Both taxpayers want to make a gift of property without incurring a gift tax liability that they must pay with other assets. At the end of the transactions, neither taxpayer has property left, and their gift tax liability is the same. *See* note 7 *supra*.

[78] *See* United States v. Kaiser, 363 U.S. 299, 308-09 (1960) (concurring opinion, Frankfurter, J.) ("The Commissioner cannot tax one and not tax another without some rational basis for the difference."); IBM v. United States, 343 F.2d 914, 923 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966) (equality of treatment central to administration of I.R.C. § 7805(b)).

If taxpayers entering similar transactions are treated differently, the obvious result is to penalize those without adequate tax counsel.

[79] *See* Harrison v. Commissioner, 17 T.C. 1350, 1356 (1952), *acq.* 1952-2 C.B. 2:

> We are now called upon for the first time to decide whether the value of that gift tax as a retained interest by the donor may be excluded from the gross value of the gifts in determining the net value of the gift subject to gift tax. . . . [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.

[80] Although courts have not interpreted the gift tax and income tax provisions in pari

Unappreciated Property: Donor *C* transfers eighty lots subject to the condition that the donee pay the gift tax. Each lot has a basis of $5,000 and a fair market value of $5,000. To achieve the same result, Donor *D* transfers sixty-three lots and retains seventeen, which he sells to pay his gift tax.[81] Both donors incur equal gift tax liabilities.[82] Donor *D* has no taxable income from the transaction because the amount he realizes less his basis is zero.[83] Donor *C* should have no taxable income either: similarly situated taxpayers should have similar tax burdens,[84] and the income tax and gift tax systems should be administered consistently whenever such administration does not conflict with the policies behind the statutes.[85]

Appreciated Property: Donor *E* makes a net gift of eighty lots, each having a basis of $100 and a fair market value of $5,000. Donor *F* transfers sixty-three lots and retains seventeen, which he sells to pay his gift tax.[86] Under the net gift theory, the two donors incur the same gift tax liability on gifts valued at $315,000.[87] Donor *F* has sold seventeen lots, each with a basis of $100 and a fair market value of $5,000, giving him a capital gain of $83,300.[88] Should Donor *E* have taxable income arising from his transfer of the eighty lots? Again, the motivations of and nontax consequences to the donors are the same.[89] They should, therefore, incur similar income tax liabilities: Donor *E* should be taxed on the appreciation

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materia (*see* Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947); Note, *supra* note 42, at 532), both tax systems share a concern for concentrating on the substance of a transaction rather than on its form (*see, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) (income tax); Gregory v. Helvering, 293 U.S. 465, 470 (1935) (income tax); Burnet v. Guggenheim, 288 U.S. 280, 287 (1933) (gift tax)).

[81] These figures assume that the gift tax liability is $85,000, exactly the amount raised by selling the retained lots.

[82] *See* note 7 *supra*.

[83] *See* I.R.C. § 1001(a), *quoted in part in* note 70 *supra*.

[84] *See* note 78 *supra*.

[85] *See* notes 79-80 and accompanying text *supra*.

[86] These figures assume that the gift tax liability is $85,000, exactly the amount raised by selling the retained lots.

[87] *See* note 7 *supra*.

[88] Donor *F* realizes $85,000. Subtracting his basis of $1,700 in the 17 lots, he has a gain of $83,300 on the transaction. *See* I.R.C. § 1001(a), *quoted in part in* note 70 *supra*. Under I.R.C. § 1221, the gain is a capital gain if it results from the sale or exchange of a capital asset. The property transferred is a capital asset unless it was, for example, "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. § 1221(1). Assuming a capital gain, Donor *F* may deduct $41,650 under I.R.C. § 1202 or use the alternative capital gains provisions of I.R.C. § 1201(b) to compute his taxable income.

[89] *See* note 77 *supra*.

of the property.[90] By reducing the transaction to its substance, as courts have attempted to do,[91] one sees that Donor *E* has retained a portion of the gift which he uses to pay his gift tax. Where the property has increased in value, he realizes this appreciation to the extent that he uses a portion of the property to discharge his gift tax liability. Donor *E* should, therefore, recognize this benefit as income in the year of the gift.[92]

As the preceding paragraph indicates, the basic tax policies of horizontal equity[93] and substance over form[94] suggest that the taxpayer who makes a net gift of appreciated property should recognize that portion of the appreciation from which he benefits. One might argue that the recognition of appreciation should be deferred because taxpayers who make outright gifts of appreciated assets need not recognize any appreciation at the time of the gift-giving.[95] In those cases, recognition of appreciation is postponed until the donee disposes of the asset (other than by another gift).[96] Congress has, however, refused to extend this treatment to cases where the donor receives partial consideration for the transfer[97] or where the donor uses a portion of the appreciated property to pay his gift tax.[98]

Another possible objection to the taxation of appreciation at the time of the net gift is that it may prevent certain taxpayers from transferring appreciated property.[99] The court of appeals

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[90] *See* notes 78 & 80 *supra*. If the property transferred is indivisible, then the taxpayer cannot sell a portion to raise money for the gift tax. However, distinctions should not be drawn based on whether the gift property is divisible. To do so would introduce further inequities in the administration of the tax laws. The donor of indivisible property has no alternative but to make a net gift if he wants the donee to pay the gift tax. Nontaxation would thus penalize those donors of divisible property who make an uninformed decision to retain a portion of the gift property to pay the gift tax.

[91] *See* Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq*. 1971-2 C.B. 4; Harrison v. Commissioner, 17 T.C. 1350, 1352 (1952), *acq*. 1952-2 C.B. 2; note 79 *supra*.

[92] *See* note 21 *supra*.

[93] *See* note 78 *supra*.

[94] *See* note 80 *supra*.

[95] *See* I.R.C. § 1015 (donee's basis for determining gain equal to donor's basis plus gift tax paid but not exceeding market value).

[96] *See* I.R.C. §§ 1001(a), 1015. If the donee sells the property he will have a gain under § 1001(a). If he gives the property away, the new donee's basis will be determined under § 1015.

[97] *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *infra*.

[98] *See* Johnson v. Commissioner, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974); I.R.C. § 1001(a); note 21 and accompanying text *supra*.

[99] If a donor has insufficient liquid assets with which to pay the gift tax on a transfer, he might also have insufficient funds with which to pay the tax on appreciation. *See* note 100 *infra*.

noted in *Johnson* that such taxation would not impose hardship on most taxpayers.[100] These objections to taxation of appreciation at the time of a net gift do not outweigh the benefits achieved in the form of equal and fair administration of the income tax system.

B. *How Much Taxable Income?*

Given that a net gift of appreciated property results in taxable income, under what theory should the tax be imposed and how should the amount of taxable income be ascertained? Each of several theories supporting taxation leads to a different amount of taxable income. The following analysis of the two most viable theories[101] proceeds from a simplification of the facts of *Hirst*: the donor gives property with a basis of $5,000 and a fair market value of $400,000 to his donee; the gift tax liability (computed in accordance with the net gift formula[102]) is $85,000.[103]

The retained interest theory[104] would treat the donor as if he had withheld an interest in the property and directed the donee to use that interest to discharge the gift tax liability.[105] The donor then recognizes any gain or loss on the disposition of the retained interest.[106] The donor's basis in the retained interest is that amount

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[100] *See* 495 F.2d at 1084-85. The *Johnson* court suggested that the donor could require the donees to pay the gift tax and the capital gains tax. *Id.* at 1085 n.11. This would complicate matters because the payment of the capital gains tax would itself give rise to more capital gains tax. *See* Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929). This problem is not insoluble—a formula could be devised to determine the gift and capital gains taxes due on such a transaction.

[101] Two other approaches may be dismissed without detailed discussion. First, a strict reading of Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929), leads to the taxation, as ordinary income, of the full amount paid by the donee to discharge the gift tax. Under this approach, the transfer of property to the donee is a gift and the payment of the donor's gift tax discharges the donor's obligation. This gives rise to ordinary income. As the *Johnson* court recognized, however, the transfer of property and the payment of the gift tax should not be treated as two distinct transactions, but rather as a single transaction involving an exchange of a capital asset. *See* Johnson v. Commissioner, 495 F.2d 1079, 1084 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974). Second, a gift-gift analysis treats the transaction as a gift of property to the donee and a gift back to the donor of the amount of the gift tax paid. This approach is difficult to reconcile with the facts of most net gift cases, in which the payment of the donor's gift tax is bargained for by the donor. *See* Turner v. Commissioner, 49 T.C. 356, 358 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq.* 1971-2 C.B. 4; note 67 *supra*.

[102] *See* note 7 *supra*.

[103] *See* note 8 *supra*.

[104] *See* Turner v. Commissioner, 49 T.C. 356, 362 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969), *nonacq.* 1971-2 C.B. 4; Harrison v. Commissioner, 17 T.C. 1350, 1356 (1952), *acq.* 1952-2 C.B. 2; notes 19 & 21 and accompanying text *supra*.

[105] *See* note 21 and accompanying text *supra*.

[106] In effect, the donor sells the retained interest to the donee in return for payment

bearing the same relation to the entire basis as the amount realized (the amount of the gift tax) bears to the fair market value of the property.[107] The total gain equals the amount realized on the donor's disposition of his retained interest ($85,000) less the donor's basis in the retained interest ($1,062.50).[108] Because this is a sale or exchange of a capital asset,[109] the donor may utilize the capital gains deduction; his taxable income from the transaction would then be $41,968.75.[110] This analysis is consistent with the gift tax view of the transaction[111] and treats equally the net gift giver and the donor who retains property to pay his gift tax.[112] Furthermore, it conforms to the donor's intention in framing the transaction, namely, to have the gift tax burden discharged from the corpus of the gift rather than from the donor's other assets.[113]

Alternatively, under the part sale, part gift theory, the donor sells the property to the donee for less than its fair market value,[114]

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of the donor's gift tax. The donor must recognize any gain from the sale. *See* I.R.C. § 1001.

[107] Treas. Reg. § 1.61-6(a) (1957) reads in part:

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part.

See generally Welsh Homes, Inc. v. Commissioner, 279 F.2d 391, 395 (4th Cir. 1960) (allocation among separate parcels of land); Hunter v. Commissioner, 44 T.C. 109 (1965) (allocation between retained life interest and remainder).

The donor's basis is that amount (X) that bears the same relation to the entire basis ($5,000) as the value of the retained interest ($85,000) bears to the fair market value of the property ($400,000).

$$\frac{X}{5{,}000} = \frac{85{,}000}{400{,}000} \qquad X = \$1{,}062.50$$

[108] *See* I.R.C. § 1001(a), *quoted in part in* note 70 *supra*.

[109] *See* Johnson v. Commissioner, 495 F.2d 1079, 1084 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974); I.R.C. § 1221 (defining capital asset); note 88 *supra*.

[110] The taxpayer's gain is $85,000 minus $1,062.50, or $83,937.50. If the gain is capital (*see* I.R.C. § 1222 (defining capital gain)), then the taxpayer may deduct 50% of the gain, leaving taxable income of $41,968.75 (*see* I.R.C. §§ 1201, 1202 (deduction for capital gain)). *See* note 88 *supra*.

[111] *See* note 7 *supra*.

[112] If the property is indivisible, the donor will not have that alternative. *See* notes 21 & 90 *supra*.

[113] *See* note 74 *supra*.

[114] Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, provides in part:

> Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis.

See text accompanying notes 13-16 *supra*.

receiving as consideration the discharge of his gift tax.[115] The gain on the transaction equals the donor's gift tax liability less his basis in the entire property.[116] The donor's taxable income is then $40,000.[117] The part sale, part gift characterization has two drawbacks. First, it does not accurately reflect the donor's primary motivation in making the transfer: to make a gift of the property.[118] Second, the tax consequences under this view differ from those resulting from alternative ways of achieving the same goal.[119] If the donor retains a portion of the property which he then sells to pay the gift tax, he cannot offset his entire basis in the property transferred against the amount realized on the sale.[120]

The retained interest theory is the most attractive. Under it, a net gift giver encounters the same income tax liability as a donor who physically divides the property and sells a portion of it to pay his gift tax.[121] The part sale, part gift theory, on the other hand, may treat unequally taxpayers who happen to structure their transactions differently.[122] The retained interest result also conforms to

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[115] *See* note 15 and accompanying text *supra*.

[116] *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *supra*. Arguably, a donor making a part sale, part gift should allocate his basis as when making a bargain sale to a charity under I.R.C. § 1011(b). *See* Note, *supra* note 42, at 533-36. The authorities have, however, foreclosed this argument. *See* Finicke v. Commissiouer, 39 B.T.A. 510 (1939), *acq.* 1939-2 C.B. 193 (taxpayer has gain of amount realized less entire adjusted basis in property transferred); Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *supra*; Letter Ruling 7752001, at 10, IRS LETTER RULINGS REP. (CCH) (Dec. 30, 1977).

[117] The gift tax liability ($85,000) less the basis ($5,000) is $80,000. Because this is a capital gain (*see* I.R.C. § 1222; note 88 *supra*), the taxpayer may deduct one-half under I.R.C. § 1202.

[118] *See* note 62 *supra*; text accompanying note 124 *infra*.

[119] *But see* note 90 and accompanying text *supra*.

[120] *See* note 88 and accompanying text *supra*.

[121] *See* Treas. Reg. § 1.61-6(a) (1957), *quoted in part in* note 107 *supra*; note 88 and accompanying text *supra*. To determine taxable gain under the basis allocation provisions of Treas. Reg. § 1.61-6(a), the donor would allocate the same proportion of the basis to a portion of the property physically retained as to a portion in which he had retained an interest. The amount realized (the gift tax paid) is also the same in both cases. (This analysis assumes that a donor may physically retain a portion whose fair market value equals the gift tax liability on the property transferred.) Under I.R.C. § 1101(a), the same gain will result from both transactions because both taxpayers realize the same amount and have the same basis.

[122] The consequences to the taxpayer under the part sale, part gift theory and the retained interest theory roughly coincide, but do differ in important respects. If the gift tax paid exceeds the donor's adjusted basis in the property transferred, then the donor will have gain under both theories. The gain under the retained interest theory will, however, exceed the gain under the part sale, part gift theory. *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *supra*; text accompanying notes 104-13 *supra*.

what the gift tax cases regard as the substance of the transaction.[123] In addition, the retained interest theory articulates the intent of the parties. The donor does not want to sell his property to the donee, he merely wants to make a gift on condition that the donee discharge the resulting gift tax.[124]

The Internal Revenue Service has consistently maintained that net gift transactions are part sales, part gifts.[125] Because the Service's position results in less taxable income than the retained interest theory,[126] courts are unlikely to adopt the retained interest analysis. Although the part sale, part gift treatment does not treat even-handedly taxpayers who choose different ways to structure their transactions,[127] it comes closer to doing so than does *Hirst* and is therefore a more desirable approach.

What would be the impact on taxpayers if the courts accepted the part sale, part gift theory?[128] For a taxpayer to realize income on a net gift, his gift tax liability must exceed his basis in the property.[129] Consequently, the property must have appreciated substantially before the taxpayer need worry about income tax liability from a net gift. In addition, the capital gains tax imposed[130] will not be very large. The most the taxpayer will be required to pay on a gift not in excess of $2,000,000 is thirty-five percent of the gift tax liability or approximately fourteen percent of the fair mar-

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If the gift tax paid exceeds the allocated basis as computed by Treas. Reg. § 1.61-6(a) (1957) (*see* note 107 *supra*), but is less than the donor's adjusted basis in the property, then the donor will experience a gain under the retained interest theory but no gain or loss under the part sale, part gift theory. *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *supra*; text accompanying notes 104-13 *supra*.

If the gift tax paid is less than the donor's allocated basis under Treas. Reg. § 1.61-6(a), then the donor will have a loss under the retained interest theory but no loss or gain under the part sale, part gift theory. *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *supra*; Treas. Reg. § 1.61-6(a) (1957); text accompanying notes 104-13 *supra*.

[123] *See, e.g.*, Harrison v. Commissioner, 17 T.C. 1350, 1353 (1952), *acq*. 1952-2 C.B. 2, *discussed in* note 79 *supra*.

[124] *See* note 77 *supra*.

[125] *See* Estate of Henry v. Commissioner, 69 T.C. ____, [1978] TAX CT. REP. (CCH) Dec. 34,960 (Feb. 6, 1978); Letter Ruling 7752001, *supra* note 116.

[126] *See* note 122 *supra*.

[127] *See* note 122 *supra*.

[128] For general discussions of the usefulness of net gifts under the part sale, part gift theory, see Lowenstein, *Federal Tax Implications of Gifts Net of Gift Tax*, 50 TAXES 525, 528-29 (1972); *Net Gifts—A Critical Look at Johnson v. Commissioner*, TAX MNGM'T MEM., *supra* note 42, at 5-7.

[129] *See* Treas. Reg. § 1.1001-1(e)(1), T.D. 7207, 1972-2 C.B. 106, 162, *quoted in part in* note 114 *supra*.

[130] *See* note 88 and accompanying text *supra*.

ket value of the gift.[131] Furthermore, the taxpayer who is concerned about paying income tax on a net gift may insist that the donee pay the income tax as well as the gift tax arising from the transaction.[132]

CONCLUSION

In *Hirst v. Commissioner*, the Fourth Circuit confronted two ostensibly conflicting Sixth Circuit cases: *Turner v. Commissioner* and *Johnson v. Commissioner*. The court, following *Turner*, held that no taxable income arose from a donor's transfer of appreciated property subject to an agreement that the donee pay the gift tax. In reaching this result, the Fourth Circuit mischaracterized the true intent of the parties and perpetuated inconsistencies in the treatment of similarly situated taxpayers. The *Hirst* court failed to realize that *Turner*'s retained interest rationale, taken to its logical conclusion, results in the taxation of appreciated net gift property. By following *Turner* without distilling and reapplying the income tax principles involved, the court not only reached the wrong result but shrouded the net gift issue with confusion that will prove difficult to dispel.

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[131] The maximum marginal rate of gift taxation is currently 45% on a gift not in excess of $2,000,000. I.R.C. §§ 2001(c), 2502(a). For example, if the donor gives one gift with a fair market value of $2,000,000, his gift tax is $555,800 on the first $1,500,000, plus 45% ($225,000) on the margin. I.R.C. § 2001(c). If the donor's basis in the property is zero then he will have a capital gain in the amount of the gift tax paid by the donee, or approximately 39% of tbe fair market value of the gift. The maximum marginal rate of taxation on capital gains is 35%. *See* I.R.C. §§ 1, 1202. The largest income tax the donor would ever have to pay on a net gift of property worth $2,000,000 is approximately 14% of the fair market value of the gift. This maximum figure would only be reached, however, where the donor had enough income from other sources to bring the whole of the net gift income within the maximum marginal rate of capital gains taxation. *See* I.R.C. §§ 1, 1202.

[132] *See* note 100 *supra*.