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Taxation—Net Gift Transfer of Appreciated Real Property Held Not To Give Rise to Taxable Gain for the Donor

Section 2502(d) of the Internal Revenue Code places the primary liability for payment of gift taxes on the donor.[1] Frequently, however, donors do not have sufficient liquid assets at the time of the contemplated gift to pay the resulting gift taxes, or do not want to disturb their personal liquidity positions. To solve this problem they may make the gift conditional on the donee's agreement to pay the gift taxes, or stipulate that the gift taxes be paid out of the gift property. The Internal Revenue Service has recognized the validity of these arrangements for gift tax purposes and has sanctioned the use of a "net gift" gift tax computation method in such cases, which reduces the amount of the taxable gift by the amount of gift taxes the donee is obligated to pay.[2]

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1. I.R.C. § 2502(d) reads as follows: "The tax imposed by section 2501 [the gift tax] shall be paid by the donor." I.R.C. § 6324(b) provides that if the donor does not make timely payment of the gift tax the tax will become a lien on the gift made and the primary liability for the payment of the gift tax will shift to the donee.

2. The net gift method of valuation of property for gift tax purposes is spelled out in Rev. Rul. 75-72, 1975-1 C.B. 310, that superseded the original ruling in Rev. Rul. 71-232, 1971-1 C.B. 275. These provide that the gift tax paid by the donee may be deducted from the value of the transferred property if it can be shown that the payment of the gift tax by the donee is an express or implied condition of the transfer. The amount of the tax is computed using this net value of the gift property. The final tax result depends on two variables: the taxable value of the gift (which depends on the amount of tax paid) and the amount of tax paid (which in turn depends on the taxable value of the gift). The ruling provides the following algebraic formula to reach a solution for the amount that will be netted from the value of the gift to produce the net gift that is taxed:

$$\frac{\text{Tentative Tax}}{1 + \text{Rate of Tax}} = \text{True Tax (T)}$$

The "Tentative Tax" is the tax computed on the amount of the taxable gift. The "Rate of Tax" is the rate at which the amount of the taxable gift that exceeds the tax bracket amount is taxed. The "True Tax" is the amount to be deducted from the value of the transferred property.

These rulings are the result of the two earlier Tax Court decisions of Lingo v. Commissioner, 23 T.C.M. (P-H) ¶ 54,145 (1954), and Harrison v. Commissioner, 17 T.C. 1350 (1952), in which gifts were made in inter vivos trusts and the trustees were obligated to make the gift tax payments. The Tax Court held that the present value of the gifts could be reduced by the present worth of the future tax payments, reasoning that the donor did not *intend* the amount of property necessary for the gift tax liability to be a gift, and thus, it was not effective as property passing from the donor.

The net gift transfer is not used as a method of reducing gift tax liability. It does allow the donor to shift his burden of taxation but does not reduce the ultimate amount of the gift tax. Gift tax savings of the net gift vis-à-vis a conventional gift are illusory because the net gift is premised on the assumption that the donor would have had to sell part of the contemplated gift property to be able to pay the gift taxes on the smaller than originally planned conventional gift that would follow the sale. So in either case the gift tax would be computed on a smaller gift.

The true benefit of the net gift is that the donor does not have to sell part of the property to pay the gift taxes. This results in a reduction of the donor's capital gains tax burden. This avoidance of recognition of capital gain is one reason the *income tax* consequences of the net gift have long been disputed. *Lingo*, *Harrison* and Rev. Rul. 75-72 do not provide any direct answer to this income tax issue because they do not address the question.

While income is generally not recognized on the making of outright, unconditional gifts, the question has arisen whether a net gift transfer alters this result.[3] The United States Court of Appeals for the Sixth Circuit held in *Turner v. Commissioner*[4] that it does not. A later Sixth Circuit decision, *Johnson v. Commissioner*,[5] cast uncertainty on the vitality of *Turner* by holding that a donor realized taxable gain in a transfer slightly different in form from the *Turner* net gift.[6] Recently however, the United States Court of Appeals for the Fourth Circuit in *Hirst v. Commissioner*,[7] held that the net gift transfer of appreciated real property to family members does not result in any taxable gain to the donor.[8]

Taxpayer in *Hirst*[9] owned an undivided one-half interest in three tracts of highly appreciated, unimproved land.[10] In an effort to relieve herself of a heavy estate tax burden and out of a desire to benefit the natural objects of her bounty, she decided to make a gift[11] of the tracts

3. The agreement to pay the gift taxes provides several bases on which to argue for income taxation of the donor. As provided in Treas. Reg. § 1.1001-1(e) (1957), the gift could be characterized as part sale, part gift: a sale to the extent the gift tax exceeds the donor's adjusted basis in the property; and a gift to the extent the value of the property is greater than the gift tax. Alternatively, payment of the gift tax could confer benefits on the donor that fall within the broad definition of income found in I.R.C. § 61, especially income from discharge of indebtedness. The donee is made primarily liable for payment of the gift taxes by agreement and thus the donor is discharged from his former obligation to pay the taxes. The donor is also arguably "shedding" a debt by having the donee in essence assume the tax encumbrance placed on the gift property by the donor.

Despite these bases of recovery, it is easy to see why courts are hesitant even to think about the income tax consequences of a net gift. First, they usually occur in a family context and the donative intent of the donor is obvious (although the question of the extent of this intent is not usually raised). Second, the economic benefits to the donor are not as apparent as cash in hand.

4. 410 F.2d 752 (6th Cir. 1969), *aff'g per curiam* 49 T.C. 356 (1968).

5. 495 F.2d 1079 (6th Cir.), *aff'g on other grounds* 59 T.C. 791 (1973), *cert. denied*, 419 U.S. 1040 (1974).

6. *See, e.g.*, Duhl & Cohen, *The Net Gift Technique: A Current Analysis of the Requirements for Its Successful Use*, 42 J. TAX. 158 (1975); Malstrom, *A Shadow Over "Net Gifts,"* 64 ILL. B.J. 50 (1975); Note, *Income Tax Consequences of Encumbered Gifts: The Advent of Crane*, 28 U. FLA. L. REV. 935 (1976); Note, *Bad News for Net Givers: Donee Payment of Gift Taxes Results in Taxable Income to Donor*, 36 U. PITT. L. REV. 517 (1974).

7. 572 F.2d 427 (4th Cir. 1978).

8. *Id.* at 428.

9. Taxpayer was an 81 year old widow whose married son, one of the donees, was her only living child. *Id.* at 434-35.

10. *Id.* at 435. Taxpayer's adjusted basis and the appraised value of each tract was found to be as follows:

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

11. *Id.* Taxpayer transferred her interest in one tract to her son and his wife outright, and her

to her family. Realizing that she could not pay the resulting gift taxes because of her lack of liquid assets,[12] she had her son agree orally before the transfers that he would pay all the assessable gift taxes on all the transfers.[13] A gift tax return that computed the taxes due by the net gift method was filed,[14] and the son and his wife actually paid all the gift taxes.[15] The Commissioner asserted a deficiency in taxpayer's income tax return, claiming she recognized taxable gain to the extent the gift taxes paid exceeded her adjusted basis in the property.[16] The Tax Court found for the taxpayer.[17] The court of appeals reversed this decision, but on rehearing en banc, a majority of the court affirmed the Tax Court decision.[18] The majority reasoned that taxpayer intended no sale and received no economic benefit or gain.[19] *Johnson* was distinguished on its facts and the decision rested solely on the authority of *Turner*, which the majority considered dispositive of the question.[20] A strong dissent argued that *Turner* was no longer good authority and found that in substance taxpayer exchanged a portion of the gift property for the amount of gift taxes paid.[21]

The authority primarily relied on by the *Hirst* court was *Turner v. Commissioner*. The *Turner* donor made gifts of stock to three of her

interest in the other two tracts to two grandchildren outright and to her son as trustee for her third minor grandchild.

12. *Id.* At the time taxpayer decided to transfer her interests in the land, she owned the house in which she lived, a one-half interest in a house being used as an office building, and had $25,000 on deposit in savings accounts. *Id.*

13. *Id.* That only two of the five donees agreed to and did pay all the gift taxes in question was not addressed by the court.

14. *Id.* For a discussion of the net gift computation, see note 2 *supra*.

15. 572 F.2d at 435. A total $85,469.55 in gift tax was paid of which $68,277.00 was federal gift tax and $17,192.55 was state gift tax.

16. *Id.* at 435-36. The Commissioner made the following calculations:

Total gift tax paid	$85,469.55
Less adjusted basis of property	8,377.00
Realized gain	77,092.55
Recognized gain—50% (capital treatment)	38,546.28

17. 63 T.C. 307, 310 (1974), *aff'd per curiam en banc*, 572 F.2d 427 (4th Cir. 1978).

18. 572 F.2d at 428.

19. *Id.* at 431.

20. *Id.* at 428. Senior Circuit Judge Bryan's opinion dissenting from the decision of the panel, later made part of the majority en banc opinion, was based in part on the inviolability of the Tax Court's findings of fact and law. *Id.* at 432-33. This Note does not address this issue. For a discussion of this issue, see Commissioner v. Court Holding Co., 324 U.S. 331, 333-34 (1945); Commissioner v. Scottish Am. Inv. Co., 323 U.S. 119, 123-24 (1944); Dobson v. Commissioner, 320 U.S. 489, 501-02 (1943).

21. 572 F.2d at 437-39 (Winter and Butzner, J.J., dissenting).

children outright and six gifts in trust[22] for the benefit of her grandchildren. Each transfer was conditioned on the recipient paying the gift tax. The gift taxes were paid by the individuals out of available cash and sales of some of the stock, and by the trusts from sales of part of the stock, loans, and small amounts of current trust income. The Commissioner alleged that the transfers were part sale, part gift.[23] The Tax Court rejected the part sale analysis[24] and held that the transfers were net gifts that produced no taxable gain for the donor.[25] The United States Court of Appeals for the Sixth Circuit affirmed per curiam.[26]

The *Turner* decision was questioned by the Court of Appeals for the Sixth Circuit in *Johnson v. Commissioner* (the decision that the

22. The *Turner*, *Johnson*, and *Hirst* decisions are related to a line of cases dealing with gift tax agreements in the context of gifts in trust. Realization of taxable income has generally been found when trust income is used to pay gift taxes because the donor is considered to have retained an income interest in the trust that is taxable to him under I.R.C. §§ 671, 677 (sections attributing trust income to grantor as substantial owner of portion of trust).

In Staley v. Commissioner, 47 B.T.A. 260 (1942), *aff'd*, 136 F.2d 368 (5th Cir.), *cert. denied*, 320 U.S. 786 (1943), the decedent donor transferred stock in trust in return for the trustee's promise to pay him cash from the trust income, which the donor used to pay the gift taxes. The United States Court of Appeals for the Fifth Circuit held that this was income reserved by the donor and taxable to him as ordinary income. The *Staley* decision was relied on in a series of cases in which trustees paid the gift tax out of the trust income. In Sheaffer's Estate v. Commissioner, 37 T.C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963), the trustee was given discretion to use the trust income to pay the donor's gift tax liability. The gift tax was paid in part from the current income of the trusts and in part from borrowed funds. The United States Court of Appeals for the Eighth Circuit held that income was reserved for the benefit of the donor and was taxable to him under I.R.C. §§ 671, 677. In Commissioner v. Morgan's Estate, 37 T.C. 981 (1962), *aff'd*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963), the trustees were given discretion to sell trust corpus or borrow funds using the corpus as security to obtain funds to pay the gift tax. The trustees used borrowed funds to pay the gift tax and then repaid the loans from trust income in subsequent years. The Tax Court held that I.R.C. § 677 did not apply because the gift taxes had been paid and the repayment of the loan did not confer any benefit on the donor. In light of *Morgan* there was an entirely new proceeding in *Sheaffer*. The Tax Court in Estate of Sheaffer, 35 T.C.M. (P-H) ¶ 66,126 (1966), held in line with *Morgan* that the repayment of a loan out of trust income did not give rise to taxable income. The court also held, however, that the use of current trust income to pay a later year's tax deficiency was taxable to the donor in accord with the first *Sheaffer* decision.

23. At trial and again on appeal, the Commissioner conceded that the transfers in trust were not sales. 410 F.2d at 753.

24. The Tax Court also rejected the part sale, part gift argument in Victor W. Krause, 56 T.C. 1242 (1972), in which the court held that because the donor had no further interest in the trust to which the gift was made, and because the transfer was a net gift, not a part sale, which under *Turner* was not an income producing transfer, the donor realized no taxable gain when the trustee paid the gift taxes out of the proceeds of a loan secured by the trust. The *Turner* rationale was relied on once again in Davis v. Commissioner, 40 T.C.M. (P-H) ¶ 71,318 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972), in which the Tax Court held that the donor realized no taxable gain when the trustee paid the gift taxes out of cash on hand from a prior year because the donor retained no interest in the trust and because, as in *Turner*, the donor intended a net gift and not a part sale. The United States Court of Appeals for the Fifth Circuit affirmed per curiam the Tax Court's disposition of the part sale contention. 469 F.2d 694, 694 (5th Cir. 1972).

25. 49 T.C. 356, 363 (1968).

26. 410 F.2d at 753.

Commissioner argued was controlling in *Hirst*). The donor in *Johnson* made a gift in trust for his children of stock that was subject to a security interest under a loan agreement entered into by the donor immediately before making the gift. Under this prior arrangement, the lending bank received a thirty day note on which the donor had "no personal liability." The trustees of the trust to which Johnson transferred the stock, the donor's wife and the bank, replaced the donor's note with their own secured by the trust corpus. The donor used most of the loan proceeds to pay the gift tax. The Tax Court held the transfer to be a part sale resulting in taxable gain to the donor, distinguishing *Turner* on the ground that the *Johnson* gift was not conditioned on payment of the gift taxes by the trustees.[27]

The Court of Appeals for the Sixth Circuit affirmed the Tax Court result but rejected its reasoning, relying instead on three different bases for finding against the taxpayer. The first basis for the *Johnson* holding was that the gift of $150,000 worth of stock was an exchange for $200,000 in cash, which was income regardless of how the donor used the money. The second was that the donee, by paying the gift taxes, discharged the donor's legal obligation, resulting in the donor's constructive receipt of income under the doctrine of *Old Colony Trust v. Commissioner*.[28] In that case, payment of income taxes by an employer in consideration for services rendered by an employee was held by the United States Supreme Court to be taxable income to the employee. The third basis, and the one most heavily relied on by the court, was the finding that the donor "shed" his debt to the trust and realized income in that amount, based on the court's extension of the rule in *Crane v. Commissioner*.[29] In that case the amount of a mortgage on the seller's house for which neither the seller nor buyer had any primary personal liability was held by the United States Supreme Court to be part of the seller's amount realized on sale of the house.

The court was clearly correct in finding that *Turner* and *Hirst* were

27. 59 T.C. 791, 812-13 (1973). The Tax Court distinguished *Turner* further by finding no reservation of an interest in the trust, and on the ground that the loans were not the same thing as a donor's gift tax liability. *Id.*

28. 279 U.S. 716 (1929).

29. 331 U.S. 1 (1947). The court in *Johnson* extended the narrow *Crane* holding that "shedding" encumbrances constitutes an element of gain in sales of real property, to apply to the situation in which encumbered property is the subject of a gift, the amount of the encumbrance there being treated as a part sale. 495 F.2d at 1083-84. This reasoning may extend to net gift situations in which the gift property is "encumbered" by the obligation to pay the gift taxes, which is assumed by the donee by pregift agreement. The scope of application of this "shedding of liability" principle is still very much in debate. *See* Note, *Income Tax Consequences of Encumbered Gifts: The Advent of Crane*, 28 U. FLA. L. REV. 935 (1976).

factually almost indistinguishable[30] and that each involved proper use of the net gift form of transfer.[31] The court was also correct in finding that *Turner* was not overruled by *Johnson*, but only limited to its facts.[32] But the reasoning of the *Hirst* court is weak in several respects due to the acceptance of *Turner* as valid precedent and to the refusal to consider the arguments raised in *Johnson* as they apply to a net gift form of transfer.

First, in accord with *Turner*,[33] the court found that the donor only intended to make a net gift and not a part sale, part gift, as contended by the Commissioner. The gift tax label for the transaction does not, however, automatically determine its income tax consequences.[34] The donor's intent pertaining to all portions of the transfer must be analyzed to see if this type of gift transfer creates any basis for finding taxable income. The donative intent behind a net gift differs from that accompanying an unconditional gift. In the former case the donor's donative intent is limited to the net portion of the gift, while in the latter the donative intent goes to the whole gift property.[35] It is not clear what the donor's intent is with respect to the part of the property that is allocated to the gift tax. Restructuring the transfer, it is arguable that this portion of the gift property remained with the donor who then exchanged it with the donee for the donee's payment of the gift taxes. The *Hirst* court did not examine the possibility that there was such an exchange.[36]

Second, the court rejected the argument that the donee's payment of the gift taxes was a discharge of the donor's legal obligation resulting in income to the donor.[37] This argument was raised in *Johnson*[38] but not in *Turner*.[39] The court found the discharge of obligations rule to be

30. 572 F.2d at 428, 433.

31. The correctness of the court's finding is supported by Rev. Rul. 75-72, discussed in note 2 *supra*, which limits the use of this device to cases in which the donee's agreement to pay the gift taxes is a condition of the gift transfer.

32. 495 F.2d at 1086.

33. The *Turner* court affirmed the Tax Court in rejecting only the part sale, part gift argument. 49 T.C. 356, 362-64 (1968).

34. *See* note 2 *supra*.

35. *See id.*

36. The Tax Court in *Hirst* recognized the possibility that there had been an exchange. 63 T.C. 307, 315 (1974).

37. For a discussion of the discharge of obligations doctrine, see note 3 and text accompanying note 28 *supra*. *See also* Helvering v. Bruun, 309 U.S. 461, 469 (1940).

38. *See* text accompanying notes 28 & 29 *supra*.

39. 410 F.2d at 753. The Tax Court in *Hirst* conceded that the reasoning used in *Johnson* was a more "realistic" view of the net gift, 63 T.C. 307, 315 (1974), but nevertheless abided by *Turner*, as did the court of appeals.

a flexible one that depends on the relations of the parties and the existence of other obligations.[40] The court implied in a hypothetical that the son's payment of the gift tax was a "gift back" to his mother resulting in no taxable income to her.[41] The facts do not support this gift back theory however. The donee was obligated by a promise to the donor to pay the gift taxes for the donor's benefit in order to receive the gift of property. Also, the donee paid no gift tax on his payment of the gift taxes. In essence, the transfer was a payment to the donor in return for the gift, which was then used to satisfy the gift taxes.[42]

Third, the court stated that the substance of the net gift transaction rather than its form should control the donor's tax liability,[43] but relied nevertheless on the net gift *form* of the transfer to reach its result.[44] In substance, the donor in *Hirst* was attempting to arrange for payment of the gift taxes without incurring any taxable gain in the process. This goal was carried out in *Turner* and *Hirst* by use of the net gift transfer. This same goal was attempted in *Johnson* by a transfer in which the net gift device was not used, but in that case the donor had to pay income tax as a cost of achieving this goal. It is difficult to reconcile these opposing tax results given the common underlying substance of the transactions. Had taxpayer in *Hirst*, as in *Johnson*, taken out a loan using the gift property as security before the transfer, used the proceeds to pay the gift taxes, and then transferred the encumbered property, she would have realized taxable income. Had she sold a capital asset before the transfer to raise cash to pay the gift taxes she would have realized taxable gain. Had she retained a portion of the capital asset transferred equal in value to the amount of gift taxes due and exchanged this with the donee for the payment of the gift taxes, she would have realized taxable gain from the exchange. But because she used a net gift form of transfer she could make the same gift and get the taxes paid at no additional tax cost, even though she thereby seemed to

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40. 572 F.2d at 431.

41. *Id.*

42. *Cf.* Douglas v. Willcuts, 296 U.S. 1 (1935) (taxpayer realized income when, pursuant to contract, a trust discharged his debt).

43. 572 F.2d at 430; *see* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Gregory v. Helvering, 293 U.S. 465, 470 (1935).

44. In form, Hirst received no cash in hand from the transfer nor did she make a sale of her property in the ordinary sense of the term. But in substance she did not need to receive cash in hand to realize economic benefit from the transfer. For a discussion of the capital gains tax savings available with use of the net gift, see note 2 *supra*. Also, in substance she did not need technically to make a sale in order to realize income from the transfer. *See* Helvering v. Bruun, 309 U.S. 461, 469 (1940).

enjoy economic gain. It appears that the court in *Hirst* did not adequately analyze the substance of the net gift and compare it with that of other forms of transfer before deciding on its income tax consequences. In this respect, the court let the form of the transfer control its result.

In *Hirst*, the Court of Appeals for the Fourth Circuit has given renewed approval to the use of the net gift transfer as a tax saving device and has reduced the uncertainty surrounding its use after the *Johnson* decision. Donors lacking cash can still use this gift technique and benefit additionally from the capital gains tax savings that arise from using it. The donee will still only have to pay gift tax on the *net* gift, not the full value of the property transferred. Courts will continue to have to base their tax results on factual distinctions concerning the form of the transfer. Congress ultimately may have to step in and more clearly provide for taxation of the donor in these situations or provide for nonrecognition of gain if policy should so suggest. Until then, however, courts should consider applying existing doctrines such as *Old Colony Trust* and *Crane* to achieve more consistent income tax results.

The issue in *Hirst* is a close one that has given a great deal of conceptual trouble to the courts. Unfortunately, the *Hirst* court decided to adhere to the factually similar *Turner* decision, without adequately dealing with the critical analysis made of that case in *Johnson*. Thus, the court did not fully consider the conditional nature of the gift, the limits to the donative intent, the exchange element of part of the transfer, the presence of economic gain, and the applicability of nonsale bases for finding taxable income such as the *Old Colony Trust* and *Crane* doctrines. A closer examination of these factors should produce a different net gift income tax result than the one reached in *Hirst*. But until Congress acts or the United States Supreme Court decides to resolve the inconsistencies between *Johnson* on the one hand, and *Turner* and *Hirst* on the other, the net gift device will continue to have vitality and tax planning utility in the Fourth Circuit.

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