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## Apportioning Basis: Partial Sales, Bargain Sales and the Realization Principle

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# Apportioning Basis: Partial Sales, Bargain Sales and the Realization Principle

STEPHEN B. COHEN\*

## I. INTRODUCTION

The Internal Revenue Code generally taxes appreciation in the value of property only on realization, defined to mean when property is sold or exchanged.<sup>1</sup> In measuring gain on a sale or exchange, an allowance must be made for the return of capital, referred to as basis.<sup>2</sup> Basis offsets the amount realized—that is, the price received for property—in order to calculate taxable gain.<sup>3</sup>

A partial sale occurs when only a part of property is sold. In theory, there are three possible methods of determining basis and thereby measuring the gain on a partial sale: frontloading, apportionment, or

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1. I.R.C. § 61(a)(3) (1997) defines gross income as including “[g]ains derived from dealings in property.” Treas. Reg. § 1.61-6(a) (1957) explains this phrase as meaning “[g]ain realized on the sale or exchange of property.” In a few instances, the Code does tax unrealized appreciation. Such instances include the treatment of dealers in securities under I.R.C. § 475, commodity straddles under I.R.C. § 1256, and original issue discount under I.R.C. § 1272.

Unless otherwise noted, when this Article refers to a code section or to “the Code,” it is referring to the 1986 Internal Revenue Code, as amended and in effect for 1997.

2. *See generally* 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 41.2.1 (2d ed. 1989).

3. § 1001(a).

backloading. Frontloading allows up to the entire basis of the original property to offset the amount realized from selling only part. Apportionment uses a fraction of the entire basis, equal to the fraction of the property that has been sold. Backloading permits none of the basis to offset the amount realized, until the entire gain on the original property is taxed in full.<sup>4</sup>

In practice, apportionment has been the general rule since enactment of the modern income tax eighty-five years ago.<sup>5</sup> Even with this long history, the tax literature contains no discussion of why basis should be apportioned on partial sales.<sup>6</sup> This is true even though the question affects the tax treatment of a variety of other transactions, including bargain sales.

A bargain sale, also referred to as a part sale/part gift, occurs when property is *intentionally* sold for less than fair market value. The tax law permits basis to be frontloaded on a bargain sale, that is, the entire basis may offset the amount realized.<sup>7</sup> This result has been called

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4. To illustrate, assume that a parcel of land costs 200 (with the basis under section 1012 being its cost), that the parcel appreciates by 100, and that one-half of the parcel is sold for 150. Under frontloading, the sale of one-half the parcel produces no gain, since up to the entire 200 basis is available to offset the 150 amount realized. Under apportionment, the sale of one-half the parcel produces a 50 gain, which equals the 150 amount realized offset by 100, one-half of the entire basis. Under backloading, the sale of one-half the parcel produces a 100 gain, which equals the 150 amount realized up to the 100 gain on the entire property.

5. Treas. Reg. § 1.61-6(a) states:

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 . . . 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.

6. Treatises and casebooks explain the mechanics of the apportionment rule, without mentioning possible reasons for it. *See, e.g.*, 2 BITTKER & LOKKEN, *supra* note 2, ¶ 41.7; MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 156 (3rd ed. 1995); WILLIAM A. KLEIN & JOSEPH BANKMAN, *FEDERAL INCOME TAXATION* 166-71 (11th ed. 1994); PAUL R. MCDANIEL ET AL., *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 237-39 (3rd ed. 1994).

7. Treas. Reg. § 1.1001-1(e)(1) (as amended in 1994) states, "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."

In 1933, the IRS ruled that basis should be apportioned on a so-called part sale/part gift. I.T. 2681, XII-1 C.B. 93 (1933). However, in 1939 the U.S. Board of Tax Appeals held that no gain was realized when a taxpayer sold appreciated property at cost, and after a short period of nonacquiescence, the IRS acquiesced. *Fincke v. Commissioner*, 39 B.T.A. 510, 516 (1939), *nonacq.* 1939-1 C.B. 47, *withdrawn and acq.*, 1939-2 C.B. 12. The Supreme Court later approved the method under which the entire basis may offset the amount realized on a transfer partly by sale and partly by gift. *Diedrich v. Commissioner*, 457 U.S. 191, 199-200 (1982).

illogical, arbitrary, and inconsistent with the general rule for partial sales.<sup>8</sup> A bargain sale, it is argued, is really two separate transfers.<sup>9</sup> In one transfer, part of the property is sold for fair market value. In the other transfer, the remaining part is the subject of a gift. From the characterization of the transaction as partly a sale and partly a gift, it follows that basis should be apportioned between the part sold and the part given.

Curiously, critics of the current treatment of bargain sales regard the general apportionment rule as self-evidently correct and do not consider whether allowing the entire basis to offset the amount realized on a bargain sale might be justified.<sup>10</sup> While this Article defends the rule

8. The Treasury has stated, "The logical treatment is to allocate part of the basis to the gift portion, and part of the basis to the sale portion." 1976 IRS GCM LEXIS 274, at \*32-\*33, available in LEXIS, FEDTAX Library, GCM File.

An article in the *Tax Law Review*, which argues that *Fincke*, *supra* note 7, was "probably decided incorrectly," characterizes allowing the entire basis to offset the amount realized on a bargain sale as "arbitrary." James J. Freeland et al., *Part Gift-Part Sale: An Income Tax Analysis With Policy Considerations*, 47 TAX L. REV. 407, 409-10 & n.25 (1992). The article further states, "[C]onsistency would be served by extending this bifurcation treatment [i.e., apportioning basis] to all part gift-part sales." *Id.* at 422.

Although criticizing the current treatment of so-called part sale/part gift transactions, the Freeland article stops short of actually recommending that basis be apportioned, because "the fair market value of the property must be known in order to compute properly the gain to be recognized on the transfer." *Id.* at 422. However, the article does advocate apportionment (referred to as "bifurcation") for purposes of determining the holding period of the property in the hands of the transferee of a part sale/part gift, which admittedly would require knowing "the fair market value of the asset transferred." *Id.* at 425. There is no indication why, if fair market value is to be determined for bifurcating the property for holding period purposes, that same determination of fair market value cannot also be used to apportion basis. Moreover, there is no explanation why determining fair market value is more difficult in a part sale/part gift than in other partial sales of property, in which basis *is* apportioned. In any event, whenever a so-called part sale/part gift occurs, the value must be determined for gift tax purposes.

Other commentators have also assumed that allowing the entire basis to offset the amount realized on a bargain sale is wrong and that apportionment is the correct result. See MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION: A GUIDE TO THE LEADING CASES AND CONCEPTS* 281 (1994) (describing the current treatment of bargain sales an "odd result"); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 17 n.68 (1992).

9. "The typical part gift-part sale often involves a single asset, but is, by definition, always comprised of two simultaneous, yet distinguishable transactions." Freeland et al., *supra* note 8, at 421.

10. One might note that neither Board of Tax Appeals in *Fincke*, 39 B.T. 510, which established the current rule for bargain sales, nor the Supreme Court in *Diedrich*, 457 U.S. 191, which endorsed this rule, explained why it was rejecting apportionment in favor of allowing the entire basis to offset the amount realized on a bargain sale.

apportioning basis on partial sales generally, it also concludes that frontloading rather than apportionment should apply to bargain sales.

Part II explains apportionment of basis on partial sales as a consequence of taxing gain from a particular asset, rather than from a portfolio, perspective. Part III provides four arguments which support frontloading, that is allowing the entire basis to offset the amount realized, on a bargain sale. First, a bargain sale is more plausibly characterized as a single unitary transfer in which the entire basis should offset the amount realized, rather than as two separate transfers in which the basis must be apportioned between the part sold and the part given. Second, allowing the entire basis to offset the amount realized on a bargain sale is consistent with the Code's treatment of ordinary gifts of appreciated property. Third, frontloading is more equitable than apportionment because it does not favor the prosperous taxpayer who can afford an outright gift over a less affluent transferor who may need reimbursement of the original cost. Fourth, frontloading may be easier to administer than apportionment.<sup>11</sup> Part IV argues, however, that in the special case of a bargain sale to charity, basis should be apportioned in order to limit charitable deductions of unrealized appreciation.

## II. THE GENERAL APPORTIONMENT RULE FOR PARTIAL SALES

### A. *The Unwarranted Presumption Favoring Apportionment*

The general rule apportioning basis on partial sales seems to be regarded as presumptively correct.<sup>12</sup> This regard is similar to the unwarranted deference accorded proportionality in other contexts, for

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11. In principle, we could construct a mathematical function specifying the relationship between different basis methods and factors relevant to social welfare, such as equity, allocative efficiency, and administrative feasibility. See generally Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987). We would then solve the function to determine which basis method maximizes social welfare. In practice, such mathematical precision escapes us. Tax policy is a social, not a laboratory, science. Controlled experiments, which directly measure the relationship between the method of assigning basis and factors affecting social welfare, are not possible. Indirect measures, even when generated by sophisticated statistical techniques, are of doubtful reliability. See, e.g., Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405, 438-39 (1997); George R. Zodrow, *Economic Analysis of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity*, 48 TAX L. REV. 419 (1993). The best that we may be able to do is suggest relevant considerations and describe the probable consequences of different methods of assigning basis.

12. See *supra* note 6.

example, in favor of a proportional rate structure<sup>13</sup> or a proportional (that is, straight-line) method of depreciation.<sup>14</sup> However, the proposition that the fraction of the basis assigned to the part sold should equal the fraction of the value of the property sold is not itself an argument in support of the proposition. Rather, it is a tautology, tantamount to no more than an assertion that the proposition is correct. A more careful analysis is needed, examining arguments for and against each of the three possible basis methods, namely frontloading, apportionment, and backloading.

### B. *The Realization Principle*

The considerations that shape the tax law's definition of realization may also help explain why the tax law generally apportions basis on a partial sale. Under an "ideal" income tax, it might be preferable to tax appreciation in the value of property as it accrues, rather than deferring tax until realization. However, accrued gains may be difficult to measure, and taxpayers may lack sufficient liquid assets with which to pay a tax on accrued gains.<sup>15</sup> Thus, considerations of measurement and liquidity receive the most weight in the tax law's definition of realization.

Nevertheless, realization is not defined to include all instances in which measurement and liquidity are not a problem or to exclude all instances in which measurement and liquidity obstacles exist. Accrued gains on publicly traded securities are not considered realized even though easy to measure and liquid, perhaps in order to treat consistently fungible and nonfungible property. Gain on the exchange of one item of property for another property is considered realized, notwithstanding measurement and liquidity obstacles, presumably in order to prevent

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13. For an example of the deference accorded proportional tax rates, see generally WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953). For an explanation of why this deference is unwarranted, see generally CHARLES O. GALVIN & BORIS I. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* (1969).

14. For criticisms of the deference accorded the proportional allocation of depreciation deduction through the straight-line method, see CHIRELSTEIN, *supra* note 8, at 147-49, and 1 BITTKER & LOKKEN, *supra* note 2, ¶ 23.1.4.

15. See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1141-43 (1974); David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 623-26 (1967).

indefinite tax deferral through barter. Thus, at times other objectives, such as consistent tax treatment<sup>16</sup> and preventing indefinite tax deferral,<sup>17</sup> may outweigh measurement and liquidity considerations in defining realization for purposes of the tax law.

### C. Accurate Measurement and Frontloading

Frontloading has the advantage of eliminating measurement obstacles. This method does not require determining the market value of the entire property in order to measure gain on a partial sale, because the entire basis may offset the amount realized from the part sold. In contrast, both apportionment and backloading require determining the market value of the entire property in order to measure the gain. Under apportionment, this value must be known in order to calculate what fraction of the value has been sold and accordingly what fraction of the basis of the entire property to assign to the part sold.<sup>18</sup> Under backloading, the value must be known in order to determine the amount of gain on the entire property and accordingly the extent to which the amount realized may be taxed.

If property is fungible, the value of the entire property may be easy to determine by observing the price at which identical property sells on a public market.<sup>19</sup> Even if the property is not fungible, it may be possible to infer the value of the whole, provided the property is uniform in character and the physical proportion sold can be specified. For example, if a twenty-acre parcel of land varies little in its characteristics, the amount realized from selling five acres can be multiplied by four to infer the value of the entire twenty-acre parcel.<sup>20</sup>

If property is not fungible and if it is impractical to infer the value of the whole as indicated above, courts have occasionally created an

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16. Inconsistent treatment may cause both inequity and allocative inefficiency, although the degree of inequity seems to be inversely related to the degree of inefficiency. See Boris I. Bittker, *Equity, Efficiency, and Income Theory: Do Misallocations Drive out Inequities?*, in *THE ECONOMICS OF TAXATION* 19, 19-31 (Henry J. Aaron & Michael J. Boskin eds., 1980).

17. Tax deferral reduces revenue. Either the lost revenue must be supplied from other sources, or government spending must be reduced.

18. See Freeland et. al., *supra* note 8, at 422. Treas. Reg. §1.61-6(a) (1957) requires that basis be "equitably apportioned." The Code provision that requires apportionment of basis on a bargain sale to charity states, "[T]he adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property." § 1011(b).

19. "Fungible property" means property of which "any unit is, by nature or usage of trade, the equivalent of any other like unit." U.C.C. § 1-201(17) (1989).

20. See Treas. Reg. § 1.61-6(a), ex. 1.

exception to the apportionment rule and permitted basis to be frontloaded.<sup>21</sup> For instance, in *Inaja Land Co. v. Commissioner*, the court held that, on the sale of an easement in real property, the entire basis could offset the amount realized.<sup>22</sup> *Inaja* may appear to stand for the general proposition that basis may be frontloaded whenever a difficult subjective appraisal is required to apportion basis. Nevertheless, Treasury Regulations attempt to limit the effect of *Inaja* to its precise facts, namely the sale of an easement in real property,<sup>23</sup> and to require

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21. See, e.g., *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947); *Fasken v. Commissioner*, 71 T.C. 650 (1979).

22. *Inaja*, 9 T.C. at 736. In *Inaja*, the taxpayer sold a perpetual easement to pollute waterfront property to the city of Los Angeles for \$50,000. *Id.* at 730-32. The basis of the property as a whole was approximately \$61,000. Because of the difficulty of determining what fraction of the original property the easement constituted, the Tax Court held that the entire basis could offset the amount realized from selling only the easement. *Id.* at 736.

The Tax Court justified the result by the “impracticality” and “impossibility” of apportioning basis in the specific case before it.

Petitioner does not contest the rule that, where property is acquired for a lump sum and subsequently disposed of a portion at a time, there must be an allocation of the cost or other basis over the several units and gain or loss computed on the disposition of each part, except where apportionment would be wholly impracticable or impossible. Petitioner argues that it would be impracticable and impossible to apportion a definite basis to the easements here involved, since they could not be described by metes and bounds. . . .

*Id.* at 735-36 (citation omitted).

What did the court mean when it said that basis could not be apportioned, since the easements could not be described by metes and bounds? Presumably, it meant that apportioning basis could not be done objectively, but only with the aid of “impracticable” and “impossible” subjective appraisals.

Metes and bounds refer to physical measurements of the dimension of real property. If the part disposed of can be described by physical dimensions, then it may be easy to calculate the fraction sold by dividing the area sold by the area of the property as a whole. However, in *Inaja* the easement could not technically be described as a physical proportion of the entire property. Determining the ratio of the easement to the whole would have required a subjective estimate. While such an estimate was not literally “impossible,” it might nevertheless have been unreliable.

23. IRS Rulings have permitted explicit exceptions to apportionment only in the case of the sale of an easement. See, e.g., Rev. Rul. 59-121, 1959-1 C.B. 212; Rev. Rul. 68-291, 1968-1 C.B. 351.



apportionment in other cases<sup>24</sup> in which a subjective estimate of value may be required.<sup>25</sup>

The Treasury's rejection of frontloading even in cases requiring subjective appraisal, except for the *Inaja* precedent, reflects a judgment that only extraordinary measurement difficulties should permit deferral of gain on a partial sale.<sup>26</sup> This rejection of frontloading, however, does not explain why, of the two remaining options, the tax law generally prefers apportionment over backloading for determining basis and thereby measuring the gain on a partial sale. If anything, a desire to limit deferral should result in the backloading of basis in order to tax gain as soon as possible, rather than the current apportionment rule.

#### D. Choosing Between Apportionment and Backloading

Apportionment might be preferred over backloading through a formalistic application of the realization principle. If only a portion of appreciated property is sold, then only the gain attributable to that portion is *realized*, in the sense of being the subject of a sale or exchange. The gain attributable to the portion sold equals the amount realized, minus a proportionate share of the basis. Accordingly, basis

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24. The sale of an option to acquire property is arguably a partial sale of the underlying property. The buyer will presumably exercise the option if the property increases in value above the strike price. The owner therefore has sold a part of the property consisting of the right to profit from any increase in value above the strike price. However, "the taxable event occurs when the option is exercised or expires," because until then it is impossible to determine whether the amount received by the taxpayer granting the option is ordinary income generated by the unexercised option or part of the amount realized from the underlying property, generating gain or loss after the adjusted basis is taken into account. 2 BITTKER & LOKKEN, *supra* note 2, ¶ 40.8.3. While the difficulty of apportioning basis to the option might justify frontloading of basis and treating the option sale as a taxable event, the additional difficulty of determining the character of the gain justifies delaying any tax at all until exercise or lapse. See also Bruce Kayle, *Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property*, 48 TAX L. REV. 233 (1993); Calvin H. Johnson, *Taxing the Income from Writing Options*, 73 TAX NOTES 203 (Oct. 14, 1995).

25. Treas. Reg. § 1.61-6(a), ex. 2 appears to require a subjective appraisal in order to apportion basis on a partial sale. A taxpayer acquires for a lump sum a used car lot and a filling station and later sells the filling station alone.

26. Treas. Reg. § 1.61-6(a) states, "[G]ain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of."

There has been an analogous development in the law applicable to installment sales. In 1980, Congress enacted § 453(j) to "reduce substantially [t]he justification for treating transactions as 'open.'" S. Rep. No. 96-1000, at 24 (1980), *reprinted in* 1980 U.S.C.C.A.N. 4696, 4719. Prior to the enactment of § 453(j), the open transaction doctrine permitted the frontloading of basis when future payments under an installment contract were subject to contingencies and therefore could be estimated only through difficult subjective appraisals. See *Burnet v. Logan*, 283 U.S. 404 (1931).

must be apportioned on a partial sale so that only that gain which is truly realized is taxed.

Nevertheless, backloading of basis could also be defended by focusing on the practical considerations of accurate measurement and liquidity, which are said to require the realization principle in the first place. As noted above, *both* apportionment and backloading require knowing the market value of the property as a whole. Therefore, the possible difficulty of appraisal does not justify choosing one method over the other. Moreover, liquidity should not pose an obstacle to backloading. Recall that backloading taxes the gain on the entire property only up to the amount realized. Provided that the amount realized consists of cash, the taxpayer has liquid assets with which to pay the tax assessed under the backloading method.

True, the effect of backloading basis is to tax both the realized gain on the part sold and the formally unrealized gain on the part that remains unsold. Nevertheless, the practical considerations supporting the deferral of taxation, namely difficulty of measurement and lack of liquidity, do not afford grounds for preferring apportionment to backloading. Apportionment therefore can be justified as preferable to backloading only with reference to some other factor.

*E. Measuring Gain: A Specific Asset or  
Portfolio Frame of Reference?*

On the sale of an asset, gain is generally figured with respect to the appreciation on that asset alone and without regard to appreciation on other assets in the taxpayer's portfolio. To illustrate, consider the following example. *A* owns property *W*, with a basis of 100 and value of 200, and property *X*, with a basis of 100 and value of 200. *B* owns property *Y*, with a basis of zero and a value of 200, and property *Z*, with a basis of 200 and a value of 200. Suppose that each decides to sell property in order to raise cash. *A* sells property *W*, and *B* sells property *Z*. Under the existing income tax, gain is calculated with reference to the amount realized from and the basis assigned to the specific asset sold. Thus, *A* reports 100 of gain on selling *W*, and *B* reports zero gain on selling *Z*.

The only difference between the two taxpayers is the specific assets each owns and the relative amounts of unrealized gain on each asset. Except for this difference in the amount of gain on particular assets, *A*

and *B* are in the same economic position. Each initially owns property with a total basis of 200 and a total value of 400 and thus has 200 in unrealized property gain. Each then sells 200 worth of property for cash. Why should they be taxed differently?

One could imagine a realization-based system under which they would in fact be taxed the same.<sup>27</sup> The taxable gain arising from the sale of a particular asset would be figured with reference to the total gain on all assets in the taxpayer's portfolio. Such a system could employ either an apportionment rule (taxing a fraction of the amount realized as gain equal to the ratio of gain to market value of the entire portfolio) or a backloading rule (taxing the amount realized as gain to the extent of gain on the entire portfolio).

However, a portfolio perspective would require measuring accurately the amount of gain on, and hence the market value of, the taxpayer's entire portfolio of assets. In the absence of a sale of the entire portfolio for cash, such a measurement could require subjective appraisals. The difficulty of making such appraisals is in fact a principal reason for instituting the realization principle in the first place, rather than taxing property gains on accrual. These same measurement obstacles also explain why the Internal Revenue Code generally calculates taxable gain on the sale of an asset by looking at that specific asset alone, without reference to the taxpayer's entire portfolio.

#### *F. The Specific Asset Perspective and Apportioning Basis*

Apportionment of basis follows from the fact that, when a taxpayer sells an asset, gain is calculated with respect to the appreciation on that asset alone and without regard to the appreciation on other assets in the taxpayer's portfolio. If partial sales are to be treated in a manner consistent with other sales of property, then gain on a partial sale also ought to be determined with respect to the appreciation on the specific part sold and without respect to any other gain, including gain on the part of the property that is not sold. The apportionment rule achieves this result by limiting the amount of taxable gain to the gain on the specific part sold. A backloading of basis rule, by contrast, would tax

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27. One modest step in the direction of measuring gain from a portfolio perspective is the recent Treasury proposal to assign a basis to any security equal to the average basis of all identical securities held by the taxpayer. See Department of the Treasury, General Explanation of the Administration's Revenue Proposals 70-71 (1996).

not only the gain on the specific part sold but also the gain on the fraction of the property that is not sold.<sup>28</sup>

A backloading rule for partial sales would also treat taxpayers differently, depending on whether they acquired property piecemeal or as a whole. To illustrate, assume that *C* and *D* each own ten acres of land, acquired at a cost of 100 an acre, and that *C* acquired the property acre by acre in ten separate transactions, whereas *D* acquired the ten acres in a single transaction. If *C* disposes of one acre for 200, *C* will realize a gain of 100, equal to the amount realized from selling the acre, minus the 100 basis. *C*'s gain or loss is calculated only with respect to the specific asset sold and not with reference to the unrealized gain on the other separately acquired properties.

If *D* disposes of one acre for 200 and basis is apportioned, *D* will also realize a 100 gain. *D*'s gain or loss is calculated with respect to the specific part sold and not with reference to the unrealized gain on the rest of the property. Backloading for this partial sale, on the other hand, would result in *D*'s reporting the entire 200 amount realized as gain, without any offsetting basis.<sup>29</sup>

To summarize the points so far, the Treasury has rejected frontloading of basis on a partial sale, even when measurement is difficult, in order to limit tax deferral. The most important considerations in defining realization, accurate measurement and liquidity, offer no more support for apportionment than for backloading. A preference for apportionment over backloading can be justified by the idea that gain on the sale of an asset is generally figured only with respect to that particular asset, rather than with reference to the taxpayer's entire portfolio.

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28. On the other hand, society might decide that consistent treatment is less important than limiting the deferral of taxation afforded by the realization principle. If we place more importance on limiting this deferral advantage, then backloading might be chosen over apportionment.

29. If backloading did apply to partial sales, *D* might arrange to acquire the 10-acre plot piecemeal, for example, in 10 formally separate transactions. Under such an arrangement, the disposition of a single acre would appear to be an entire (rather than a partial) disposition of property, and gain would be measured with reference to that specific acre alone. In order to enforce a backloading rule, we would have to recast the formally separate transfers as a single acquisition. See *infra* note 33 (discussing this problem in more depth).

### G. Specific Code Provisions Which Backload Basis

Notwithstanding the general apportionment rule, several Code sections provide a different result when property is exchanged in part for other property that may be received without the recognition of gain, and in part for cash (or for other property) whose receipt produces recognition.<sup>30</sup> For example, suppose that property with a basis of 100 and value of 200 is exchanged for like-kind property worth 100 plus cash of 100. This transaction constitutes partly a like-kind exchange and partly a sale for cash.

If basis were equitably apportioned, one-half of the 100 basis of the original property would be assigned to the partial sale. The transferor would accordingly report 50 of gain.<sup>31</sup> Instead, the Code taxes the 100 amount realized in full (up to the gain on the entire property), without any basis offset.<sup>32</sup> In effect, basis is backloaded with respect to the receipt of cash (or other property).<sup>33</sup>

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30. The transactions and applicable Code sections include: the exchange of property for like-kind and nonlike-kind property under § 1031(b); the involuntary conversion of property into similar and dissimilar property under § 1033(a)(2); the rollover of the proceeds from selling a principal residence into a new principal residence and other property under § 1034 (repealed 1997); the exchange of property for stock and other property in a controlled corporation under § 351(b); and a nondividend distribution by a corporation with respect to stock under § 356(a).

31. In a similar vein, suppose that property with a basis of 100 and value of 200 is destroyed by fire and that the taxpayer uses only 100 of 200 of insurance proceeds to acquire property "similar or related in use." The transaction constitutes partly an involuntary conversion into similar property and partly a sale for cash. Under apportionment, the taxpayer would report 50 of gain. However, section 1033(a)(2) in effect backloads basis by taxing the entire 100 gain.

32. See § 1031(b).

33. To avoid this result, taxpayers may attempt to disaggregate the transaction into two separate transfers. The first transfer would involve the sale of part of the original property for cash, in which basis is apportioned to the part sold under Treas. Reg. § 1.61-6(a) (1957), followed by a second formally separate exchange of the remaining part of the original property for like-kind property.

Of course, if two transfers occur on or about the same date and with the same transferor and transferee, then the IRS may try to recast the transfers as a unitary exchange of the original property for like-kind property plus cash. Nevertheless, it may be difficult for the IRS to discover when formally separate transfers are in fact interdependent since taxpayers have the initiative in the design and execution. The IRS has a greater chance of success when a contract or other writing explicitly refers to the interdependence of formally separate deals.

*Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652 (5<sup>th</sup> Cir. 1968), demonstrates a court's handling of a case involving an interdependence of formally separate deals. In *Redwing*, the taxpayer sold used trucks to General Motors for cash. *Id.* at 655. Within a few weeks, a wholly owned subsidiary of the taxpayer bought new trucks from General Motors for cash. *Id.* Testimony at trial established that the sale of used trucks to General Motors by the taxpayer was conditioned on the purchase of new trucks from

In failing to provide for apportionment of basis in what might be called part taxable sale/part nonrecognition transactions, Congress may not have been aware that it was departing from the general apportionment of basis rule. The inconsistency between these Code provisions and the general apportionment rule may therefore be accidental rather than deliberate, one of the many discontinuities resulting from the convoluted, complex process of enacting and amending the Internal Revenue Code.

If Congress wants to treat these transactions in a manner consistent with ordinary partial sales, it could amend the Code to provide for apportionment.<sup>34</sup> On the other hand, Congress may believe that limiting the deferral advantage afforded by the realization principle is more important than consistent treatment. If so, perhaps these Code

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General Motors by the taxpayer. *Id.* Consequently, the court held that under § 1031 the two transactions should be integrated and treated as an exchange of used trucks, plus the net amount of cash transferred by the taxpayer, for new trucks. *Id.* at 654, 659.

Other cases discussing this issue include *Diedrich v. Commissioner*, 457 U.S. 191 (1982), and *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991). In *Diedrich*, the taxpayers made a gift of property to their children. *Diedrich*, 457 U.S. at 192. The gift was explicitly conditioned on the children agreeing to pay the gift tax owed by the taxpayers. *Id.* Therefore, the court treated the parents as transferring the property in return for the children's agreement to pay the gift tax. *See id.* at 198-99.

In *Cottage Savings*, the taxpayer sold a mortgage pool to another institution for cash. *Cottage Savings*, 499 U.S. at 557. A federal regulatory agency required in a written memorandum that the taxpayer simultaneously buy a mortgage pool with about the same value from the other institution for cash. *Id.* Therefore, the court found the transactions to be interdependent and treated them as an exchange of one mortgage pool by the taxpayer for another mortgage pool. *See id.* at 557-58.

34. In addition to the statutory provisions described above, the tax law generally does not allow any portion of basis to offset the sale of a carved-out term interest. Instead, the amount realized from the partial sale is taxed in full if the part sold is a term interest in property. Cogent reasons for an exception to the general apportionment rule do exist in this instance. The sale of the term interest creates a future interest, which increases in value over time as the term interest declines in value. The tax law usually finds it difficult to tax this increasing value of the future interest properly. The term interest is taxed in full, without any basis offset, as a surrogate or substitute for taxing the increasing value of the future interest. Alternatively, the tax law could apportion basis to the sale of a term interest if the increasing value of the future interest were properly taxed, as in the case of original issue discounts under § 1272 and stripped bonds under § 1286. *See generally* William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L. REV. 153 (1983); Jeffrey L. Kwall, *The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space*, 49 OHIO ST. L.J. 1 (1988); Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725 (1992).

provisions should be left unchanged and backloading should be adopted for partial sales generally.

#### *H. Frontloading Basis for Acquisition Indebtedness*

In addition to Code provisions that backload basis, there are also a few provisions that frontload basis. The most important provisions affect the transfer of property to a controlled corporation in exchange for stock plus the assumption of liabilities.<sup>35</sup> Basis is frontloaded if there is no tax avoidance purpose, as for example, if the liabilities were incurred in order to finance acquisition of the transferred property. As a result, provided assumed liabilities do not exceed the property's basis, the transferor reports no gain.<sup>36</sup>

The critical point is that the frontloading of basis in this instance reflects a policy judgment. The incorporation of business property, with associated liabilities no more than basis, simply changes the form of business organization. The transferor does not actually withdraw cash or other property from the ongoing enterprise.<sup>37</sup> Consequently, it is not an appropriate occasion for taxing gain.<sup>38</sup> The current rule that

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35. See § 357(a), (c). An area of only minor consequence is the treatment of a nondividend distribution with respect to stock that is not out of earnings and profits. Under subsections 301(c)(2) and (c)(3), the amount realized constitutes gain only to the extent that it exceeds the stock's basis. A nondividend distribution is difficult to distinguish from a capital gain redemption in which only the basis of redeemed shares is available under § 302(b) to offset the amount realized.

36. To illustrate, assume that land costing 100 is acquired for a cash down payment of 20 and a mortgage of 80. Later, when the land has appreciated in value to 200 and the outstanding mortgage principal is reduced to 50, it is transferred to a controlled corporation in return for stock plus assumption of the remaining 50 mortgage. Ordinarily, the mortgage assumption would be treated as the equivalent of receiving cash, so that the transferor would report 50 of gain under § 351(b). However, by virtue of subsections 357(a) and (c), the transferor may use the entire basis to offset the mortgage assumption, thereby reporting no gain.

37. On the other hand, suppose that the property had been mortgaged some time after acquisition and that the proceeds had been used to finance the transferor's personal consumption. In that event, the purpose would be considered one of tax avoidance, and the mortgage assumption would be treated like the receipt of any other nonqualifying property. The transferor, in other words, would be treated as if the transferee, instead of assuming the mortgage, had simply paid the transferor an equivalent amount in cash. See § 357(b) (addressing assumption of liability for tax avoidance purposes).

38. Curiously, this reasoning has not been extended to other nonrecognition provisions. For example, suppose that property is exchanged for like-kind property plus assumption of acquisition debt. Under § 1031(b), the gain is taxed to the extent of the assumed debt. See Treas. Reg. § 1.1031(b)-1(c) (as amended in 1967) (defining unlike-kind property to include the relief of mortgage liabilities); Treas. Reg. § 1.1031(d)-2, ex. 1 (1960) (providing an example of property exchanged in part for assumption of debt).

Taxing the gain, however, seems inconsistent with the purpose of § 1031, since the investment in like-kind property continues unabated, without the withdrawal of cash or

allocates the entire basis to a bargain sale of property ought to be judged by a similar standard.

### III. BASIS ON A BARGAIN SALE

#### A. *The Critique of Current Law*

The case law and administrative practice do not apply the apportionment of basis rule for partial sales to a bargain sale, in which property is intentionally sold for less than fair market value.<sup>39</sup> Instead of being apportioned, up to the entire basis may offset the amount realized from a bargain sale.

As noted above, this result has been criticized as illogical, arbitrary, and inconsistent with the general apportionment of basis rule. A bargain sale, it is argued, consists of two separate transfers.<sup>40</sup> In one transfer, part of the property is sold for fair market value. In the other transfer, the remaining part is the subject of a gift. From the characterization of the transaction as a part sale/part gift, it follows that basis should be apportioned, as for other partial sales.

Nevertheless, four kinds of arguments support allowing the entire basis to offset the amount realized on a bargain sale. First, a bargain sale is more plausibly characterized as a single unitary transfer in which the entire basis should offset the amount realized, rather than as two separate transfers in which the basis must be apportioned between the part sold

nonlike-kind property. Professor Marvin A. Chirelstein made the following observation on the exchange of property for like-kind property plus assumption of acquisition debt, [The transferor] has withdrawn no cash at any stage, and as the object of the provision is to defer recognition until the original property is converted to money or dissimilar assets, it would seem consistent for [the transferor] to recognize no gain on the mortgage transfer . . . . The section follows a different course, however . . . .

CHIRELSTEIN, *supra* note 8, at 292.

With careful planning, taxpayers may be able to design around this problem by seeking out like-kind property encumbered by a mortgage at least equal in amount to the mortgage to be assumed in the exchange. Treas. Reg. §1.1031(b)-1(c) provides that the amount of nonlike-kind property received is reduced for any mortgages assumed by the taxpayer. *See also* Treas. Reg. § 1.1031(d)-2, ex. 2.

39. *See supra* note 7 and accompanying text.

40. "The typical part gift-part sale often involves a single asset, but is, by definition, always comprised of two simultaneous, yet distinguishable transactions." Freeland et. al., *supra* note 8, at 421.



and the part given. Second, allowing the entire basis to offset the amount realized on a bargain sale is consistent with the Code's treatment of ordinary gifts of appreciated property. Third, this method of allocating basis is more equitable than apportionment because it would not favor the prosperous taxpayer who can afford an outright gift over a less affluent transferor who may need reimbursement of the original cost. Fourth, this method may be easier to administer than apportionment.

### *B. Two Separate Transfers or a Unitary Sale?*

The part sale/part gift label, preferred by the critics of current law, may itself distort the analysis of how to determine basis. Part sale/part gift implies that there really are two separate transactions: a sale of part of the property for fair market value and a gift of the other part. While part sale/part gift is one way of characterizing the transaction, it does not describe what we directly observe. We do not actually observe two separate transactions, but only a single transaction: the sale of property for less than its value. It is more accurate to describe the transaction, at least initially, as the intentional sale of property at a bargain price, or as a bargain sale for short.<sup>41</sup>

Labeling the transaction as a bargain sale advances the analysis of how to determine basis. The label makes clear that it is plausible to characterize the transaction, not as two separate transfers, but rather as a single, unitary transfer in which the transferor is paid less than the property's value and in which apportionment is inappropriate because in fact the entire property is sold.<sup>42</sup> In reality it is mistaken to view the transferor as selling part of the property for full fair market value, when the payment of full market value for part of the property is conditioned on the transfer of the rest of the property for free.<sup>43</sup>

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41. An intentional sale of property at a bargain price should be distinguished from the unintended sale of property for less than its value, in which the transferor has not made a gift but instead has made a bad bargain. This second transaction is referred to as an unintended bargain sale, or as a bad bargain for short.

42. The use of the part sale/part gift label implies that basis should be apportioned, and the use of the bargain sale label implies that the entire basis should offset the amount realized. However, Treas. Reg. § 1.1001-1(e)(1) (as amended in 1994), which allocates the entire basis to a bargain sale, describes the transaction as a part sale/part gift, while § 1011(b), which provides for apportionment in the case of a part sale/part gift to a charitable organization, describes the transaction as a bargain sale.

43. Nevertheless, some commentators have argued that allowing the entire basis to offset the amount realized on a bargain sale creates an anomaly. They offer the following example to substantiate their argument:

Assume *A* has corporate stock with a fair market value of \$100 and an adjusted basis of \$20. If *A* sells half of the stock to *B* and gives the remainder

### C. *The Realization Principle and Gifts*

Although sales of property produce realization of gain to the transferor, the federal income tax treats ordinary gifts of appreciated property as not producing realization.<sup>44</sup> In addition, the transferee assumes the transferor's basis,<sup>45</sup> so that gain not realized on the gift transaction will be reported on a taxable disposition by the transferee.<sup>46</sup>

This treatment of gifts as not producing realization is supported by practical considerations. If a gift caused taxation to the transferor, the property would have to be valued, and the taxpayer might be forced to liquidate assets to pay tax on the gain. However, these measurement and liquidity considerations are not always determinative, as for example, with the exchange of one property for another property, in which realization occurs despite such obstacles.<sup>47</sup> Moreover, the gift must usually be valued anyway to determine the gift tax amount.<sup>48</sup>

Perhaps the decisive factor here is that most gifts of appreciated property are made to family members and simply change who holds

to C, A's gain on the sale is \$40 (\$50 amount realized—\$10 adjusted basis (one half of \$20)). If, however, A transfers the stock to C for consideration of \$50, the gain is \$30 (\$50 amount realized—\$20 adjusted basis). C has received the same \$50 gift each time and A the same \$50 consideration, but the part gift-part sale regulation results in \$10 less gain realized by A.

Freeland et al., *supra* note 8, at 410 (citations omitted).

This example assumes that two separate transfers—first a sale to one person for fair market value and second an ordinary gift to a different person—should be treated the same as the single transfer of all the stock to one person. However, there is no anomaly if society decides to treat a sale of appreciated property for less than fair market value as a unitary transfer.

44. This view is implicit in §§ 102(a) and 1015(a), which provide that the donee has no gain on receipt of a gift and that the donee assumes the donor's basis. The two principle exceptions involve already accrued ordinary income and installment obligations. With regard to the first exception, the Supreme Court has held that a gift of interest coupons shortly before the maturity date causes realization of the accrued ordinary income gain to the donor. *Helvering v. Horst*, 311 U.S. 112, 119 (1940). With regard to the second exception, under § 453B(a) a gift of an installment obligation causes taxation of gain to the donor.

45. § 1015(a).

46. A gift of appreciated property therefore defers taxation of gain and shifts the incidence of taxation.

47. See Treas. Reg. § 1.61-6(a) (1957).

48. See § 2001.

formal legal title to property within the family unit.<sup>49</sup> Therefore, as a matter of principle, such gifts are not considered an appropriate occasion for taxing property gains. The decision to treat intrafamily gifts as not producing realization of gain is not inevitable, and an income tax could plausibly have reached a different result. For example, first in 1962 and later in 1969, the Treasury unsuccessfully proposed treating certain gifts as taxable events.<sup>50</sup>

Nevertheless, once we decide to treat intrafamily gifts as not producing realization, the more general outcome of not treating any gifts as taxable events follows on practical grounds. Drawing the line between intrafamily and extrafamily gifts is a difficult exercise. It depends on whether one defines the family unit narrowly as constituting the nuclear family, or broadly as including more distant relations and also friends.<sup>51</sup> Moreover, even if the family unit is defined narrowly, gifts outside the family unit may be a relatively small proportion of total gifts. Thus, distinguishing intrafamily from extrafamily gifts is probably not worth the trouble.

To recapitulate, the federal income tax has generally treated gifts of appreciated property as not causing taxation of gain. Both principled and practical considerations support this result.

#### *D. The Effect of Allocating the Entire Basis to a Bargain Sale*

Provided the price paid is no more than the property's basis, allowing the entire basis to offset the amount realized on a bargain sale produces exactly the same income tax consequences as an outright gift. The transferor realizes no gain,<sup>52</sup> and (in order to preserve the unrealized gain for later recognition) the transferee's basis equals the transferor's basis for the entire property.<sup>53</sup>

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49. See William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 354-58 (1972).

50. See *President's 1963 Tax Message: Hearings Before the House Ways and Means Comm.*, 88<sup>th</sup> Cong., 1<sup>st</sup> Sess. 24, 54-55, 128-140 (1963); *Hearings on Tax Reform Before the House Ways and Means Comm.*, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess., Pt. 2 3969-4185 (1969). See also Chirelstein, *supra* note 8, at 58.

51. Andrews, *supra* note 49, at 350-51.

52. Under § 1001(a), gain equals the excess of the amount realized over the adjusted basis. If the amount realized is no more than the adjusted basis, there can be no excess and therefore no gain.

53. The transferee's basis should preserve any unrealized gain in full for later recognition when the transferee disposes of the property. The transferee's basis should therefore equal the transferor's basis, plus any gain realized to the transferor. Provided that the amount paid is no more than the transferor's basis (so that no gain is realized), the transferee's basis will be the transferor's basis. As a result, taxation of gain is deferred and shifted to the transferee.

To illustrate, suppose that property with a value of 200 and a basis of 100 is sold for 100. With basis frontloaded, the amount realized is fully offset by the entire basis, and the bargain sale, like an outright gift, will not cause the transferor to realize gain. Because the transferor realizes no gain, the transferee assumes the transferor's 100 basis.

Under apportionment, by contrast, the amount realized would be offset by only a fraction of the entire basis (equal to the ratio of the amount realized over the market value of the entire property). With basis apportioned in the above example, the 100 amount realized would be offset by only 50 of basis, producing 50 of realized gain. In order to preserve the unrealized gain for later recognition (but no more), the transferee's basis would be 150, which equals the transferor's 100 basis plus the 50 gain realized by the transferor.

### *E. Analogy to an Ordinary Gift*

Consider the following example. Parent buys a \$100,000 vacation home,<sup>54</sup> which appreciates in value to \$200,000. Parent then transfers the house to Child, asking to be paid in return only the original \$100,000 cost. Should this transfer of appreciated property for no more than its cost produce realization of gain to Parent? It would if the apportionment rule applied to a bargain sale, as has been proposed. In that event, only \$50,000, one-half of the original \$100,000 basis, would be assigned to the part sold for \$100,000, producing realization of \$50,000 of gain to Parent.

On the other hand, if we treat an ordinary gift of property as not producing realization (just as we would the incorporation of a business with assumed liabilities no greater than basis), then why not also the sale

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Treas. Reg. § 1.1015-4(a) (as amended in 1972) implements this result by providing that, after a part sale/part gift, the transferee's basis shall equal the amount paid by the transferee for the property or the transferor's basis, whichever is greater. See Larry D. Ward, *Taxation of Gratuitous Transfers of Encumbered Property: Partial Sales and Section 677(a)*, 63 IOWA L. REV. 823, 826-27 (1978).

54. Before 1998, § 121 permitted taxpayers who are 55 years of age or older to exclude up to \$125,000 of gain on the sale of a principal residence. Section 1034 also provided for deferral of gain on the sale of a principal residence if the proceeds were used to acquire a new principal residence within specified time limits. Currently, § 121 permits married taxpayers to exclude up to \$500,000 of gain and single taxpayers to exclude up to \$250,000 of gain, on the sale of a principal residence, regardless of age. Section 1034 has been repealed.

of appreciated property for no more than its basis? Like an ordinary gift, such a transaction typically occurs between family members and simply changes who holds formal legal title to property within the family unit without altering the income of the unit as a whole. We may decide that the transaction is analogous to a gift and therefore not an appropriate occasion for taxing gain. Such a decision can be implemented by allowing the entire basis to offset the amount realized, so that the transferor realizes no gain.<sup>55</sup>

Moreover, apportionment of basis would unduly favor the wealthiest taxpayers. A more affluent parent may be able to afford an outright gift of the vacation home without asking to be paid anything. A less affluent parent may need reimbursement of the original cost. Would it be fair to treat the outright gift by the first as not producing realization, but the sale of appreciated property for no more than basis by the second as causing taxable gain?

The larger message is that assigning basis is not simply a technical issue, but rather should reflect policy judgments about when to tax gain on property. If we believe that the sale of appreciated property at cost (or less) is an appropriate occasion for taxing gain, then perhaps basis should be apportioned. On the other hand, if we believe that it is not an appropriate occasion, then current law, which allocates the entire basis to a bargain sale, is the correct result.

#### *F. Distinguishing an Intentional Bargain Sale from a Bad Bargain*

Property may be sold for less than fair market value either intentionally in order to make a gift or unintentionally as the result of a bad bargain. Even if we decided to apportion basis on an intentional bargain sale, the entire basis should still be available to offset the amount realized from a bad bargain. We would therefore have to distinguish the intentional sale of property for less than fair market value from cases in which the transferor has simply made a bad bargain.

Of course, if the bargain amount exceeds the annual gift tax exclusion, the distinction will also have to be made in any event in order to determine whether the transfer is subject to gift tax.<sup>56</sup> The distinction may also be required in order to determine the transferee's holding period. Moreover, distinguishing an intentional bargain sale from a bad

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55. On the other hand, to the extent that the transferor receives an amount in excess of the basis, the gain is reported. *See* Treas. Reg. § 1.1001-1(e), ex. 1 (as amended in 1994).

56. *See generally* § 2001.

bargain may not be difficult. If the transferor and transferee are related parties, it may be fair to presume that the sale of property for less than its value is intended. If they are unrelated, it may be reasonable to presume that the sale of property for less than its value is a bad bargain. Nevertheless, related parties sometimes do bargain at arm's length over the sale of property, and taxpayers sometimes intend to benefit unrelated parties.

Current law has the advantage (although admittedly minor) of providing the same rule for determining basis whether a transfer is an intentional bargain sale or simply a bad bargain. In all cases in which property is sold for less than its value, whether there is a gift or a bad bargain, the entire basis is still available to offset the amount realized.

### G. Holding Period

Critics of allocating the entire basis to a bargain sale also recommend that, for purposes of determining the transferee's holding period, a so-called part sale/part gift be bifurcated. On the part sold, the holding period would begin anew as of the date of the transfer, as is the case with sales.<sup>57</sup> On the part given, the transferee would use the holding period already established for the transferor, as is the case with gifts.<sup>58</sup>

While arithmetically appealing, this recommendation is questionable, given the underlying nature of the transaction in which property is sold at or below cost. If a sale of appreciated property for no more than its basis is not an appropriate occasion for realizing gain because the transaction is considered a unitary transaction, analogous to an outright gift, then the holding period should be determined in the same manner

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57. See § 1223 (addressing the holding period of property).

58. Critics have explained their recommendation as follows:

In the case of a gift, full tacking is allowed to the transferee, while no tacking results on a sale. The logical conclusion would seem to be that partial tacking should apply to a part gift-part sale. To illustrate, again assume *D* owns property with a fair market value of \$40 and a basis of \$10. If *D* sells the property to *E*, an individual, for \$20, inherently there is both a sale portion and a gift portion of this transaction. In theory, the sale portion should be treated as a true sale of property while the gift portion should be treated as a true gift of property. This result would mandate the commencement of a new holding period for the sale portion and the tacking of *D*'s holding period to *E*'s for the gift portion.

Freeland et al., *supra* note 8, at 413-14 (citations omitted).

as for an outright gift. The transferee should use the holding period of the transferor with respect to the entire property, without bifurcation.

#### *H. Should Complete Nonrecognition Apply?*

Current law permits nonrecognition on a bargain sale only to the extent that appreciated property is sold for no more than its basis. It still requires gain to be reported to the extent that the amount realized exceeds the property's basis. But why require recognition of gain on intrafamily sales in which the amount realized does exceed basis? Such sales, by definition, simply rearrange who holds title within the family, so why recognize the gain. These questions spotlight the rationale for allocating the entire basis on a bargain sale. Perhaps this rationale could justify nonrecognition on intrafamily sales of appreciated property *for more than the basis*, as the Code now provides for sales between husband and wife.<sup>59</sup>

As a practical matter, however, complete nonrecognition in such instances would require determining which sales of appreciated property, in addition to transfers between spouses, should be treated as intrafamily transfers and which should be treated as transfers between separate economic units. This is hardly an easy task. Should only sales between parents and children be covered, or should the scope be broader to include sales with siblings, grandparents, aunts, and uncles? And should persons of a specified relationship be covered without regard to their respective ages? At some point in their lives, many children may become economically independent of their parents, although they do so at varying ages and to varying degrees.

Nonrecognition should generally apply to intrafamily sales of appreciated property for more than basis only to the extent that these difficulties of definition can be resolved. Current law, which allocates the entire basis to a bargain sale, helps to avoid the difficulty of distinguishing such intrafamily sales from sales between economically independent units. The same basis method, allowing the entire basis to offset the amount realized, applies to both kinds of transactions.

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59. In 1984, Congress added § 1041 to the Code for transfers of property effected after July 18, 1984. See Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 793. Section 1041 provides for nonrecognition on all transfers of property between spouses. *Id.*

## IV. A SPECIAL CASE: BARGAIN SALES TO CHARITY

Although current law generally permits the entire basis to offset the amount realized from a bargain sale, there is one exception. When the transferee is a charity, basis must be apportioned under the method generally prescribed for partial sales.<sup>60</sup> Consequently, a taxpayer selling appreciated property at a bargain price to a charity is taxed on a portion of the appreciation, even if the amount realized does not exceed the property's basis.

To illustrate, suppose that stock with a value of 400 and basis of 200 is sold for the bargain price of 200. If the buyer is not a charity, the entire basis may offset the amount realized, and the seller reports no gain. However, if the buyer is a charity, then apportionment of basis allows the 200 amount realized to be offset by only one-half of the basis, or 100, producing 100 of realized gain.

If the entire basis may generally offset the amount realized from a bargain sale, as current law provides, why create an exception for transfers to charities? One answer is that the exception addresses a particular problem which arises only when the transferee is a charity, namely the Code's allowance of a charitable deduction for unrealized property gains. A taxpayer who makes an outright gift of appreciated property to charity may generally deduct the entire fair market value, even though the appreciation is never taxed to the donor or a member of the donor's extended household.<sup>61</sup> For example, a charitable donation of stock with a 400 value and 200 basis will ordinarily result in a deduction of the full 400 value of the property, although none of the 200 appreciation has been realized.

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60. Section 1011(b) states:

If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

61. However, when appreciation represents potential ordinary income or short-term capital gain, or in the case of specified tangible personal property, the deduction is limited to the property's basis. § 170(e)(1).



This allowance of a charitable deduction for unrealized appreciation is controversial.<sup>62</sup> Proponents believe that the benefits to the public, in the form of increased charitable giving, more than offset the revenue loss. Critics, who obviously disagree, propose two reforms: either treat a charitable gift as producing realization to the donor,<sup>63</sup> or reduce the charitable contribution by the amount of unrealized appreciation, thereby limiting the deduction to the property's basis.

Taxpayers frequently try to maximize the degree to which their charitable gifts consist of unrealized appreciation. However, in the case of outright gifts, their ability to do this is limited by their supply of low-basis assets. Without apportionment of basis on bargain sales to charity, however, this limit would virtually disappear. Taxpayers could arrange for a charitable gift to consist purely of unrealized appreciation by selling appreciated property to a charity at cost.<sup>64</sup>

For example, a taxpayer who owned property with a value of 400 and basis of 200 could sell it to charity for 200. Without apportionment, the taxpayer would realize no gain and at the same time deduct the 200 bargain element as a charitable contribution. With apportionment, on the other hand, the taxpayer is forced to realize 100 of gain, which reduces the amount of unrealized appreciation being deducted from 200 to 100. Requiring apportionment of basis on a bargain sale to charity therefore might be justified as limiting the ability of taxpayers to create a charitable deduction consisting solely of unrealized appreciation.<sup>65</sup>

## V. CONCLUSION

Once a bargain sale is labeled as a part sale/part gift, measuring taxable gain appears to be a simple matter of applying the general

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62. See, e.g., Cherie J. O'Neil et al., *Reassessing the Tax-Favored Status of the Charitable Deduction for Gifts of Appreciated Assets*, 49 NAT'L TAX J. 215 (1996).

63. Accurate measurement and liquidity are not obstacles to treating a charitable gift (as opposed to an ordinary gift) as producing realization of gain. The property must be valued anyway in order to determine the amount of the charitable deduction. Realized gain is at least offset by the deduction, so there is no additional tax imposed as a result of a charitable gift producing realization to the donor and therefore no need to liquidate assets to pay the tax.

64. Professors Boris I. Bittker and Lawrence Lokken note that, without apportionment:

[A] taxpayer who sold appreciated property to a charity for its adjusted basis did not realize gain (since the amount realized did not exceed the property's adjusted basis) and could deduct the difference between the sales price and the property's fair market value as a charitable contribution. In effect, therefore, taxpayers could make deductible gifts of "pure" appreciation.

2 BITTKER & LOKKEN, *supra* note 2, ¶ 35.2.4.

65. I am grateful to Daniel Halperin for pointing out to me this justification for § 1011(b).

apportionment rule for partial sales. Calculate the fraction of the property sold and allow the same fraction of the property's basis to offset the amount realized.

However, on closer examination, policy reasons favor allowing the entire basis to offset the amount realized on a bargain sale of appreciated property. First, a bargain sale is more plausibly characterized as a single unitary transfer in which the entire basis should offset the amount realized, rather than as two separate transactions requiring apportionment of basis between the part sold and the part given away. Second, like an ordinary gift, the sale of appreciated property for no more than basis typically occurs between family members and simply changes who holds formal legal title to property within the family unit. By allowing up to the entire basis to offset the amount realized, current law ensures that a bargain sale of property for no more than basis will not result in tax. Third, unlike apportionment, this method does not favor the prosperous taxpayer who can afford an outright gift over a less affluent transferor who may need reimbursement of the original cost. Fourth, this method is somewhat easier to administer because the same rule determines basis regardless of whether a transfer is an intentional bargain sale or a bad bargain.

The larger message is that assigning basis is not simply a technical matter. The basis method determines when gain will be taxed. Society may or may not conclude, as a policy matter, that a particular transaction is an appropriate time to tax gain. Whatever the conclusion, it is society's judgment on this issue which should guide the choice of the basis method.

