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Net Gift Gives Rise to Taxable Income to Donor: Diedrich v. Commissioner of Internal Revenue

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Net Gift Gives Rise to Taxable Income to Donor: *Diedrich v. Commissioner of Internal Revenue.*[1]—Subject to a yearly exclusion[2] and a lifetime credit,[3] the Internal Revenue Code imposes a tax upon noncharitable transfers of property by gift,[4] except those between spouses.[5] The donor is primarily liable for payment of the gift tax attendant upon such a transfer.[6] In a typical taxable gift situation the donor will satisfy this obligation out of other, non-gifted assets, thus increasing the cost to him of effecting the transfer, possibly by as much as 60% of the amount of the transfer.[7] In some instances, as a way of reducing the cost to the donor of such giving, the gift transfer has been structured so as to be explicitly conditional upon the donee's assumption of the donor's gift tax liability.[8] When the transaction is structured in this manner, the value of the taxable gift for gift tax purposes is not, as it would normally be, simply equal to the fair market value of the entire property transferred.[9] Rather, it is computed by subtracting from this fair market value the amount of gift tax paid by the donee.[10] The taxable portion of the transfer is, therefore, determined by reference to the gift tax to be paid by the donee. Because the amount of this tax cannot be computed until the amount of the taxable gift has first been determined, it is necessary to perform an involved computation to arrive at the correct amounts.[11] It is because the donee only receives a net benefit, equal to the value of the property transferred to him diminished by the amount of gift tax that he must pay, that the transaction is commonly termed a "net gift."

There is no longer any debate that the preceding properly describes the gift tax consequences of structuring a donative transfer as a net gift.[12] There has been disagreement, however, concerning what if any should be the income tax consequences of a net gift.[13] The Internal Revenue Service has maintained

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[1] 457 U.S. 191 (1982).

[2] I.R.C. § 2503 (b) (Supp. V 1981).

[3] I.R.C. § 2505 (a), (b) (Supp. V 1981).

[4] I.R.C. § 2501 (a)(1) (Supp. V 1981). This is subject to some further qualifications, none of which are relevant for purposes of this article. *See, e.g.,* I.R.C. § 2501 (a)(3) (Supp. V 1981).

[5] I.R.C. § 2523 (a) (Supp. V 1981).

[6] I.R.C. § 2502 (c) (Supp. V 1981). In the event such taxes are not paid when due, the donee is personally liable for the payment of gift taxes to the extent of the value of the gift. I.R.C. § 6324 (b) (Supp. V 1981).

[7] I.R.C. §§ 2001 (c), 2502 (a) (Supp. V 1981). Sixty percent represents the maximum marginal rate of gift tax as of January 1, 1983. The Economic Recovery Tax Act of 1981 provided for a phased-in reduction in this percentage, from the then current rate of 70%, to 50% for gifts made on or after January 1, 1985. I.R.C. § 2001(c)(2) (Supp. V 1981).

[8] The technique described can result in other advantages to the donor. *See infra* notes 188-93 and accompanying text.

[9] Rev. Rul. 75-72, 1975-1 C.B. 310, 311-13.

[10] *Id.*

[11] *Id.*

[12] *Id. See* Harrison v. Commissioner, 17 T.C. 1350, 1356-57 (1952). *See supra* notes 9-11 and accompanying text.

[13] *Compare* Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd per curiam,* 410 F.2d 752 (6th Cir. 1969), *nonacq.,* 1971-2 C.B. 4 (no income tax consequences) *with Johnson v. Commissioner,*

that such a transaction constitutes an income realization event to the donor, arguing that the gift tax to be paid by the donee constitutes consideration for the transfer.[14] The Service has in this manner attempted to characterize the transaction as being in part a sale, and only in part a gift.[15] The Service's position has been that the donor ought to realize gain on the transaction to the extent that the "consideration" received exceeds the donor's basis in the property transferred.[16] In an opinion affirmed by the Sixth Circuit Court of Appeals, the Tax Court rejected this contention.[17] The court focused instead upon the donor's intent to make a net gift, that is, a gift equal to the value of the transferred property diminished by the gift tax payable by the donee.[18] The court reasoned that since the donor had no intention of making a sale to the donee, the transaction could not properly be characterized as such for income tax purposes.[19] Later decisions of the Tax Court consistently adhered to this rationale in net gift situations, repeatedly rejecting similar attempts by the Service to characterize the net gift transaction as including a "sale" element.[20]

Recently, however, the Supreme Court considered and rejected the Tax Court's position that a net gift transaction is not an income taxable event. In

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59 T.C. 791 (1973), *aff'd* 495 F.2d 1079 (6th Cir. 1979), *cert. denied*, 419 U.S. 1040 (1974) (income tax liability incurred by donor).

[14] McNeice v. Commissioner, 41 T.C.M. (CCH) 969, 970 (1981); Evangelista v. Commissioner, 71 T.C. 1057, 1061-62 (1979), *aff'd*, 629 F.2d 1218, 1221 (7th Cir. 1980); Estate of Weeden v. Commissioner, 39 T.C.M. (CCH) 699, 700 (1979), *rev'd*, 685 F.2d 1160 (9th Cir. 1982); Benson v. Commissioner, 37 T.C.M. (CCH) 989, 990 (1978); Bradford v. Commissioner, 70 T.C. 584, 590 (1978); Estate of Henry v. Commissioner, 69 T.C. 665, 669 (1978); Estate of Owen v. Commissioner, 37 T.C.M. (CCH) 272, 273 (1978); Estate of Levine, 72 T.C. 780, 788 (1979), *aff'd* 634 F.2d 12, 17 (2d Cir. 1980); Hirst v. Commissioner, 63 T.C. 307, 310-12 (1974), *aff'd en banc*, 572 F.2d 427, 429 (4th Cir. 1978); Johnson v. Commissioner, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079, 1091 (6th Cir. 1979), *cert. denied*, 419 U.S. 1040 (1976); Estate of Davis v. Commissioner, 30 T.C.M. (CCH) 1363, 1366-67 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); Krause v. Commissioner, 56 T.C. 1242, 1248 (1971).

[15] *See* cases cited *supra* note 14.

[16] *See* Turner v. Commissioner, 49 T.C. 356, 362 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969) (transfer by donor of appreciated securities on condition that donees pay resulting gift tax liability).

[17] *Id.* at 364.

[18] *Id.* at 363.

[19] *Id.*

[20] McNeice v. Commissioner, 41 T.C.M. (CCH) 969, 970 (1981); Estate of Weeden v. Commissioner, 39 T.C.M. (CCH) 699, 700 (1979), *rev'd*, 685 F.2d 1160 (9th Cir. 1982); Benson v. Commissioner, 37 T.C.M. (CCH) 989, 991 (1978); Bradford v. Commissioner, 70 T.C. 584, 594 (1978); Estate of Henry v. Commissioner, 69 T.C. 665, 674-75 (1978); Estate of Owen v. Commissioner, 37 T.C.M. (CCH) 272, 273 (1978); Hirst v. Commissioner, 63 T.C. 307, 313 (1974), *aff'd en banc*, 572 F.2d 427, 430 (4th Cir. 1978); Estate of Davis v. Commissioner, 30 T.C.M. (CCH) 1363, 1366-67 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); Krause v. Commissioner, 56 T.C. 1242, 1248 (1971). There have been cases *contra*, but all present facts distinguishable from those in a pure net gift situation. *See* Evangelista v. Commissioner, 71 T.C. 1057, 1067 (1979), *aff'd*, 629 F.2d 1218, 1225 (7th Cir. 1980); Estate of Levine, 72 T.C. 780, 788 (1979), *aff'd*, 634 F.2d 12, 17 (2d Cir. 1980); Johnson v. Commissioner, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079, 1086 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1974).

Diedrich v. Commissioner,[21] the Court held, in an eight-to-one decision,[22] that a donor who makes a gift of property on the condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property.[23] The *Diedrich* decision is significant in that it resolves the split in the circuits created by the lower court's decision in the same case.[24] In addition, the Court's decision vindicates a position that the Commissioner had long advocated in the face of strong resistance from the courts.[25]

This casenote will first frame the legal background against which *Diedrich* was decided.[26] Next, the casenote will analyze the Supreme Court's reasoning in the *Diedrich* opinion, approving the Court's holding that a net gift transaction is an income realization event.[27] The casenote will then address the following issues which are raised by the *Diedrich* opinion. First, assuming gain is to be realized on the transaction, the casenote will consider the proper year for its recognition.[28] Specifically, this section will discuss whether recognition should be required in the year in which the donee assumes the obligation (the year of the gift), or the year in which the donee discharges the obligation (the year the gift tax is paid). Second, the casenote will consider whether, for purposes of computing the amount of the donor's gain, the donor's basis in the entire property should be set off against the amount realized, or only that portion of the donor's basis which is attributable to the "sale" portion of the transfer.[29] The Court in *Diedrich* chose the former alternative, but did not justify this conclusion. Third, the method the donee should use to compute his basis in the gifted property, and whether his holding period includes that of the donor, will be addressed.[30] The casenote will propose a resolution to each of these issues, and in doing so, will submit a method for dealing with net gift transactions which more accurately reflects the economic realities of the transaction.

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[21] 457 U.S. 191 (1982).

[22] *Id.* at 200. Justice Rehnquist wrote in dissent. *Id.*

[23] *Id.* at 199-200.

[24] *Compare* Diedrich v. Commissioner, 643 F.2d 499 (8th Cir. 1981) (income tax liability incurred by donor) *with* Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) (no income tax consequences).

[25] *See supra* note 20 and accompanying text. Taxpayer ire at the Commissioner's persistence on this issue perhaps reached its zenith in McNeice v. Commissioner, 41 T.C.M. (CCH) 696 (1981), when the petitioner requested the Court to award punitive damages against the Commissioner for continuing to litigate the issue in light of the adverse judicial precedents. *Id.* at 970 n.4.

[26] *See infra* notes 31-83 and accompanying text.

[27] *See infra* notes 84-126 and accompanying text.

[28] *See infra* notes 127-176 and accompanying text.

[29] *See infra* notes 177-195 and accompanying text.

[30] *See infra* notes 196-239 and accompanying text.

I. THE BACKGROUND OF *DIEDRICH*

Prior to *Diedrich*, the decisions generally took one of two positions on the net gift question.[31] These contrary positions are best exemplified by the two seminal cases of *Turner v. Commissioner*[32] and *Johnson v. Commissioner*.[33]

In *Turner*, the taxpayer made a number of transfers of appreciated stock to individuals and trusts.[34] These transfers were conditioned upon the transferees' agreeing to pay the donor's gift tax arising from the transfer.[35] The Commissioner characterized each transaction as a "part sale and part gift,"[36] and hence argued that the donor ought to recognize taxable income to the extent that the consideration received by her for the transfer exceeded her adjusted basis in the property.[37] Rejecting this contention, the Tax Court stated that the substance rather than the form of the transaction ought to be decisive, and that the substance should properly be determined from an examination of the donor's intent in entering into the transaction.[38] Based on its conclusion that the evident intention of the taxpayer was to make a gift equal to the value of the shares transferred less the value of the gift tax payable on the transfers, the court held that the transfers by the donor were simply gifts and did not result in taxable gain to her.[39]

The position taken by the Tax Court and approved by the Sixth Circuit in *Turner*, that the intent of the donor determined whether or not he had taxable gain on the transaction, was later followed in decisions by the Fourth and Fifth Circuits.[40] As a result, until the decision of the Eighth Circuit in *Diedrich*, the

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[31] The legal background of the *Diedrich* decision has been reviewed extensively in the legal literature. *See, e.g.*, Note, *Federal Income Tax — Net Gift Doctrine*, 63 Cornell L. Rev. 1074 (1978); Note, *Donee Payment of Gift Tax: Crane, Old Colony Trust, and the Need of Congressional Action*, 80 Mich. L. Rev. 1128 (1982); Note, *Gifts — The Income Tax Treatment of Net Gifts*, 57 Notre Dame Law. 420 (1981); Comment, *Federal Income Tax — Income Taxation of Net Gifts After Hirst v. Commissioner*, 32 Rutgers L. Rev. 389 (1979); Comment, *The Tax Consequences of Net Gifts*, 48 Tenn. L.R. 404 (1981); Comment, *A Uniform Theory for Determining Whether a Donor has Taxable Income on a Net Gift*, 16 U.S.F.L. Rev. 95 (1981).

[32] 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969).

[33] 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1974).

[34] 49 T.C. at 358.

[35] *Id.*

[36] *Id.* at 357. In fact, the Commissioner only made this argument with respect to the transfers to individuals. *Id.* The Commissioner conceded, for reasons which are not entirely clear, "that the transfers to the trusts were in no part sales." *Id.*

[37] *Id.* A part sale, part gift transaction is one in which the seller transfers property to the buyer/donee for a consideration which is less than the fair market value of the property. *See* Treas. Reg. § 1.1001-1 (e)(1) (1960). In such a case, the seller has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. Treas. Reg. § 1.1001-1 (e)(1) (1960).

[38] 49 T.C. at 363.

[39] *Id.* at 364.

[40] *See* Hirst v. Commissioner, 63 T.C. 307 (1974), *aff'd en banc*, 572 F.2d 427 (4th Cir. 1978); Estate of Davis v. Commissioner, 30 T.C.M. (CCH) 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972).

Tax Court, for *stare decisis* reasons, consistently adhered to the *Turner* rationale in net gift situations.[41]

In 1974, the *Turner* rationale for finding no income in a net gift situation was apparently undercut when the Sixth Circuit, which had written the *Turner* decision, decided *Johnson v. Commissioner.*[42] *Johnson* presented a fact situation quite different from that of *Turner*. In *Johnson*, the taxpayer borrowed $200,000 from a bank by signing a nonrecourse note secured by 50,000 shares of stock which were worth approximately $500,000, and which had a basis in his hands of $10,813.[43] He then transferred the stock to an irrevocable trust for the benefit of his children, with the trustees assuming the $200,000 liability.[44] The taxpayer paid the resulting $150,000 gift tax liability out of the proceeds of the loan, leaving him with $50,000 in cash and no obligation on the note.[45] In the Tax Court, the Commissioner took the position that the transfers were part sales and part gifts, and that the taxpayer realized a taxable gain on the transaction to the extent that the loan proceeds exceeded his basis in the stock.[46] The taxpayer, relying on *Turner*, argued that the transactions were simply gifts in the $300,000 net amount, and should not have any income tax consequences.[47] The Tax Court agreed with the Commissioner, holding that "[t]o the extent the transfers were subject to the loans they were sales and [the petitioner] . . . realized capital gains in the amount his loan exceeded his basis in the stock."[48]

In affirming the Tax Court, the Sixth Circuit agreed that the taxpayer realized income on the transaction to the extent that the loan proceeds exceeded his basis in the stock transferred.[49] In the circuit court's view, however, it was immaterial whether or not the substance of the transaction was described as a "part sale and part gift."[50] Characterizing this language as "suggestive but artificial,"[51] the circuit court instead focused, as the *Turner* court had purported to do, on the economic substance of the transaction.[52] The circuit court concluded that the $200,000 loan proceeds received by the taxpayer ought to constitute gross income under section 61 of the Code.[53] The taxpayer, the court

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[41] *See supra* note 20 and accompanying text. In Hirst v. Commissioner, 63 T.C. 307 (1974), the Tax Court acknowledged that there was some force to the Commissioner's claim that the transaction contained an exchange element. *Id.* at 315. Nonetheless, the court considered itself bound by the factually similar *Turner* precedent, and accordingly held that the donor recognized no gain on the transaction. *Id.*

[42] 495 F.2d 1079 (6th Cir. 1974), *cert. denied,* 419 U.S. 1040 (1974).

[43] *Id.* at 1080. There were actually three taxpayers, all of whom entered into substantially identical transactions. *Id.*

[44] *Id.*

[45] *Id.*

[46] Johnson v. Commissioner, 59 T.C. 791, 807 (1973).

[47] *Id.* at 812.

[48] *Id.*

[49] 495 F.2d at 1086.

[50] *Id.* at 1084.

[51] *Id.*

[52] *Id.* at 1082-83.

[53] *Id.* I.R.C. § 61(a) (1976) reads in pertinent part as follows: "[e]xcept as otherwise

noted, had received these proceeds free of any obligation to repay them out of property in his possession.[54] Although the Court of Appeals in *Johnson* implied that in substance the transaction could be viewed as analogous to the one in *Turner*,[55] it held that the conclusion that the taxpayer realized gain on the transaction would be proper in any event.[56] The taxpayer in *Johnson* had argued that with respect to the $150,000 used by the donor to pay gift tax, the transaction was equivalent to the one in *Turner*.[57] Because the donee had assumed liability for repayment of a loan, the proceeds of which were used to pay the donor's gift tax, the taxpayer argued that as an economic matter the donee had paid the donor's tax.[58] The court held, without explicitly overruling *Turner*, that even if the transaction were viewed in this way, the donor in *Johnson* would still realize income,[59] under the principles of either *Crane v. Commissioner*,[60] or *Old Colony Trust Co. v. Commissioner*.[61]

In *Crane*, the taxpayer inherited from her husband an apartment building worth approximately $250,000, subject to a nonrecourse mortgage in the same amount.[62] Seven years later, after taking approximately $25,000 in depreciation deductions, the taxpayer sold the property for the buyer's assumption of the mortgage, and for an additional consideration of $2,500.[63] She reported $2,500 of gain on the sale, claiming that all she had inherited from her husband was his equity in the building, which was zero, and hence that her gain should be the excess of the amount realized on the sale over the amount of that equity, that is, $2,500.[64] The Commissioner's position was that the taxpayer realized approximately $27,500 of gain on the sale.[65] Her basis in the building, he contended, was roughly the $250,000 it was worth when she inherited it, reduced by approximately $25,000 of depreciation allowable in the intervening seven years.[66] The amount she realized on the sale, he claimed, was $252,500, which amount was the sum of (1) the $2,500 of cash she received on the sale, and (2) the $250,000 nonrecourse mortgage to which the property was subject when the buyer purchased it.[67] The Supreme Court in *Crane* sustained the Commis-

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provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) . . . (12) Income from discharge of indebtedness; . . . ." *Id.*

[54] 495 F.2d 1083.

[55] *Id.*

[56] *Id.*

[57] *Id.* at 1081.

[58] *Id.*

[59] *Id.* at 1083.

[60] 331 U.S. 1 (1947).

[61] 279 U.S. 716 (1929).

[62] 331 U.S. at 3. The amounts in the following discussion are rounded off for simplicity.

[63] *Id.*

[64] *Id.* at 4. Note that the taxpayer's claim that her basis in the building was zero is inconsistent with her reporting position that she was entitled to depreciation deductions computed on a basis of $250,000.

[65] *Id.*

[66] *Id.*

[67] *Id.*

sioner's position, and held that the "amount realized" upon the sale of property includes the amount of nonrecourse liabilities assumed by the buyer.[68] Drawing on *Crane*, the *Johnson* court reasoned that since the taxpayer had retained the $200,000 cash proceeds of the loan, while transferring away the property which secured the offsetting nonrecourse obligation, the taxpayer realized income in the amount of the debt disposed of.[69]

In support of its holding that the taxpayer realized income to the extent that the loan proceeds exceeded his basis in the stock transferred, the *Johnson* court also relied on *Old Colony Trust*.[70] In *Old Colony Trust*, the taxpayer was a corporate executive whose employer, pursuant to a resolution adopted by the Board of Directors, had agreed to pay all state and federal income taxes which thereafter became due and payable in respect of the salaries of all the officers of the company.[71] The Supreme Court, sustaining the Commissioner's determination, held that such payments were includible in the gross income of the taxpayer in the year in which they were made.[72] The Court stated that: "[I]t is therefore immaterial that the taxes were directly paid over to the government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."[73]

In *Johnson*, the court reasoned that since the payment of gift taxes is the donor's obligation, the donee's assumption of liability on the bank loan, the proceeds of which were used to satisfy the donor's gift tax obligation, was constructively equivalent to a direct payment by the donee of the donor's gift tax obligation.[74] The court held, therefore, that the portion of the loan proceeds used to pay the donor's gift tax liability constituted income to the donor under *Old Colony Trust*.[75]

Although it appears from the foregoing that the *Johnson* court rejected outright the rule of *Turner*, the court did not purport to do this, being satisfied simply to confine *Turner* to its "peculiar fact situation." [76] As a result of this failure by the *Johnson* court to overrule *Turner* explicitly, *Johnson* was considered the rule where previously encumbered property was gratuitously transferred,[77] but the *Turner* rationale was still held controlling in net gift situations.[78]

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[68] *Id.* at 13.

[69] 495 F.2d at 1083. Prior to *Johnson*, the *Crane* case had already been applied in the gift area in First National Industries, Inc. v. Commissioner, 404 F.2d 1182, 1186 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969), where the donor was charged with capital gain upon the gift of property mortgaged in excess of its basis. *Id.*

[70] 495 F.2d at 1083.

[71] *Old Colony Trust*, 279 U.S. at 719-20.

[72] *Id.* at 729.

[73] *Id.*

[74] *Johnson*, 495 F.2d at 1083.

[75] *Id.*

[76] *Id.* at 1086.

[77] *See* Estate of Levine, 72 T.C. 780, 791 (1979), *aff'd*, 634 F.2d 12, 17 (2d Cir. 1980); Evangelista v. Commissioner, 71 T.C. 1057, 1064 (1979), *aff'd*, 629 F.2d 1218, 1224, n.15 (7th Cir. 1980).

[78] *See e.g.*, McNeice v. Commissioner, 41 T.C.M. (CCH) 969, 970 (1981); Benson v.

Thus, the *Diedrich* case was decided against divergent lines of precedent, each of which adopted a fundamentally different approach to the net gift transaction. Although both purported to analyze the economic substance of the transaction, the cases decided under *Turner* focused on the donor's intent to make a net gift in determining the economic substance of the transaction, allowing this factor to control the income tax treatment of the transaction.[79] These cases consistently held that the donor's intent to make a gift net of gift tax precluded the characterization of the transaction as in part a sale, and hence held that the donor realized no gain on the transaction.[80] *Johnson* and factually similar cases, on the other hand, examined the transaction from the point of view of the actual economic benefit realized by the donor.[81] These cases found income tax liability in connection with transactions which, while not involving net gifts in the pure sense, were nevertheless economically equivalent to net gifts.[82] Relying on *Crane* and *Old Colony Trust*, these cases held that the taxpayer realizes income by shedding a liability he would otherwise have been obligated to repay.[83] In the next section, the casenote will examine the *Diedrich* decision, focusing on the way in which the Supreme Court applied the theoretical basis of *Johnson* to facts analogous to those in *Turner*.

II. *DIEDRICH V. COMMISSIONER OF INTERNAL REVENUE*

In *Diedrich*,[84] the taxpayer and his wife each made gifts totalling approximately 85,000 shares of stock to or for the benefit of their three adult children.[85] At the time the gifts were made, the donees executed agreements providing that as a condition of receiving the gifts they would each pay a proportionate share of the gift tax for which the taxpayer was liable as a result of the transfer.[86] They subsequently paid this liability, in the amount of

Commissioner, 37 T.C.M. (CCH) 989, 991 (1978); Bradford v. Commissioner, 70 T.C. 584, 594 (1978); Estate of Henry v. Commissioner, 69 T.C. 665, 671 (1978); Estate of Owen v. Commissioner, 37 T.C.M. (CCH) 272, 273 (1978); Hirst v. Commissioner, 63 T.C. 307, 313 (1974), *aff'd en banc*, 572 F.2d 427, 428 (4th Cir. 1978); Estate of Weeden v. Commissioner, 39 T.C.M. (CCH) 699, 700 (1979), *rev'd*, 685 F.2d 1160 (9th Cir. 1982); Estate of Davis v. Commissioner, 30 T.C.M. (CCH) 1363, 1368 (1971), *aff'd per curiam*, 469 F.2d 694, 694 (5th Cir. 1972).

[79] *See Turner*, 49 T.C. at 363; Hirst v. Commissioner, 572 F.2d 427, 430 (4th Cir. 1978). In a number of cases, the Tax Court has relied more on *stare decisis* than on any explicit examination of donor intent in adhering to the *Turner* rule. *See* McNeice v. Commissioner, 41 T.C.M. (CCH) 969, 970 (1981); Bradford v. Commissioner, 70 T.C. 584, 594 (1978); Estate of Henry v. Commissioner, 69 T.C. 665, 675 (1978); Estate of Owen v. Commissioner, 37 T.C.M. (CCH) 272, 273 (1978); Krause v. Commissioner, 56 T.C. 1242, 1248 (1971).

[80] *See* cases cited *supra* note 79.

[81] *See* Estate of Levine v. Commissioner, 634 F.2d 12, 16 (2d Cir. 1980); Evangelista v. Commissioner, 629 F.2d 1218, 1225 (7th Cir. 1980); Johnson v. Commissioner, 495 F.2d 1079, 1082-84 (6th Cir. 1979).

[82] *See supra* note 81.

[83] *See* cases cited *supra* note 81.

[84] 457 U.S. 191 (1982). *Diedrich* was consolidated on appeal with Estate of Grant v. Commissioner. *Id.* at 194. Since there are no material distinctions between the two cases, *id.* at 192-94, only the facts of *Diedrich* will be set forth herein.

[85] *Id.*

[86] *Id.*

$62,992.[87] The taxpayers' basis in the stock was $51,073.[88] On their 1972 federal income tax return, the taxpayers did not report as income any part of the gift tax paid on their behalf by the donees.[89] On audit, the Commissioner determined that the taxpayers had realized gain in the amount by which their gift tax liabilities, discharged by the donees, exceeded their basis in the transferred stock.[90] The taxpayers thereafter sought a redetermination in the Tax Court of the asserted deficiencies.[91] Adhering to its prior line of decisions beginning with *Turner*, the Tax Court upheld the taxpayers' position that they had merely made a net gift of the difference between the fair market value of the transferred property and the gift tax paid by the donees.[92]

The Eighth Circuit Court of Appeals reversed, holding that the taxpayers recognized taxable gain on the transaction to the extent that the gift tax paid on their behalf by the donees exceeded their basis in the stock transferred.[93] The circuit court acknowledged that the facts in *Diedrich* were indistinguishable from those in *Turner*,[94] but went on to accept the Commissioner's contention that *Turner* and its progeny had been wrongly decided.[95] In the court's view, the approach taken by the *Johnson* court,[96] in the case of an asset gratuitously transferred subject to a pre-existing encumbrance, was also the correct one to take in a net gift situation.[97] The taxpayer argued that *Johnson* could be distinguished because in that case, the transfer was subject to a pre-existing encumbrance which had arisen as a result of the taxpayer's previous borrowing against the appreciation of the property.[98] Rejecting this argument, the court observed that in the case before it, as in all net gift situations, the liability shed only arose upon the transfer itself.[99] The court held that the difference between a previously existing encumbrance, and one which only arises as a result of the transfer itself, was not sufficient to distinguish the two situations.[100] In either

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[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.* at 193. Accordingly, the Commissioner determined a deficiency in the taxpayers' taxable income for 1972 of $5,959, computed as follows:

Gift tax paid in 1972	$62,992
Less: Basis in stock transferred	(51,073)
Long-term capital gain	11,919
Less: I.R.C. § 1202 deduction	(5,959)
Increase in taxable income	5,959

Id. n.1.

[91] *Id.* at 193.

[92] Diedrich v. Commissioner, 39 T.C.M. (CCH) 433, 433-35 (1979).

[93] Diedrich v. Commissioner, 643 F.2d 499, 504 (8th Cir. 1981).

[94] *Id.* at 501.

[95] *Id.* at 502.

[96] *Id.* (citing Johnson v. Commissioner, 495 F.2d 1079 (6th Cir. 1974)). *See supra* notes 42-61 and accompanying text.

[97] 643 F.2d at 502.

[98] *Id.* at 503.

[99] *Id.*

[100] *Id.*

case, the appeals court held, the determinative factor is receipt of the benefit.[101] It does not matter whether the benefit takes the form of relief from an encumbrance or relief from a tax liability;[102] in either case the taxpayer has constructively received income on the transaction.[103] Although the court did not expressly so state, its reliance upon and description of *Johnson* make it apparent that the arguments therein based upon *Crane* and *Old Colony Trust* formed the rationale for its decision.[104]

The Supreme Court affirmed the decision of the Eighth Circuit, finding taxable income to the donor in a net gift situation.[105] In the majority decision written by Chief Justice Burger,[106] the Court rejected the theory that the donor's intent was a factor in determining whether or not the transaction gave rise to taxable income.[107] Instead, the Court adopted the economic benefit arguments, based upon *Crane* and *Old Colony Trust*, which had formed the rationale for *Johnson*.[108] The Court reasoned as follows. When a gift is made, the donor incurs a debt to the United States in the amount of the gift tax due in respect of the transaction.[109] The donee's agreement to discharge the donor's indebtedness in consideration of the gift, therefore, gives rise to an economic benefit to the donor.[110] It does not matter whether the benefit to the donor arises from the assumption by the donee of a previously existing encumbrance upon the transferred property, or from his assumption of the gift tax arising from the transfer; the benefit to the donor is the same in either case.[111] The Court stated that:

> Consistent with the economic reality, the Commissioner has treated these conditional gifts as a discharge of indebtedness through a part gift and part sale of the gift property transferred. The transfer is treated as if the donor sells the property to the donee for less than the fair market value. The "sale" price is the amount necessary to discharge the gift tax indebtedness; the balance of the value of the transferred property is treated as a gift.[112]

Thus the Court apparently agreed with the Commissioner that an analysis of the economic realities of the net gift transaction demonstrates that both "gift" and "sale" elements are involved.[113] The Court, however, did not pur-

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[101] *Id.* at 503-04.
[102] *Id.* at 504.
[103] *Id.*
[104] *See supra* notes 62-83 and accompanying text.
[105] 457 U.S. at 192.
[106] *Id.* Justice Rehnquist wrote in dissent. *Id.* at 200.
[107] *Id.* at 197-98.
[108] *Id. See supra* notes 62 & 75 and accompanying text. The court interpreted both *Crane* and *Old Colony Trust* as standing for the general proposition that income may be realized by indirect means, and that a taxpayer must recognize income whenever he realized an economic benefit through the discharge of an obligation. *Id.* at 195-96.
[109] *Id.* at 197.
[110] *Id.*
[111] *Id.* at 198.
[112] *Id.* at 198-99.
[113] *Id.*

port to engage in any such economic analysis, nor did it explicitly adopt the Commissioner's "part sale and part gift" characterization as being an accurate reflection of the transaction's underlying economic realities.

In finding taxable income in a net gift situation and overruling the *Turner* line of cases, the Supreme Court in *Diedrich* reached the correct result as a matter of income definition. The *Turner* court had examined the transaction and found that the intention of the taxpayer was simply to make a net gift, equal in value to the total amount of the transfer reduced by the amount of the gift tax payable in connection therewith.[114] Based upon this finding, the *Turner* court had held that the transfers by the donor were simply net gifts and therefore did not result in taxable income to her. The flaw in this approach is that it confuses a gift tax analysis of the transaction with an income tax analysis. The *Turner* court apparently neglected to consider that the income and gift tax systems are conceptually and practically distinct, and that a given transaction can have implications in the former wholly apart from any it may have in the latter. Thus it is perfectly correct to state that the conditional nature of the transfer reduces the effective amount thereof, and that therefore the transaction can properly be viewed as simply a gift in the net amount. It is erroneous, however, to conclude that the transfer has no income tax consequences. The gift tax and income tax consequences of a transaction must in all cases be approached separately. In the net gift situation, the proper approach is to disregard the gift tax aspects of the transaction when analyzing whether or not it has income tax consequences.

When the net gift transaction is viewed in this manner, it is apparent that two significant occurrences have taken place. First, the donor has engaged in a transfer which has given rise to a liability equal in amount to the gift tax which becomes payable as a result of the transfer. The effect of the transfer is thus to reduce the donor's net worth by this same amount.[115] Second, the donee has furnished consideration for the transfer by assuming the donor's liability for payment of this tax obligation. Consequently, the donor's net worth has been increased by the amount of the liability assumed by the donee. Such an increase is an "accession to wealth, clearly realized,"[116] which, under the broad net worth test of income set forth by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*,[117] is properly includible in gross income. The situation can be viewed as analogous to one in which an asset is transferred subject to an existing liability. The transferor in such a situation realizes an increase in net worth in the amount of the liability of which he is relieved, and this increase is properly includible in his gross income.[118]

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[114] *See supra* notes 34-39 and accompanying text.

[115] For purposes of income tax analysis, the reduction in net worth brought about by the making of the gift must be ignored, since personal gifts are not deductible for income tax purposes.

[116] Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

[117] *Id.* at 430-32.

[118] *See* the discussion of *Crane, supra* notes 57-64 and accompanying text.

Despite the fact that the *Diedrich* holding is correct as a matter of income definition, there are a number of problems with the decision resulting from the Court's failure to analyze the net gift transaction from an economic standpoint. The Court substituted for an economic analysis of the transaction the bald statement that "[t]he principles of *Old Colony* and *Crane* control."[119] This implies nothing meaningful about the economic substance of the transaction. *Crane* and *Old Colony* merely stand for rules of law, the implications of which are wholly dependent upon the particular facts and economic substance of the transaction to which they are applied. Thus, in *Old Colony Trust*, the taxpayer's employer paid his income taxes for him pursuant to a resolution by the company.[120] The Supreme Court there held that the taxpayer realized taxable income as a result of the payment, stating that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."[121] On the facts of *Diedrich*, therefore, the rule of *Old Colony Trust* establishes that the donee's payment of the tax debt which is the donor's obligation would be equivalent to receipt by the donor of that amount. It does *not*, however, answer the question of whether or how much of that receipt constitutes taxable income.[122] To answer this question, it is necessary to analyze the economic substance of the transaction.

Similarly, the rule of *Crane*, that the seller of an asset subject to nonrecourse indebtedness must include in the amount received on such sale the amount of such indebtedness assumed by the buyer,[123] assuming it is applicable to the facts of *Diedrich*, does not establish whether the amount deemed received constitutes taxable income. Again, it is the economic substance of the transaction which controls on this issue. To argue, as does the Court, that simply because "the principles of *Old Colony* and *Crane* control"[124] the donor perforce has taxable income on the transaction, is to omit a crucial step in the analysis, that is, an examination of the true economic substance of the transaction. This omission in turn leaves open a number of issues after *Diedrich* which in all probability would have been resolved by implication had the Court engaged in such an economic analysis.

The casenote will now turn to an examination of these issues. First, the question of which year is the proper one for the recognition of the gain will be addressed.[125] Next, the propriety of the Court's apparent holding that the donor may offset against his gain his basis in the entire transferred property will be ex-

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[119] 457 U.S. at 196.

[120] *Old Colony Trust*, 279 U.S. at 720.

[121] *Id.* at 729.

[122] Many receipts of money or property, such as gifts, which are accretions to wealth, are not included in gross income. *See, e.g.*, I.R.C. § 102(a) (1976).

[123] *See supra* notes 62-69 and accompanying text.

[124] 457 U.S. at 196.

[125] The Court did not consider whether the gain ought properly to be recognized in the year the gift is made, or in the year the gift tax is actually paid by the donee. *See id.* at 191. Both the Commissioner and the taxpayer conceded this issue. Diedrich v. Commissioner, 643 F.2d 499, 500, n.2 (8th Cir. 1981).

amined.[126] The casenote will then view the problem from the donee's perspective, considering what his basis and holding period would be in the event that he should contemplate a subsequent resale of the gifted asset. The resolution of this issue will hinge on whether or not "part sale and part gift" can properly be adopted as the definitive substantive characterization of the net gift transaction. In the context of proposing resolutions to these issues, the casenote will analyze the economic substance of the net gift situation. Such an analysis will illuminate both the problems surrounding the net gift transaction and the resolutions proposed.

III. When Should the Donor Recognize Gain?

The Supreme Court's holding in *Diedrich*, that the donor in a net gift situation realizes gain to the extent that the gift tax paid by the donee exceeds the donor's basis in the property transferred, raises the issue of *when* the gain is to be recognized, in the year the donor makes the gift or in the year the donee pays the tax.[127]

The Court cited both *Crane* and *Old Colony Trust* in support of its holding in *Diedrich* that the donor in a net gift situation realizes taxable income on the transaction.[128] The Court's citation of both cases, however, creates an ambiguity concerning the implications of the decision with respect to the resolution of this timing question. If the rule of *Crane* is controlling, then the gain is realized, and hence ought to be recognized,[129] in the year in which the gift is made. In *Crane*, the Court held that the seller realized the benefit when she transferred the property subject to the mortgage debt, since in effect this removed her personal liability.[130] Two recent cases in the Second and Seventh Circuits followed *Crane* in adopting this view.[131] The regulations under Internal Revenue Code section 1001, which concern the computation of gain or loss on

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[126] 457 U.S. at 199-200. The court seemed to allow this offset. *Id.* It adduced no support for the proposition, however. *See id.*

[127] Barring anomalous situations such as a low income year or the availability of carryovers which are about to expire, it will usually be to the donor's advantage for the gain not to be recognized until the year of payment, because of the benefit of deferral. In any event, from the point of view of the practitioner, planning considerations make it crucial that this question be answered.

[128] 457 U.S. at 196.

[129] I.R.C. § 1001(c) (1976) provides: "[e]xcept as otherwise provided in this subtitle, the entire amount of the gain or loss . . . on the sale or exchange of property shall be recognized." *Id.*

[130] *Crane*, 331 U.S. at 14. The Court stated, "if he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another." *Id.*

[131] Estate of Levine v. Commissioner, 634 F.2d 12, 16 (2d Cir. 1980) (assumption of mortgage debt by trust was equivalent of constructive receipt of cash by decedent; taxpayer realized gain upon the transfer of the encumbered property); Evangelista v. Commissioner, 629 F.2d 1218, 1225 (7th Cir. 1980) (donor recognized gain upon the transfer of encumbered property to trust).

the sale or other disposition of property, are to substantially the same effect.[132] The theory underlying both the regulations and the cases appears to be that if the taxable event is taken to be a "sale or other disposition,"[133] as opposed to a discharge of indebtedness, then the gain ought properly to be recognized in the year of the disposition.[134] There is language in the *Diedrich* decision which appears to support the interpretation that it is this disposition which gives rise to the tax liability.[135] The Court emphasized the fact that the donor realizes an immediate economic benefit upon the donee's assumption of the donor's gift tax liability.[136] This emphasis, when considered in the light of the Court's apparent reliance on the reasoning of *Crane*, strongly supports the conclusion that the gain ought to be recognized in the year of the transfer.[137]

If, on the other hand, the rationale of *Old Colony Trust* is found to be controlling on this issue, it would be more logical to conclude that the gain is not taxable until the year in which the donee actually discharges the liability. In *Old Colony Trust*, the taxpayer realized income upon the actual payment of his tax liability by his employer, notwithstanding the fact that the agreement to make this payment had been made in a prior year.[138] Thus, the receipt of the economic benefit under *Old Colony Trust* is thought not to occur until the actual discharge of the taxpayer's obligation by another.[139] In a net gift situation, this

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[132] Treas. Reg. § 1.1001-2 (1980) reads in part as follows:

> (a) Inclusion in amount realized —
>
> (1) In general. Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. . . .
>
> (4) Special rules. For purposes of this section . . .
>
> (ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);
>
> (iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject; . . .

Id.

[133] I.R.C. § 1001(a) (1976).

[134] In a net gift transaction, this would be the year in which the gift was made.

[135] 457 U.S. at 191. The Court stated: "when a donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In short, the donor realizes an *immediate economic benefit* by the donee's assumption of the donor's legal obligation to pay the gift tax." *Id.* (emphasis supplied).

[136] *Id.*

[137] Considerations of tax equity also favor this conclusion. As the Supreme Court recognized, it does not make sense to treat the donor who realizes a benefit from the pre-gift sale of assets differently from the donor who realized the equivalent benefit by making a net gift. 457 U.S. at 198.

[138] *Old Colony Trust,* 279 U.S. at 720, 729.

[139] *See supra* notes 71-75 and accompanying text. In a later case, the Court described its holding in *Old Colony Trust* as follows:

> We have held that income was received by a taxpayer, when, pursuant to a contract, a debt or other obligation was discharged by another for his benefit. The transaction was regarded as being the same in substance as if the money had been paid to the taxpayer and he had transmitted it to his creditor.

Douglas v. Wilcuts, 296 U.S. 1, 9 (1935).

discharge does not take place until the donee actually pays the gift tax. Payment occurs typically in the succeeding year, since gift taxes in respect of gifts made during the calendar year are not due and payable until April 15 of the ensuing year.[140] Until this payment occurs, the donor remains by statute personally liable for payment of the gift tax,[141] and the donee's unsecured promise to pay possibly remains too speculative a benefit to constitute income.[142]

This result, that the donor realizes no income until the donee actually pays the tax, was recently reached on analogous facts by the Court of Appeals for the Ninth Circuit in *Estate of Weeden v. Commissioner*.[143] The taxpayer in *Weeden* transferred shares of stock in his brokerage business to his four nephews, upon the written condition that they pay the resulting gift taxes.[144] This stock transfer was substantially the same transaction as had been entered into by the taxpayer in *Diedrich*. Following the Supreme Court's holding in *Diedrich*, the circuit court found that the taxpayer had realized taxable income as a result of the transaction.[145] The Commissioner had further argued that the gain was properly taxable in the year in which the gift taxes were paid, while the taxpayer argued that the year of transfer was proper.[146]

The court upheld the Commissioner, holding that the gain was taxable in the year of payment of the gift tax.[147] The court employed a two part rationale to reach this conclusion.[148] First, the court said, a cash basis taxpayer must report income received in the form of property only if the property has an ascertainable market value,[149] and hence is the equivalent of cash. The court found that because the benefit of the donees' promises to pay ran only to the taxpayer, they had no ascertainable market value.[150] Second, since the taxpayer remained by statute liable for payment until the donees actually paid the gift tax, the benefit and consequently the income did not accrue until that payment was made.[151]

As the foregoing discussion demonstrates, there are reasonably strong arguments in favor of both the *Crane* and *Old Colony Trust* positions. The better approach, however, and one which is more in harmony with both the rationale

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[140] *See* I.R.C. § 6075(b)(1) (Supp. V 1981).

[141] *See supra* note 6 and accompanying text.

[142] *See* Burnet v. Logan, 283 U.S. 404, 412-13 (1931).

[143] 685 F.2d 1160 (9th Cir. 1982).

[144] *Id.*

[145] *Id.* at 1161.

[146] *Id.* Note the reversal of positions from those which it would be more typical for the parties to adopt.

[147] *Id.*

[148] *Id.* The court characterized its decision as being "based on several policy considerations." *Id.*

[149] *Id.* This argument is based upon I.R.C. § 1001(b) (1976), which reads in pertinent part as follows: "[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." *Id.*

[150] 685 F.2d at 1162.

[151] *Id.*

of *Diedrich* and the economic reality of the net gift transaction, is to adopt the rule of *Crane* that gain is realized in the year of the transfer.[152]

The Eighth Circuit in *Diedrich* relied heavily upon the *Johnson* case as the rationale for its decision.[153] Thus, because the Supreme Court's opinion in *Diedrich* approved the Eighth Circuit's reliance upon *Johnson*, it may reasonably be inferred that the Supreme Court was in basic agreement with the *Johnson* analysis. *Johnson*, although discussing both *Crane* and *Old Colony Trust*, relied more on the former to support its holding.[154] In *Johnson*, it will be remembered, the taxpayer borrowed $200,000 on a nonrecourse note, pledging $500,000 worth of stock as collateral.[155] He then transferred the stock to a trust, subject to the liability, using $150,000 out of the loan proceeds to pay the gift tax, and keeping $50,000 for himself.[156] The Tax Court in *Johnson*, finding income to the donor on the transaction, couched its analysis exclusively in terms of *Crane*.[157] The Sixth Circuit Court of Appeals, while noting that with respect to the $150,000 used to pay gift taxes the donor could be found to have realized income under *Old Colony Trust* as well as *Crane*, seemed to focus upon the shedding of the liability as the income realization event.[158] In the court's view, "each taxpayer received something of value *upon transferring* his encumbered stock into trust."[159]

The *Crane* approach, with its emphasis upon the shedding of the liability as the realization event, finds some support in the language of the Supreme Court's decision in *Diedrich*.[160] The Court stated that:

> *[W]hen a donee agrees* to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In short, the donor realizes an *immediate economic benefit* by the donee's assumption of the donor's legal obligation to pay the gift tax.[161]

Crane, therefore, ought to control for purposes of determining the year in which income is realized. As the foregoing analysis sought to show, the cases which

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[152] *See Crane*, 331 U.S. at 13. It could perhaps be argued, however, that this analysis will only apply to net gifts which occurred before October 19, 1980, the effective date of the Installment Sales Revision Act of 1980, Pub. L. 96-471, 94 Stat. 2247 (1980). This Act repealed the 30% down payment requirement for installment sale treatment, as well as the requirement that there be more than one payment. *Id.* at § 2. Furthermore, the Act provided that installment sale treatment must apply, unless the Taxpayer affirmatively elects otherwise. *Id.*, I.R.C. § 453(d)(1) (Supp. V 1981). For transactions to which it applies, this may constitute a rationale for recognizing gain in the year of payment.

[153] *See supra* notes 96-104 and accompanying text. The circuit court in *Diedrich* stated that "[a]s we view the problem, the correct approach was taken by Johnson v. Commissioner. . . ." Diedrich v. Commissioner, 643 F.2d 499, 502 (8th Cir. 1981).

[154] *Johnson*, 495 F.2d at 1083.

[155] *Id.* at 1080.

[156] *Id.*

[157] *Johnson*, 59 T.C. at 808-12.

[158] *Johnson*, 495 F.2d at 1083.

[159] *Id.* (emphasis supplied).

[160] 457 U.S. at 197.

[161] *Id.* (emphasis supplied).

laid the groundwork for the Supreme Court's opinion in *Diedrich*, as well as some language in the *Diedrich* opinion itself, both support this conclusion. Furthermore, the arguments in favor of the *Old Colony Trust* approach and against the *Crane* approach, as presented by the Ninth Circuit in *Weeden*,[162] are not entirely convincing. The argument that the donee's promise has no ascertainable fair market value, and hence that its worth does not constitute an "amount realized," is against the clear policy of the regulations, which state that "only in rare and extraordinary cases will property be considered to have no fair market value."[163] In a net gift situation it appears incorrect to maintain that a promise to pay a sum certain on a date certain in the future is not susceptible of accurate valuation, even if in fact there exists no market for the obligation. The argument is also unsupported by the cases the *Weeden* Court cited in its favor.[164] These cases stand only for the proposition that in the case of a contract where the existence and amount of the consideration is "wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty,"[165] a taxpayer realizes no income before payment is actually made.[166]

The second argument advanced by the *Weeden* court was that since the donor remains statutorily liable for the gift tax until payment is actually made by the donee, he therefore realizes no benefit until this payment is in fact made.[167] This argument appears contrary to the dictates of Treas. Reg. section 1.1001-2(a)(4)(ii) (1981).[168] This regulation specifically includes as an amount realized upon the disposition[169] of an asset, the amount of recourse liability secured by that asset, regardless of whether or not the transferor is in fact released from liability.[170] The policy supporting this regulation appears to be that assumption by a buyer or donee of primary liability for a debt is sufficient to cause the seller or donee to realize income. This conclusion finds support in a case following the rule of *Johnson*. In *Evangelista v. Commissioner*,[171] it was held that the fact that the taxpayer remained secondarily liable on a note secured by assets he transferred to a trust did not alter the conclusion that he received an economic benefit (and hence taxable income) from the trust's assumption of his liability.[172] Similarly, in *Oates v. U.S.*,[173] the taxpayer transferred certain oil

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[162] *See supra* notes 143-151 and accompanying text.

[163] Treas. Reg. § 1.1001-1(a) (1960).

[164] Burnet v. Logan, 283 U.S. 404 (1931); Jones v. Commissioner, 524 F.2d 788 (9th Cir. 1975); *In re* Steen, 509 F.2d 1398 (9th Cir. 1975); Wilhoit v. Commissioner, 308 F.2d 259 (9th Cir. 1962).

[165] Burnet v. Logan, 283 U.S. 404, 413 (1931).

[166] *Id.*

[167] *Weeden,* 685 F.2d at 1152.

[168] *See supra* note 132 and accompanying text.

[169] For purposes of the regulation in question, "disposition" includes a gift. Treas. Reg. § 1.1001-2(a)(4)(iii) (1960).

[170] Treas. Reg. § 1.1001-2(a)(4)(ii) (1960).

[171] 629 F.2d 1218 (1980).

[172] *Id.* at 1225.

[173] 24 A.F.T.R.2d (P-H) 69-5628 (N.D. Tex. 1969).

and gas leases subject to an outstanding mortgage to various related persons.[174] The District Court held that the taxpayer realized income on the transfer and that it was immaterial that the taxpayer remained secondarily liable on the note.[175]

For the reasons discussed above, the rule of *Crane* should control the question of the timing of the donor's gain in a net gift situation. Accordingly, gain should properly be recognized in the year in which the transfer of the property to the donee takes place.[176] This conclusion is the more logical one in view of existing precedent. The Supreme Court's implicit recognition that the *Johnson* analysis is proper also supports the inference that the *Crane* analogy is the correct one. The *Weeden* court, in holding that the donor should not recognize gain until the donee actually pays the tax, reached an incorrect result which should not be followed.

IV. Should Basis be Allocated in Computing Donor's Gain?

The *Diedrich* decision held that the donor in a net gift situation realizes capital gain income equal to the amount by which the gift tax liability arising from the transfer exceeds his adjusted basis in the property transferred.[177] The Supreme Court recognized that the economic reality of the net gift transaction does contain a certain element of exchange; income tax liability is thus imposed on the donor because he has disposed of the property at least in part in a taxable transaction, that is, in a sale.[178] The remainder of the transfer is characterized as a gift,[179] and is subject to gift tax. Since the transfer of an asset by gift in general generates no income tax consequences,[180] it must be the disposition of part of the asset in a deemed "sale" which results in gain to the donor. The question then becomes how much gain the donor must recognize. Under *Diedrich*, the donor is deemed to have received the amount of the gift tax paid on his behalf by the donee. The gain must therefore be the excess of this amount realized over his basis. This conclusion, however, raises the further question of whether the donor must allocate his basis in determining the amount of his gain. The donor had a basis in the entire transferred asset; hence a certain amount of this basis is potentially allocable to the "gift" portion of the transfer, and a certain amount (the remainder) to the "sale" portion. If such an allocation would be proper in determining the donor's gain, his gain would be the excess of the gift taxes paid by the donee over that portion of his basis allocated to the "sale" portion of the transfer.

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[174] *Id.* at 69-5631.
[175] *Id.* at 69-5632.
[176] This conclusion may be qualified to the extent stated *supra* at note 152.
[177] *Diedrich,* 457 U.S. at 199-200.
[178] *Id.* at 198-99.
[179] *Id.* at 199.
[180] I.R.C. § 102(a) (1976).

The *Diedrich* decision prima facie answers the allocation question in the negative, stating that "[t]he gain thus derived by the donor is the amount of the gift tax liability less the donor's adjusted basis in the entire property.[181] The Court, however, does not adduce any real support for this position, except perhaps its general statement that "[t]his treatment is consistent with § 1001 of the Internal Revenue Code."[182] It shall be shown that the treatment proposed by the Court is in fact not consistent with the Code's general rules for determination of the amount of gain or loss in the case of a taxable disposition, as set forth in section 1001, and furthermore, that such treatment is inconsistent with the economic reality of the net gift transaction.

In its opinion in *Diedrich*, the Court emphasized the "part sale and part gift" characterization of the net gift transaction.[183] Unfortunately, this conclusory[184] characterization obviated any necessity for the Court to engage in an economic analysis of the transaction, enabling it instead to justify its answer to the basis allocation question simply by its general reference to section 1001.[185] This reference is apparently an implicit invocation of Treas. Reg. section 1.1001-1(e)(1), which states: "[W]hen a transfer of property is in part a sale and in part a gift, the transferor has gain to the extent that the amount realized by him exceeds his adjusted basis in the property."[186]

Thus, the Court apparently was of the opinion that because the net gift transaction contains elements of both sale and gift, Treas. Reg. section 1.1001-1(e)(1) automatically applies, and hence basis allocation is not the rule in the net gift situation.

The problem with this approach is that it forsakes analysis in favor of the blind application of a conclusory and facile rule. This is especially disconcerting because the Court was not forced into applying this rule. There exist transactions containing elements of both sale and gift, and to which, it could be argued, the net gift transaction can more properly be analogized, which are not treated in this way.[187] In any event, the Court in *Diedrich* was changing entirely

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[181] 457 U.S. at 199.

[182] *Id.* I.R.C. § 1001 (1976) states in pertinent part as follows:

> (a) Computation of gain or loss. — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) Amount realized. — The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. . . .

Id.

[183] 457 U.S. at 198.

[184] It is worthy of note that the *Johnson* court, to which the Supreme Court in *Diedrich* owes much of its reasoning, considered the "part sale and part gift" characterization to be merely conclusory. *Johnson*, 495 F.2d at 1082.

[185] 457 U.S. at 199.

[186] Treas. Reg. § 1.1001-1(e)(1) (1960).

[187] *See infra* note 192 and accompanying text.

the tax treatment of net gifts, and it was certainly free to adopt any treatment of the basis question which was rationally justifiable.

Although it is beyond the scope of this casenote to undertake an elaborate general criticism of Treas. Reg. section 1.1001-1(e)(1), its implicit application by the Court in this case dictates a treatment of the net gift transaction which is consistent neither with principles of tax equity, nor with the treatment of the transaction which an economic analysis would suggest. The casenote will now perform such an analysis.

Leaving aside considerations of liquidity and donor preference, and focusing instead solely on economic substance, it is true that every net gift transaction could be restructured as a traditional gift transaction. Such a transaction, but for income tax considerations, would be the economic equivalent of a net gift transaction. Suppose, for example, that a donor is in the 50 percent bracket for gift tax, and he is willing to give up property worth $900 for the benefit of his donee. It is clear that he can structure the transfer in one of two ways. He can transfer the entire $900 in a net gift transaction, imposing on his donee the condition that he pay the gift tax. In this case the portion of the transfer taxable for gift tax purposes will be $600, and the donee will pay $300 in gift tax, retaining the balance. Alternatively, the donor could simply transfer $600 to the donee in a traditional gift transaction, free of any conditions, and satisfy the gift tax liability himself out of the $300 he retained. If the only concern is the economic substance of the transaction, as measured by the changes in net worth of the donor and donee during the transaction, then before income taxes are considered, both donor and donee are utterly indifferent about which form is chosen for the transaction.

The income tax consequences of the two transactions will now be considered. Suppose that in the preceding example the donor's basis in the property worth $900 was $180. If the donor made the transfer to the donee as a traditional gift, he would give $600 worth of property, keeping $300 worth of property with which to pay the gift tax. When he sold the property worth $300 to raise cash to pay the tax, he would realize capital gain income of $240, that is, the excess of the $300 received over $60, which is his basis in that portion of the property.[188] It is proper that the donor should realize this gain, because upon the sale he is realizing the appreciation of the property he is selling. If, however, the same transaction were structured as a net gift, the donor would under *Diedrich* recognize a gain of only $120, that is, the excess of the $300 in gift tax paid by the donee, which the donor is deemed to have received, over $180, the donor's basis in the entire property transferred. This result obtains in spite of the underlying economic equivalence of the two transactions. It appears to be of primary concern to Congress as a policy matter that similarly situated taxpayers be treated alike, and hence that substantial differences in tax liability do not hinge upon purely formal differences in the way substantially

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[188] *See* Treas. Reg. § 1.61-6(a) (1960).

equivalent transactions are structured.[189] This principle ought to have guided the Court in assessing the income tax consequences of the net gift form of the transaction. The Supreme Court in *Diedrich* failed to apply this principle, and as a result, the conclusion they reach is bad tax policy, in that it treats identically situated taxpayers differently. Since the application of Treas. Reg. section 1.1001-1(e)(1) to the net gift transaction would lead to such a result, such a result is unsupportable.

The rule in a net gift situation should be that the donor recognizes gain equal to the excess of the gift tax paid by the donee over that portion of the donor's basis allocable to the gift tax portion of the transfer. Such a rule would, as shown above, be more in accord with the economic substance of the transaction.

This rule would also be more consistent with the Code's general treatment of situations where one portion of a larger piece of property is disposed of by sale. Where a portion of a larger property is sold, the general rule is that only that portion of the taxpayer's basis in the entire property which is properly allocable to the portion of the property which was sold may be used to offset his gain.[190] There is case law supporting the proposition that such an allocation must be made.[191] Similarly, in the case of a bargain sale to a charitable organization, a transaction analogous to the one at issue here in that a portion of the property involved is transferred gratuitously, and the remainder is sold, I.R.C. section 1011(b) specifically provides for allocation of basis.[192] The general theory behind this provision is that a taxpayer ought not to derive more after-tax benefit from the previously unrealized appreciation of property by disposing of it by gift than he could by selling it and retaining the proceeds himself.[193] Yet, as shown above, this is exactly what occurs in a net gift transaction after *Diedrich* if basis allocation is not the rule. Due to this tax avoidance ef-

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[189] *See, e.g.*, S. REP. NO. 494, 97th Cong., 2d Sess. 97-98 (1982), *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 781, 866-67; S. REP. NO. 144, 97th Cong., 1st Sess. 2 (1981), *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 108-9.

[190] Treas. Reg. § 1.61-6(a) (1960) states in pertinent part as follows:

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

Id.

[191] Hunter v. Commissioner, 44 T.C. 109, 115 (1965); Welsh Homes, Inc. v. Commissioner, 279 F.2d 391, 395 (4th Cir. 1960).

[192] I.R.C. § 1001(b) (1976) reads as follows:

> (b) Bargain Sale to a Charitable Organization. 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.

Id.

[193] *See* H.R. Rep. No. 413, 91st Cong., 1st Sess. 53-54, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1699, 1969-3 C.B. 200, 235.

fect which can be achieved by structuring certain donative transfers as net gifts, arguments of tax equity support the conclusion that basis allocation is the correct result here.

This casenote has argued that in computing the amount of the donor's gain, basis should be allocated between the sale and gift portions of the transferred property. This result is not only desirable from the point of view of tax policy, but more in accord with the Internal Revenue Code's general philosophy regarding the taxation of appreciation in respect of which the taxpayer has reaped a benefit. Nevertheless, this was not the result in *Diedrich*, where the Court allowed the donor to offset against his gain his basis in the entire property transferred.[194] As demonstrated above, this result dictates an inconsistent and theoretically incorrect method for computing the donor's gain on the transaction, and creates a tax-avoidance incentive for structuring gratuitous transfers as net gifts. Furthermore, it would appear to ignore the fact that there really does exist in a net gift situation some true element of gift, which if viewed separately would not be an income taxable event at all. The entire property is not being "sold," only a portion of it is. Ignoring this reality, and treating the transaction as if the entire property transferred were being sold, generates a result which comports with neither the intent of the parties nor the realities of the economic exchange.

It should be noted, however, that in *Diedrich* the question of the *amount* of the donor's gain was *per se* not in issue. The Supreme Court did not squarely address the issue of basis allocation; in effect the Court simply affirmed the Commissioner's determination as to the amount of the gain.[195] Thus, the *Diedrich* decision cannot be read as an explicit adoption by the Court of "part sale and part gift" as the definitive substantive characterization of the transaction, or of Treas. Reg. section 1.1001-1(e)(1), which was not even cited in the decision, as the last word on the basis allocation question. Accordingly, it would be incorrect to interpret the *Diedrich* decision as holding that basis allocation is not the proper rule here. Although it cannot be gainsaid that the Court appeared to take the position that gain should not be allocated in computing the donor's gain, it is not too late for the more plausible treatment proposed herein to be adopted.

V. What Should Be Donee's Basis and Holding Period?

A. *Donee's Basis*

Should the donee in a net gift situation contemplate the subsequent resale of the property so received,[196] it will of course be important for him to know his

[194] *Diedrich*, 457 U.S. at 199.

[195] Since this determination was more favorable to the taxpayer than would be the result urged by this casenote, he was naturally not disposed to dispute it.

[196] The donee may, for example, contemplate resale to raise the funds necessary to satisfy the gift tax liability.

basis and holding period in respect of the asset to calculate properly his gain or loss. There was no reason for the Supreme Court to raise or consider this issue in the *Diedrich* decision, and it did not do so. If the Court had explicitly adopted "part sale and part gift" as the definitive substantive characterization of the net gift transaction, then it would have resolved this issue *sub silentio*. The reason for this is that in the case of transactions which are so characterized, a basis computation method is prescribed by Treas. Reg. section 1.1015-4(a), which reads in pertinent part:

> (a) General rule. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of —
> (1) Whichever of the following is the greater:
> (i) The amount paid by the transferee for the property, or
> (ii) The transferor's adjusted basis for the property at the time of the transfer, and
> (2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid. . . .[197]

I.R.C. section 1015(d) in substance provides that in the case of property acquired by gift, the basis of the property in the hands of the transferee is increased by that portion of the gift tax paid on the transfer which is attributable to appreciation in the property.[198] For example, if $5 of gift tax is paid on the transfer of property worth $10 and having a basis of $2 in the hands of the transferor, the transferee gets an increase in basis under this section equal to $4 ($8/$10 x $5).

As previously discussed, however, the Supreme Court in *Diedrich* stopped short of holding that "part sale and part gift" is the definitive characterization of the net gift transaction.[199] As a consequence, the *Diedrich* decision cannot and should not be read as absolutely prescribing all the substantive tax consequences which follow from such a characterization. The result dictated by Treas. Reg. section 1.1015-4(a) should be applied in the net gift situation only if and to the extent that it comports with Congressional intent, as expressed in the Code's treatment of analogous basis questions, and with the economic reality of the transaction. It will be shown here that the application of this

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[197] Treas. Reg. § 1.1015-4(a) (1960).

[198] I.R.C. § 1015(d)(6) (1976) provides in pertinent part:

> (A) In General. — In the case of any gifts made after December 31, 1976, the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as —
> (i) the net appreciation in value of the gift, bears to
> (ii) the amount of the gift.
> (B) Net Appreciation. — For purposes of paragraph (1), the net appreciation in value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift.

Id.

[199] *See supra* note 195 and accompanying text.

regulation treats the question of the donee's basis in a manner which is consistent with the view of the net gift transaction under which the donor does not allocate his basis when computing the amount of gain that he is required by *Diedrich* to recognize. This view does not, however, take proper account of the economic realities of the net gift transaction, and should not be adopted.[200] Accordingly, it will be argued in this section that in the computation of the donee's basis, the result dictated by Treas. Reg. section 1.1015-4(a) should likewise not be adopted in the net gift situation.

In general, an asset's basis is simply its cost.[201] A taxpayer may incur costs in connection with an asset in a number of ways. He may make direct expenditures with respect to the asset, for example when he purchases it[202] or makes improvements to it.[203] Alternatively, he may incur an income tax liability with respect to the asset, under circumstances which require him to include in income all or part of the previously untaxed appreciation.[204] In such a case, the appreciation which is taxed is added to the cost of the asset, so that the same appreciation is not taxed again when the property is later sold.[205] This situation may conveniently be thought of as simply the reverse of depreciation. Instead of receiving a benefit, the taxpayer incurs a cost, and instead of commensurately reducing his basis, he commensurately increases it. The principle is simply that the taxpayer should increase basis to reflect all the costs of an asset, and should reduce it to reflect all benefits.

It is for the foregoing reasons that I.R.C. section 1015 gives a donee a basis adjustment for gift tax paid in respect of the transfer to him of property. Failure to do this would be in effect to disregard a significant "cost" associated with the asset, that is, the cost of transferring it to the donee.[206] A further rationale for allowing this adjustment is that failure to allow it would in effect create a "tax upon a tax."[207] This comes about in the following manner. In a net gift situation, the payment of the gift tax reduces the value to the donee of the transferred property. Thus, payment of the gift tax in effect consumes some of the appreciation in the property. Failure to allow a basis adjustment for this gift tax creates a situation in which the donee, upon the subsequent resale of the property, pays a tax upon the portion of the appreciation which has in effect already been paid as gift tax, thus creating a "tax upon a tax."

Conceptually, in a net gift transfer there are three "costs" which have been incurred with respect to an asset when it reaches the donee's hands.

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[200] *See supra* notes 177-94 and accompanying text.

[201] I.R.C. § 1012 (1976).

[202] *Id.*

[203] I.R.C. § 1016(a)(1) (1976).

[204] *See e.g.*, I.R.C. § 1031(d) (1976).

[205] *Id.*

[206] *See* S. REP. NO. 1983, 85th Cong., 2d Sess. 70-71, *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 4791, 4859-60.

[207] *See* H.R. REP. NO. 1380, 99th Cong., 2d Sess. 44, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3398. A similar rationale justifies allowing a step-up in basis for property inherited from a decedent. *See* I.R.C. § 1014(a) (Supp. V 1981).

These are (1) the donor's original cost; (2) the amount of the asset's appreciation in respect of which, pursuant to *Diedrich*, the donor incurred income tax liability on the transfer;[208] and (3) the amount of the property's appreciation which was in effect paid for gift taxes in connection with the transfer. Accordingly, the donee's basis ought to reflect all and only these costs. This result, as the following example will make clear, is only generated by Treas. Reg. section 1.1015-4(a) if one adopts the erroneous method of computing the donor's gain suggested by the Supreme Court in *Diedrich*. This implies that the results generated by Treas. Reg. section 1.1015-4(a) are themselves erroneous.

Suppose once again that a donor in the 50 percent bracket for gift tax makes a net gift transfer of $900 worth of appreciated property having a basis of $180, with the following results. $300 is paid in gift tax in respect of the transfer by the donee, of which $240 is attributable to appreciation, and $60 is attributable to basis.[209] If the donor does not allocate basis in computing his gain, then he recognizes a capital gain of $120. The donee's basis, therefore, ought to be $540. This amount is the sum of the donor's original cost ($180), the portion of the appreciation taxed to the donor as capital gain ($120), and the portion of the appreciation which was paid for gift taxes ($240). This is the same result as that which would be generated by the application of Treas. Reg. section 1.1015-4(a).[210]

The application of Treas. Reg. § 1.1015-4(a), therefore, is consistent with the donor's gain computation method implicitly recognized by the Court in *Diedrich*. It does not, however, follow that its application in the net gift situation would be correct, in view of this casenote's position that *Diedrich* was incorrectly decided in this regard. In fact, this result implies just the reverse. It has been argued in this casenote that the correct method for computing the donor's gain in a net gift situation involves recognizing that both sale and gift are material elements in the net gift transaction, and that the only treatment of the transaction which is consistent with its economic reality involves dealing separately with these two conceptually distinct elements. Allocating the donor's basis between the two parts was proposed as the only way to effect this separate treatment. If this approach were adopted, the solution to the problem of the donee's basis would follow naturally from familiar basis rules of general application,

[208] *See supra* notes 204-05 and accompanying text.

[209] *See supra* note 198.

[210] Under Treas. Reg. § 1.1015-4(a) (1960), the donee's basis equals the greater of (i) the amount paid by the transferee for the property (here $300), or (ii) the transferor's adjusted basis for the property at the time of the transfer (here $180), plus the increase for gift taxes authorized by section 1015(d) (here $240), for a total of $540. *Id.* This result always will be obtained because the "amount paid" by the donee, the gift tax, will in all cases equal the sum of the donor's basis and the gain recognized by him on the transaction. This is because the donor's gain is defined under *Diedrich* to equal the difference between the gift tax paid and the donor's basis. *See* Diedrich v. Commissioner, 457 U.S. 191, 192 (1982). Note that under the preceding analysis, the donee's basis is conceptually and in reality the same "in whole or in part" as the donor's basis. *See* Treas. Reg. § 1.1223-1(b) (1960). For the implications this has on the question of "tacking," *see infra* notes 217-239 and accompanying text.

without regard to the conceptually erroneous rule set forth in Treas. Reg. section 1.1015-4(a).

The foregoing can be demonstrated by the following example. Suppose once more that the donor has transferred property worth $900, and having a basis of $180, to his donee in a net gift transaction. Suppose further that the casenote's position regarding the computation of the donor's gain has been adopted, and hence the donor has incurred á taxable gain of $240, rather than $120 as under *Diedrich*, on the transfer.[211] The donee, in computing his basis, would address the "gift" and "sale" aspects of the transactions separately. With respect to the $600 "gift" portion of the transfer, his basis would simply be the donor's basis in that portion, here $120,[212] adjusted for gift tax paid as provided in I.R.C. section 1015(d). Here that adjustment would be $240, giving the donee a total basis, in the assets which comprise the $600 "gift" portion of the property, of $360. With respect to the $300 "sale" portion of the transfer, the donee's basis would simply be the $300 he "paid" for the property. Thus, the donee's total basis in the entire property transferred would be $660.[213] Note that this amount is $120 higher than the property's basis in the donee's hands as computed under Treas. Reg. section 1.1015-4(a). This is the correct result because, under this analysis, the donor recognizes $120 more gain on the initial transfer than under the analysis apparently adopted by *Diedrich*.[214]

The Supreme Court in *Diedrich* did not explicitly adopt "part sale and part gift" as the authoritative substantive characterization of the net gift transaction. Accordingly the Court left unresolved the question of whether Treas. Reg. section 1.1015-4(a) will control the donee's computation of his tax basis in property received in a net gift transfer. This casenote has argued that the application of this regulation would be consistent with a conceptually incorrect method of computing the donor's gain, and therefore ought not to control. The "sale" and "gift" portions of the transaction should be treated separately. On-

[211] *See supra* notes 177-194 and accompanying text.

[212] I.R.C. § 1015(a) (1976).

[213] It may appear at first blush as though the donee receives basis credit for the gift tax twice. In fact, however, there is no "double credit" involved. The $300 received by the donor which was used to pay his gift tax is included as an increase to the donee's basis because the donor will have paid a capital gain tax on that amount of appreciation of his property, and that portion of the property's increase in value should not again be taxed. The $240 increase in the donee's basis which is attributable to gift taxes paid is independently proper. Its function is not to discourage gifts. Were basis not raised by the amount of gift taxes paid, a donor would recognize that a shift of resources to the donee would incur a tax without a corresponding adjustment in basis for the donees. *See* I.R.C. §§ 1015(b) (1976), 1015(d) (Supp. V 1981) and Treas. Reg. §§ 1.1015-2, -4, -5, (1960), in which Congress has authorized increases in a donee's basis both by amounts of gain recognized upon transfers to trust and by amounts of gift taxes paid, regardless of the fact that such amounts may superficially appear redundant. I.R.C. §§ 1015(b), (1976), 1015(d) (Supp V 1981); Treas. Reg. § 1.1015-2, -4, -5 (1960).

[214] If $120 more of appreciation is taxed in connection with the transaction, but there is not a commensurate increase in basis, then upon a subsequent sale of the property by the donee the same appreciation would be taxed again.

ly if this method is adopted will the tax treatment of the net gift transaction remain faithful to its economic substance.[215]

B. *Donee's Holding Period*

The second question which arises for the donee in a net gift situation is whether or not he is permitted to "tack" the donor's holding period. If the donee is permitted to "tack," then in determining whether his gain on the sale is long-term or short-term,[216] he substitutes the donor's acquisition date for his own. There are, of course, situations in which this is quite desirable from the donee's point of view.

The general rule is that the holder of an asset may tack where his basis is to be computed "at least in part" by reference to the basis of the person from whom he acquired the asset.[217] Thus, the method by which the donee computes his basis in a net gift will affect the tacking issue. As discussed previously, it is unclear from the *Diedrich* opinion whether or not the donee in a net gift situation computes his basis under Treas. Reg. section 1.1015-4(a). In this section the casenote will first examine how the tacking question would come out if this regulation were to control the donee's basis computation.[218] The casenote will then examine the implications for the tacking question which would be raised by the adoption of the basis computation method previously proposed by the casenote.[219]

It is apparent that on its face, the operation of Treas. Reg. § 1.1015-4(a) does not give the donee a basis determined "at least in part" by reference to the donor's basis, and hence tacking would seem not to be permissible in a net

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[215] In addition, this method possesses the advantage of removing the unjustifiable income tax benefit which can be derived from structuring gratuitous transfers of appreciated property as net gifts. *See supra* notes 188-93 and accompanying text.

[216] This determination is important because only 40% of long-term gains are includible in the taxable income of the taxpayer, whereas 100% of short-term gains are so includible. *See* I.R.C. § 1202(a) (Supp. V. 1981).

[217] Treas. Reg. § 1.1223-1(b) (1960). The regulation reads as follows:

> (b) The holding period of property in the hands of a taxpayer shall include the period during which the property was held by any other person, if such property has the same basis in whole or in part in the hands of the taxpayer for determining gain or loss from a sale or exchange as it would have in the hands of such other person. For example, the period for which property acquired by gift after December 31, 1920, was held by the donor must be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purposes of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor.

Id.

[218] *See infra* notes 217-35 and accompanying text.

[219] *See infra* notes 236-39 and accompanying text.

gift situation.[220] This is the position of the Internal Revenue Service.[221] The Court of Appeals for the Fifth Circuit, however, has disagreed with the Service on this point.

In *Citizen's National Bank of Waco v. United States*,[222] the settlor transferred to trusts stock worth $714,601 and having a basis of $498,468.[223] The stock was subject to liabilities in the amount of $500,000.[224] The settlor reported a long term capital gain of $1,532 in connection with the transfer.[225] The issue in the case was whether the trust, upon its subsequent sale of the stock, was entitled to tack the settlor's holding period.[226] The court held that tacking was permissible,[227] reasoning as follows. I.R.C. section 1015(a), the court noted, provides generally that in the case of a gift, the transferee's basis shall be the same as the donor's basis.[228] The court further noted that I.R.C. section 1015(b) provides that in the case of a sale to a trust, the transferee's basis is the same as the grantor's basis "increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer. . . ."[229] Thus, both subsections (a) and (b) of I.R.C. § 1015 require the transferee to determine his basis at least in part by reference to the transferor's basis. Treas. Reg. § 1.1015-4, the court observed, leads to the same result, although the words used therein disguise the fact that the donor's basis is relevant to the computation.[230] The court stated that the relevant number under Treas. Reg. § 1.1015-4(a) is either the transferor's basis, or the amount paid by the transferee for the property.[231] Since in a net gift situation the "amount paid" is by definition equal to the transferor's basis increased by the amount of gain recognized by the transferor, the court noted, the regulation effects a mere change in terminology. The court concluded that this ought not to be determinative with respect to the donee's tacking rights.[232] Accordingly, the court held that to the extent Treas. Reg. section 1.1015-4(a) would prevent a transferee who is a trustee from tacking the settlor's holding period, the regulation is invalid.[233]

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[220] Treas. Reg. § 1.1015-4(a) (1960). This regulation provides that the donee's basis shall be the sum of (1) the greater of (a) the amount paid by the transferee (i.e. the gift tax) or (b) the donor's basis, and (2) the basis adjustment provided by I.R.C., § 1015(d) (Supp. V 1981). *Id.* In a net gift situation, the amount paid by the transferee will, by hypothesis, always be greater than the donor's basis, and hence it appears that the donor's basis is never directly relevant in computing the donee's basis.

[221] *See* Priv. Ltr. Rul. (CCH) 7752001, 12 (1977).

[222] 417 F.2d 675 (5th Cir. 1969).

[223] *Id.* at 676.

[224] *Id.*

[225] *Id.*

[226] *Id.*

[227] *Id.* at 680.

[228] *Id.* at 677 n.2.

[229] I.R.C. § 1015(b) (1976).

[230] 417 F.2d at 679.

[231] *Id.*

[232] *Id.* at 680.

[233] *Id.*

The *Waco* decision has been criticized on the grounds that since there is no section in the Code equivalent to I.R.C. section 1015(b) which is applicable to individuals, the decision creates an unjustifiable distinction between individuals and trusts as transferees with respect to tacking rights.[234] This is because *Waco* appears to allow tacking where a "part sale and part gift" is made to a trust, but not when it is made to an individual.

If, however, the "part sale and part gift" label were held to be determinative of all the substantive income tax consequences of the net gift transaction, then an argument based on *Waco* could be made which would allow individuals to tack, as follows. Under such circumstances, the donee's basis in net gift situations would be computed under Treas. Reg. § 1.1015-4(a). If this were the case, then the amount computed under § 1.1015-4(a)(1)(i) ("price paid") would always be equal to the donor's basis increased by the amount of gain recognized by the donor upon the transfer. This result would follow automatically in every net gift situation, because the "price paid" is by definition equal to the gift tax, and the gain is measured as the difference between the donor's basis and the gift tax. It therefore follows that the "price paid" must always equal the donor's basis increased by the amount of gain recognized by the donor.

As a result, if Treas. Reg. § 1.1015-4(a) controls the donee's basis computation under *Diedrich*, one effect of the decision would be to dictate the same basis computation method for individuals that I.R.C. § 1015(b) mandates for trusts. Under such circumstances, the donee's basis in a net gift situation would be determined in part by reference to the donor's basis, although the wording of Treas. Reg. § 1.1015-4 tends to disguise this fact. It could therefore be argued, in light of *Waco*, that after *Diedrich* tacking is proper in net gift situations.

The argument is problematic, however, because it ignores Congress's apparent intent in enacting the tacking provisions. Congress apparently intended these provisions to apply in cases where the transaction by which the transferee acquired the property was itself without tax consequences, such as a tax-free exchange of stock pursuant to a reorganization.[235] After *Diedrich*, the net gift transaction no longer falls into this category, and it is therefore possible to argue that it would be contrary to Congressional intent to allow tacking in such situations.

The entire issue can be avoided, and a more reasonable and proper treatment of the tacking questions provided if, as previously suggested, the sale and gift components of the transaction are treated separately. Treating the components separately would result in a tax treatment both more consistent and more in accord with the economic reality of the transaction. Under this ap-

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[234] *See* Dallman, *Income Tax Consequences of Net Gifts*, 59 TAXES 275, 283-89 (1981).

[235] *See* H.R. REP. 1, 69th Cong., 1st Sess. 6-7, *reprinted in* 1939-1 C.B. (Part 2) 315, 319; S. REP. 52, 69th Cong., 1st Sess. 18, *reprinted in* 1939-1 C.B. (Part 2) 332, 346.

proach, the donor's basis would be allocated between the "sale" and "gift" portions of the transfer, and the donee would be able to tack the donor's holding period for the latter but not the former.[236] This not only would constitute a reasonable solution to the tacking problem, but, as shown above, would be in accord with an overall treatment of the transaction which is at once fairer and more consistent with the economic realities of the transaction. Whether or not the transaction is structured as a net gift would become irrelevant as far as income and gift tax consequences are concerned. This is the only supportable result, since the transaction does not differ in economic substance depending upon its structure as a net gift or a regular gift. This equivalence may be illustrated as follows.

Suppose as before that the donor has an appreciated asset worth $900, and having a basis in his hands of $180, which he desires to transfer to his donee. Suppose further that for this donor the gift tax on a taxable transfer of $600 is $300. If the donor makes a gift of $600 worth of the property and retains $300 worth to pay the gift tax, then after the transaction the following conditions obtain. The donee has property worth $600 having a basis of $360 (equaling the donor's basis of $120 plus the gift tax adjustment of $240 provided by I.R.C. § 1015(d)),[237] and is permitted to tack the donor's holding period. The donor is out of pocket $900, and has incurred a taxable capital gain of $240.

On the other hand, if the donor transfers the entire $900, styling the transaction as a net gift, under *Diedrich*, the following results obtain if the treatment of the transaction argued for in this casenote is not adopted. The donor would be out of pocket $900, and he would have incurred a taxable gain of $120 in respect of the transfer. The donee would initially receive property worth $900. His basis in this property would be $540, if it were computed under Treas. Reg. § 1.1015-4(a).[238] When he sold $300 worth of property to raise cash to pay the gift tax, he would recognize $120 of capital gain. It is unclear whether or not he would be permitted to tack the donor's holding period. Note that the effect of *Diedrich* is to allow a substantial portion of the donor's gift tax liability to be discharged out of appreciation which is taxed to the donee.

Different and conceptually more correct results would obtain, however, if, in the case of a transaction styled as a net gift, its gift and sale portions were treated separately. The donor would, as before, be out of pocket $900, but he would have incurred a taxable capital gain of $240 in respect of the "sale" portion of the transaction. The donee would initially receive $900. His basis in the $600 "gift" portion would be $120, subject to a section 1015(d) adjustment of $240 upon his payment of the gift tax. For purposes of any subsequent resale, he would be permitted to tack the donor's holding period. His basis in the $300 "sale" portion would be its cost, $300. Thus his sale of this portion to raise

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[236] At one time, the Service itself took this position. *See* I.T. 2681, XII-1 C.B. 93 (1933).
[237] *See supra* note 198.
[238] *See supra* note 210.

funds to pay the gift tax would not generate any taxable gain to him, which is the correct result since the donor would have already been taxed on this appreciation.[239]

In summary, the *Diedrich* decision raises the question of whether the donee in a net gift situation will be permitted to tack the donor's holding period in determining whether his gain on a subsequent resale of the property is long-term or short-term. If the "part sale and part gift" characterization of the transaction is adopted, then the tacking issue will remain unresolved, pending more explicit adjudication. This uncertainty can be obviated by explicitly rejecting this characterization as conclusory and misleading, and instead analyzing the net gift as effectively two separate transactions. The result of such analysis is to treat alike the net giver and the traditional giver who engage in economically equivalent transactions.

Conclusion

Many issues arise in connection with a net gift transaction. In *Diedrich v. Commissioner,* the Supreme Court squarely addressed only one of them. In its narrow holding that the donor in a net gift situation realized taxable gain, the Court is surely correct. The *Diedrich* opinion, however, has given ambiguous indications concerning the other issues raised by the net gift transaction. These issues include the timing and amount of the donor's gain, and the amount of the donee's basis and the length of his holding period. The issue of the timing of the donor's gain should be resolved by adopting the approach of *Crane,* which requires that the assumption of liability by the donee be considered the realization event. Thus, the donor should realize gain in the year in which he makes the net gift transfer. The remaining issues should not be resolved by resort to the conclusory and facile "part sale and part gift" characterization. Instead, a treatment of the transaction which respects its economic substance should be adopted. Thus, the transaction should be viewed as having separate and distinguishable "sale" and "gift" elements. In this manner, the donor's basis can be allocated between these two elements in computing the amount of his gain. The result of this allocation is to tax the donor on the gain from which, as an economic matter, he has actually benefitted. Such an allocation also resolves the question of the proper method for the donee to employ in computing his basis in the transferred property, by allowing him to apply well-settled basis rules to the "sale" and "gift" portions of the transferred property separately. In like manner, this allocation resolves the tacking problem, since a separate treatment of the "sale" and "gift" portions obviates the need to interpret the ambiguous and confusing Treas. Reg. section 1.1015-4(a).

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[239] Tacking would not be permitted with respect to the "sale" portion, under Treas. Reg. § 1.1223-1(b) (1960). Of course, this is irrelevant if the "sale" portion is immediately resold to pay gift tax, because no gain would be realized.

The treatment proposed by this casenote provides solutions to the problems treated herein which are consistent with one another, as well as being faithful to the economic realities of the net gift transaction. It is therefore urged that its adoption be considered by any courts interpreting *Diedrich*.

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