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With Strings Attached: Federal Income Tax Consequences to Donors of Conditional Gifts

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I. INTRODUCTION

When a taxpayer gives a gift, the transaction is a taxable event. Through section 2501 of the Internal Revenue Code, the federal government imposes a tax on the donor of the gift,\(^1\) graduating the amount of tax paid from 18% to 70% of the value of the gift.\(^2\)

As expected, when the federal government imposes a tax, attempts are made by those on whom the tax is laid to transfer the tax burden or to avoid its payment altogether. Thus, early cases reflect attempts by donors of gifts to transfer the tax burden to the recipients by creating the gifts in trust and having the trustees use the trust income to discharge the gift tax liability.\(^3\) However, using section 677 of the Internal Revenue Code, which treats a grantor as the owner of any part of a trust that distributes income to him, the Commissioner of Internal Revenue had successfully argued that the gift tax payment from the trust income was ordinary income to the grantor and thus taxable.

To avoid such an application of section 677, donor-taxpayers began to structure gift transactions so that the trustees paid the

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1. I.R.C. § 2501. See also I.R.C. §§ 2502 and 2503. Section 2502(c) states: "The tax imposed by section 2501 shall be paid by the donor." Section 2503(b) allows the donor to give each donee up to $10,000 a year in gifts without the imposition of any gift tax.

2. I.R.C. §§ 2502 and 2001. The 1981 Economic Recovery Tax Act, P.L. 97-34 has reduced the maximum gift and estate tax rates from 70% to 50%. The rate reduction will be phased in from 1982 to 1985 so that in 1985 a 50% tax rate will apply to all taxable gifts and bequests which exceed $2,500,000. The reduced tax rate will apply to estates of decedents dying after, and gifts made after, December 31, 1981.

3. See infra note 25.

4. I.R.C. § 677 states in part: "The grantor shall be treated as the owner of any portion of a trust . . . whose income . . . is . . . (1) distributed to the grantor . . . ."
gift tax with money from a loan to the trust secured by the trust corpus. The trust income was used to repay the loan in a later year. The result was that the donor was held not to have received any taxable income from the trust's payment of the gift tax or repayment of the loan.5

Recently, two additional methods have been developed to circumvent the application of section 677. The first is simply by conditioning the gift upon the donee's payment of all the gift taxes.6 The second method, although a bit more complicated, accomplishes the same purpose. Using the intended gift as security, the donor first obtains a loan equal to the amount of the gift tax he would have to pay. The donor then establishes a trust with the donee as beneficiary and the same gift property as the trust corpus. Next, the trustee executes a note to the original lender cancelling the donor's original loan using the same trust corpus as collateral. Finally, the donor pays the gift tax with the loan money and is free and clear of any debt, while the trustee pays back the loan that was used to pay the gift tax.7

The issue that arises in these transactions is whether the amount of the gift tax paid by the donee or trustee should be considered part of the donor's taxable income to the extent that the gift tax paid exceeds the donor's basis in the gift property.8 Federal circuits are split on the issue9 and have approached it in

5. See Estate of Annette S. Morgan, 37 T.C. 981 (1962), aff'd per curiam, 316 F.2d 238 (6th Cir. 1963), cert. denied, 375 U.S. 825 (1963). In Morgan, the taxpayer-donor transferred property to a trust and the trust took a bank loan to pay the gift tax. When trust income was used to repay the loan, the Commissioner claimed that under section 677, the repayment was income to the donor. The Tax Court held that since the gift tax liability no longer existed, the repayment of the loan could not be for the benefit of the donor, and thus there was no income tax consequence to the donor.


8. See I.R.C. § 61. Gross Income Defined. (a) "[G]ross income means all income from whatever source derived. . . ." Treas. Reg. § 1.1001-1(e) (1972) states that "where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property."

9. Even though the Internal Revenue Code is federal law and is to be applied uniformly, the Code is subject to varying interpretations. Because the decisions of any one court of appeals are not binding on the other circuits, conflicting decisions may result.
three basic ways: 1) some have examined the intent of the donor in making the gift; 2) others have examined the extent to which the donor has realized an economic benefit; 3) still another has adopted a hybrid approach, combining elements of the first two. The United States Supreme Court has not addressed the issue.

Those federal courts that have rested their decision on a subjective determination of the donor's intent in making the gift have held that there are no income tax consequences to the donor. The analysis requires an examination of the facts surrounding the transaction and a determination about whether the donor intended the transaction to be a gift or a sale. If the donor is found to have intended a gift, the entire transaction is characterized as a net gift and there are no income tax consequences to him. If, however, the donor is found to have intended to sell the property for an amount equal to the gift tax then under the rationale termed part sale, part gift there is income to the donor equal to the amount of the gift tax due less the donor's adjusted basis in the gift property.

Courts of appeals that have applied an economic benefit analysis have concluded the donor has realized taxable income.

10. See Davis v. Commissioner, 30 T.C.M. (CCH) 1363 (1971), aff'd per curiam, 469 F.2d 694 (5th Cir. 1977); Turner v. Commissioner, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969).

11. Under the net gift rationale, it is concluded that the donor intended to make a gift equal to the total value of the transferred property less the amount of the gift tax to be paid. Thus the donor does not realize any income. In addition, the amount of the gift tax to be paid is based on the net gift. See Rev. Rul. 75-72, 1975-1 C.B. 310; superseding Rev. Rul. 71-232, 1971-1 C.B. 275. See also Pamela Lingo, 13 T.C.M. (CCH) 436 (1954); Sarah H. Harrison, 17 T.C. 1350 (1952), acquiesced in, C.B. 2; infra note 25.

12. Under the part gift, part sale rationale, the amount realized from the part of the transaction that is considered a sale, i.e., the gift tax amount, is taxable, while the remainder is a gift with no income tax consequences to the donor.


This approach examines the facts of the transaction independently of a donor's intent to determine whether there is any economic gain or benefit to him. If a donor is found to have received an economic benefit then there are potential income tax consequences. Under this approach, the donor's benefit, if any, is in the form of relief from a legal obligation to pay the gift tax and is thus taxable.\textsuperscript{15}

The Fourth Circuit has developed a third approach, a hybrid analysis\textsuperscript{16} that first uses the intent rationale to determine if the donor intends to make a gift or a sale of the property,\textsuperscript{17} taking into consideration the familial relationships between the giving and receiving parties.\textsuperscript{18} It also looks at the economic result of the transaction to determine whether the donor has received any type of economic benefit as a result of the donee paying all the gift tax due.\textsuperscript{19}

This comment begins with a review of the cases that have established these three basic approaches. It follows with an analysis of the approaches and concludes that the economic benefit thinking best reflects the underlying policies of the Internal Revenue Code and existing case law. As a result, when a donee or trustee pays the gift tax, the donor receives an economic benefit to the extent that the gift tax paid exceeds the donor's adjusted basis. This amount, it is concluded, should be included in the donor's taxable income.

\section*{II. FEDERAL COURTS OF APPEALS APPROACHES}

\subsection*{A. Intent Test}

The 1968 Tax Court decision in \textit{Turner v. Commissioner},\textsuperscript{20} where the court first developed the intent approach, dealt with

\begin{itemize}
  \item Apparently, through \textit{Turner} and \textit{Johnson} the Sixth Circuit has adopted both approaches depending on the exact facts of the transaction.
  \item 572 F.2d at 430.
  \item \textit{Id.} at 431, 432.
  \item \textit{Id.} at 431.
  \item 49 T.C. 356 (1968), \textit{aff'd per curiam}, 410 F.2d 752 (6th Cir. 1969).
\end{itemize}
the income tax consequences to a donor resulting from a gift conditioned upon the donee's payment of all federal and state gift taxes. The donor made gifts of stock that had greatly appreciated in value to six trustees and to three individual donees. The three donees in turn personally obligated themselves to pay the resulting gift tax and the six trustees obligated their respective trusts. Upon the donees' payment of the tax, the Commissioner claimed that the transfer was a part gift, part sale transaction and that the donor had realized a long-term capital gain to the extent that the gift tax paid exceeded the donor's adjusted basis in the transferred property.

Contrary to the Commissioner's argument, the Tax Court held that where the donees pay the gift tax, the resulting transaction is a net gift. Because it is a gift, there are no income tax consequences to the donor. The Tax Court reasoned that the donor did not intend to effect any type of transaction other than a gift and the fact that the donees had to pay the gift tax did not change the basic transaction. Finding no identical case law, the court examined earlier decisions on the issue of payment of gift tax by a trustee from trust income and concluded that the part gift, part sale rationale advanced by the Commissioner was totally inconsistent with these holdings. The condition imposed by the donor on the donee did not alter the fact that the transfer was a gift. It is the substance of the transaction and not the form that

21. 49 T.C. at 358. The donor actually received checks from the transferees for the computed share of the gift tax. It is unclear about whether the donor paid the gift tax with these funds or whether she paid the gift tax first and then kept the money she received. Id. at 358-59.
22. Id. at 360. The Commissioner conceded that the transfers to the trusts were not sales based on the fact that the individual transferees were personally liable to pay the gift tax while the trustees were not. Therefore the only issue was whether the gift to the individuals was a part gift, part sale. Id. at 362-63. If there was a sale, the gain would have been a long term capital gain because the sold stock was a capital asset and the taxpayer had purchased the stock over 47 years ago. See I.R.C. § 1223.
23. 49 T.C. at 364.
24. Id. at 363.

In Staley, the taxpayer gave stock to a trust reserving the right to $150,000
is decisive. In its attempt to identify the substance of the trans-
action, the court looked at the relationship between the parties. 
Here, the donor was making transfers to her children and grand-
children. In view of the close familial relationships, it was clear 
to the court that the petitioner intended to make a gift. 25

As further support for its holding that the transaction con-
stituted a gift and as such meant no income tax consequences for 
the donor, the Tax Court reasoned that to hold otherwise would 
give the donee a double credit for the gift tax paid when com-
puting the donee's new basis for the gift. This is so because 
under Treasury Regulation 1.1015-4 the basis of property in the 
hands of the donee in a part gift, part sale transaction equals the 
sum of the amount the donee pays for the property plus the 
amount of the gift tax paid. 27 The court concluded that a part 
gift, part sale interpretation would allow the donee to credit the 
same money twice: once as the amount paid for the property and 
again as the gift tax paid. This result was unacceptable to the 
court and was persuasive evidence that the part gift, part sale 
characterization is inappropriate when the donee pays the 
donor's gift tax. 28 On appeal, the Court of Appeals for the Sixth

of the trust income to pay the gift tax. Rejecting the taxpayer's claim of sale, 
the Tax Court held that the taxpayer had retained an interest of $150,000 in 
the trust and this amount was to be included as part of his taxable ordinary in-
come under section 166 of the 1934 Internal Revenue Code (now I.R.C. § 677). In 
doing so, the court also rejected the Commissioner's characterization of the transac-
tion as part sale, part gift. 47 B.T.A. at 265.

In both Harrison and Lingo, the donor transferred property to a trust on the 
condition that the trust would pay the resulting gift tax. Each case held that 
the amount of the gift subject to gift tax was the gross gift amount less the 
amount of the gift tax, and based its conclusion on the belief that by making 
such a condition the donor intended to make a net gift. Harrison, 17 T.C. at 
1356-57; Lingo, 13 T.C.M. (CCH) at 441.

In Sheaffer, the trustee of a trust paid the gift tax due on a transfer from the 
donor partly out of trust income and partly from the proceeds of a loan obtained by 
using the trust assets as security. The Tax Court held that under section 677, 
the gift tax amount paid by the trustee was taxable to the donor to the extent 
that the money came from the trust income. The trust income used to repay the 
loan was not taxable to the donor. 37 T.C. at 105-06.

26. 49 T.C. at 363. The Tax Court rejected the Commissioner's distinction 
between the gift to the trustees and to the individual donees. The transfers 
were substantively identical and therefore should be similarly characterized for 
income tax purposes. Id.


28. 49 T.C. at 363-64. For a discussion of the donee's new basis see infra 
notes 77 & 79-81 and accompanying text.
Circuit affirmed the Tax Court's holding.\textsuperscript{29}

Despite \textit{Turner} the Commissioner continued, unsuccessfully, to advance the part gift, part sale argument in instances where the gift tax was paid by the donee or the trustee after cancelling the donor's loan obligation. For example, in both \textit{Estate of Annette S. Morgan}\textsuperscript{30} and in \textit{Krause v. Commissioner}\textsuperscript{31} the Tax Court again rejected the part gift, part sale argument and adhered to \textit{Turner} as authority that a net gift transaction produced no income tax consequence to the donor. The effect of this line of cases is to allow the donor of a gift to avoid any tax consequences arising from the donee paying the gift tax on the transferred property.

\textbf{B. Economic Benefit Approach}

Undaunted by the Tax Court's continual rejection of the part gift, part sale approach, the Commissioner continued to argue that the net gift transaction results in taxable income to the donor. However, the Commissioner gradually changed his line of attack and instead started looking to the concept of gross income. He argued that the net gift results in an economic benefit to the donor and as such is includable as gross income. Five years after \textit{Turner} his perseverance paid off in the Sixth Circuit's holding in \textit{Johnson v. Commissioner}.\textsuperscript{32}

In \textit{Johnson} the taxpayer obtained a $200,000 non-recourse loan\textsuperscript{33} secured by 50,000 shares of appreciated stock worth over $500,000. Two days later the taxpayer placed the pledged stock

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\item \textsuperscript{29} Commissioner v. Turner, 410 F.2d 752 (6th Cir. 1969).
\item \textsuperscript{30} See supra note 5.
\item \textsuperscript{31} 56 T.C. 1242 (1971), appeal dismissed, (6th Cir. 1972). In \textit{Krause}, the trust-transferee accepted property subject to the trust paying the gift tax. The tax was paid with money from a loan secured by the trust assets. The Tax Court held that the donor realized income from the trust under section 677 only to the extent the trust accumulated income prior to the actual payment of the gift tax. Income realized after this date was not taxable to the donor under \textit{Morgan}. \textit{See supra} note 5. The Tax Court also held there was no sale of income interest. 56 T.C. at 1248.
\item \textsuperscript{32} 59 T.C. 791 (1973), aff'd, 495 F.2d 1079 (6th Cir.), \textit{cert. denied}, 419 U.S. 1040 (1974).
\item \textsuperscript{33} With a non-recourse loan, the recipient of the loan is not personally liable for the proceeds. Rather the collateral for the loan is used to repay the loan in instances of default. \textit{See Black's Law Dictionary} 953 (rev. 5th ed. 1979).
\end{itemize}
in trust for his children. The trustees of the trust then executed a note with the original lender cancelling the taxpayer's debt and opened a $200,000 debit account with the lender using the $500,000 of appreciated stock as security. The taxpayer-grantor then paid the $150,000 gift tax on the original $500,000 gift transfer to the trust. Since he no longer was obligated to repay the $200,000 loan, the taxpayer pocketed the remaining $50,000.\textsuperscript{34}

The Commissioner notified the taxpayers of a deficiency, alledging that the taxpayers had realized a long-term capital gain equal to the amount by which the original loan exceeded their basis in the transferred stock.\textsuperscript{35} The taxpayers contested the deficiency in the Tax Court claiming that they had realized no income because the transfer was a net gift.\textsuperscript{36} The Tax Court rejected the taxpayers' claims, distinguishing \textit{Turner} both on the facts and on the law.\textsuperscript{37} Finding that the transactions in \textit{Johnson} were in actuality a part gift, part sale, the court relied on the United States Supreme Court decision in \textit{Crane v. Commissioner}\textsuperscript{38} to hold that the taxpayer had shed his tax liability and thus had realized taxable income to the extent that the original loan exceeded the taxpayer's basis in the stock.\textsuperscript{39}

The Court of Appeals for the Sixth Circuit upheld the Tax Court's result but based its ruling on the new theory that the taxpayer-grantor had received an economic benefit. Stating that the Tax Court's finding of part gift, part sale merely asserted a conclusion, the appellate court preferred instead to concentrate

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\item \textsuperscript{34} 495 F.2d at 1080. Because there was no longer any obligation on the original note, the taxpayer had $50,000 free and clear.
\item \textsuperscript{35} 59 T.C. at 806.
\item \textsuperscript{36} \textit{Id.} The taxpayers could not have actually relied on the holding in \textit{Turner} because the relevant events occurred four years before \textit{Turner} was decided.
\item \textsuperscript{37} Factually, in \textit{Turner} the donor required the donees to pay the gift tax while in \textit{Johnson} there was no such condition upon the receipt of the gift. Legally, the taxpayers in \textit{Johnson} had no reserved interest in the trust corpus while in \textit{Turner} there was a reserved interest. \textit{Id.} at 812.
\item \textsuperscript{38} 331 U.S. 1 (1947). \textit{See infra} notes 89-91 and accompanying text.
\item \textsuperscript{39} The Tax Court stated:
\begin{quote}
We hold that the transfers in question constituted in part a gift and in part a sale. To the extent that the fair market value of the stock transferred . . . exceeded the amount of his loan it was a gift subject only to the payment by him of the gift taxes thereon, which have been paid and are not an issue herein. To the extent the transfers were subject to the loans they were sales and petitioners each realized capital gains in the amount his loan exceeded his basis in the stock.
\end{quote}
\end{itemize}

59 T.C. at 812.
on what it considered to be the substance of the transaction. In essence, $500,000 worth of stock was exchanged for $200,000 in cash of which $150,000 was used to pay the gift tax. The court advanced three bases, any one of which could support the decision reached by the Tax Court. Under the first, the taxpayer is seen to have received something of value in exchange for the transfer of stock in the form of payment of the gift tax. This value constitutes income under section 61 of the Internal Revenue Code, which broadly defines gross income as “all income from whatever source derived . . . .” The second combines section 2502(d) of the Tax Code and the principles of Old Colony Trust Co. v. Commissioner. Section 2502(d) makes payment of the gift tax the donor’s legal obligation; under Old Colony Trust “[t]he discharge by a third party of an obligation to him is equivalent to receipt by the taxed person.” Combining these two principles, the donee’s gift tax payment discharges the donor of his tax liability and thus the gift tax paid is effectively income to the donor. The third basis focuses on the taxpayer’s shedding of his loan obligation by transferring the stock into a trust and having the trust cancel his debt using the trust corpus as security for the new debt. Believing that the transactions fall within the boundaries of Crane v. Commissioner, the court concluded that the taxpayer realized income when he disposed of the debt; the amount realized being equal to the amount of the loan.

40. 495 F.2d at 1082. The court stated: The substance of a transaction rather than its form must ultimately determine the tax liabilities of individuals. . . . When one overall transaction transferring property is carried out through a series of closely related steps, courts have looked to the essential nature of the transaction rather than to each separate step to determine tax consequences of the transfer. Id. (citations omitted).
41. Id. at 1083. In this instance, the taxpayer ended up with $200,000 free of any obligation to repay.
42. Id.
43. I.R.C. § 2502(d).
44. 279 U.S. 716 (1929) (an employer’s payment of his employee’s income tax is recognized as income to the employee).
45. Conceivably, the donee could be liable for payment of the gift tax if the donor refuses to pay it and the IRS elects to force payment by the donee rather than the donor. I.R.C. § 6324(b).
46. 279 U.S. at 729.
47. 495 F.2d at 1083.
48. Id.
49. Id.
The *Johnson* majority criticized the *Turner* approach of relying on the donor's intent to distinguish between a gift and a sale, especially in view of the resulting tax implications when intent to make a gift is found. The court stated: "It is better to apply the Tax Code equitably to basically similar transactions than to impose different results depending on a hindsight determination of 'actual intent'." The court asserted that the principles of *Turner* lie in a "maze of cases" none of which had considered the argument made by the Commissioner in *Johnson* that certain amounts should be taxed based on principles other than section 677 of the Tax Code. The court ended with the unclear statement that "*Turner* has no precedential value beyond its peculiar fact situation."

Continuing his line of attack, the Commissioner has recently prevailed in the Court of Appeals for the Eighth Circuit. In *Diedrich v. Commissioner,* the court stated that *Turner* and its progeny were incorrect and that *Johnson* is the correct approach. In *Diedrich,* the donor made a gift of low basis, highly appreciated stock to a family member on the express condition that the donee would pay all the resulting gift taxes. The Commissioner claimed that the taxpayer received a real and substantial economic benefit resulting in a taxable accretion to wealth.

Stating that it is insignificant that *Johnson* involved pre-existing encumbrances, the court focused on what it viewed as a constructive receipt of income by the taxpayer-donor. The court reasoned that it makes no difference whether the taxpayer

50. *Id.* at 1082-83 n.6.
51. *Id.* at 1085.
52. *Id.* at 1086.
54. 643 F.2d at 502. The court also cited Estate of Levine v. Commissioner, 72 T.C. 780 (1979), aff'd, 634 F.2d 12 (2d Cir. 1980) for additional support. In *Levine,* the taxpayer made a gift of real estate encumbered by a non-recourse mortgage to a trust for his children. The trust assumed the mortgage plus other additional expenses associated with the real estate. Relying on *Crane,* see supra note 38, and *Old Colony Trust,* see supra note 44, the court held that the donor realized a taxable gain. 634 F.2d at 14-16.
55. 643 F.2d at 500.
56. The taxpayer unsuccessfully tried to distinguish *Johnson* on two points. First, that *Johnson* must be limited to its own facts because the tax court has not followed it in subsequent pure net gift cases. Second, the taxpayer in *Johnson* personally realized a portion of the appreciated stock while in *Diedrich* the donee's agreement to pay the gift tax doesn't arise but for the net gift. *Id.* at 503.
receives the benefit in the form of relief from tax liability or encumbrance, or whether the liability arose before or at the same time as the transfer. In either case, the taxpayer received a benefit that is taxable. Moreover, the court held that the donor's intent cannot eliminate the economic realities of the transaction.

C. Hybrid Approach

Both Turner and Johnson are Sixth Circuit decisions. It is unclear from the language of Johnson whether it completely overruled Turner and it is also unclear which of the two views represented by these cases is the correct one in determining the tax consequences. In Hirst v. Commissioner, the Fourth Circuit Court of Appeals attempted to reconcile the dichotomy and in doing so developed an approach that combines elements of both the intent and economic benefit approaches.

In Hirst, the taxpayer gave her son land on the condition that he pay the resulting gift tax. The Commissioner claimed a deficiency but the Tax Court held that Turner still controlled the outcome under these facts and that the transactions in Hirst were a net gift. As a result, the court found no taxable gain to the taxpayer. The Tax Court conceded that there was merit to the Commissioner's argument that the transaction resulted in taxable income, but was unwilling to overrule its past decisions, especially because the transactions in Turner and Hirst were so similar. The court stated: "Things have gone too far by now to wipe the slate clean and start all over again," with obvious reference to Turner and its progeny.

57. Id. at 504.
58. Id. See 52 Temp. L. Rev. 139, 151 (1979).
60. 63 T.C. at 314-15.
61. Id. at 315.
62. The Tax Court stated:
[T]here can be no reasonable dispute that liability for the gift tax is placed by statute primarily upon the donor, section 2502(d) of the 1954 Code, and that payment of the tax by the donee must be regarded as discharging that liability of the donor. Moreover, the discharge of a solvent taxpayer's liability is ordinarily regarded as conferring a benefit upon him which may furnish the basis for taking it into account in the computation of taxable income.
63. T.C. at 310.
63. Id. at 315.
On appeal, the Fourth Circuit affirmed the Tax Court ruling and agreed that *Turner* rather than *Johnson* controlled. In doing so, the court followed a hybrid approach. The court distinguished *Johnson* as involving a pre-transfer draw-down of a portion of the appreciated value of transferred asset's. None of the money was committed to pay the gift tax. As a result of the trustee's repayment of the taxpayer's loan, the taxpayer had $200,000 to do with as he pleased. Thus the taxpayer had received some economic benefit. In *Hirst*, the court concluded that the donor "was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off." The donor had owed nothing before the transaction and had received nothing because of it. The only gain the donor accrued was release from the real estate tax liabilities due on the unproductive property that was the subject of the gift. The court felt that this was not the type of economic benefit that would result in income tax consequences.

The court of appeals agreed that generally the discharge of a debt is viewed as income, but added that the rule is not universal. The relationship of the parties and the existence of other obligations should also be considered. The entire circumstances of the transaction should be examined to determine the true intent of the donor to make either a sale or gift. In light of the non-commercial, familial nature of the transaction and the fact that the donor never actually received funds to pay the gift tax, the court concluded that the taxpayer intended to make a gift, not a sale, to her children. The majority closed by stating that

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64. On appeal, a three judge panel held 2 to 1 to reverse the tax court decision. However, after a rehearing en banc, the court sustained the taxpayer's position in a 4-3 decision. 572 F.2d at 427-28.
65. By pre-transfer draw-down the court means to say that the donor, by borrowing against the appreciated value of the stock, had actually reduced the remaining value of the stock because its new value was equal to its appreciated value less the amount of the loan.
66. 572 F.2d at 431.
67. *Id*.
68. *Id* at 430.
69. *Id* at 430 n.9.
70. *Id* at 431. The court gave the example of when a son borrows money from a bank and his father pays off the loan without charging the son. The payment by the father is not taxable to the son but rather, is a gift. *Id. But see infra* note 84.
71. 572 F.2d at 432.
although *Johnson* limited *Turner*, it never explicitly overruled it and thus *Turner* is still good law for an identical fact situation. 72

In a vehement dissent, Senior District Judge Thomsen admitted that the facts in *Turner* and *Hirst* were similar but concluded that *Turner* is simply wrong. He stated that the characterization of a transaction as a net gift does not preclude treating it as a taxable event for income tax purposes. 73 Judge Thomsen explained that the Sixth Circuit in *Johnson* based its ruling on the fact that the gift tax is a legal obligation of the donor and its discharge by the trust is equivalent to a receipt of income by the donor. 74 The substance of the transaction determines the ultimate tax liabilities and here, in substance, the donor received an amount equal to the gift tax in exchange for the property. He concluded that the result of the transaction is no different than if the donee had actually paid money directly to the donor. 75 Judge Thomsen

72. *Id.* at 434. Note that the Fourth Circuit in *Hirst* felt compelled to follow the Sixth Circuit's ruling in *Turner* even though it was not required to do so.

There is a question as to the status of *Turner* after *Johnson*. Though *Johnson* appears to overrule *Turner* it never expressly states so. Keying on the non-explicit language and the "intricate and consistent pattern of decisions" the *Hirst* tax court concluded that *Turner* is still a viable precedent. 63 T.C. at 314-15. The Fourth Circuit agreed and said that *Turner* should be followed in a fact situation similar to *Turner*. 572 F.2d at 434. It should be noted that what one court viewed as a consistent line of cases, the *Johnson* court refers to as a "maze of cases." 495 F.2d at 1083. The Second Circuit concluded in Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980), that *Johnson* did overrule *Turner* and that *Johnson* should be followed. *Id.* at 17.

The *Johnson* court's statement with respect to *Turner* can be interpreted in several ways. First, *Turner* has continued vitality in a factually similar transaction. Second, *Turner*'s authority remains only when the Commissioner makes similar arguments and concessions with respect to the transaction and an inconsistent result would follow. In *Turner*, the Commissioner used a part gift, part sale argument rather than the economic benefit approach and conceded that the trustees should be treated differently than the individual donees because the trustees were not personally liable for payment of the tax. The third interpretation is that *Turner* is no longer good law. In actuality, the second and third interpretations give the same result because the Commissioner now argues realization of income resulting from the discharge of a debt and economic benefit theories. See *Johnson*, 495 F.2d at 1083. Thus the Fourth and Sixth Circuits will continue to follow *Turner* in cases of indistinguishable facts until it is clearly overruled despite their recognition that the economic benefit rationale of *Johnson* is a more realistic approach. *But see* the strong dissenting opinions in *Hirst*, 572 F.2d at 437 (Thomsen, J., dissenting).

73. 572 F.2d at 437 (Thomsen, J., dissenting).
74. *Id.*
75. *Id.* at 438-39.
closed by noting that if there is taxable income the result is fair to both the taxpayer and to the government: No part of the transaction is taxed twice and no part escapes taxation.\textsuperscript{76}

III. CRANE V. COMMISSIONER AND THE ECONOMIC BENEFIT APPROACH OF JOHNSON: CHOOSING SUBSTANCE OVER FORM

In developing the intent approach the \textit{Turner} court relied on what it believed to be similar but not identical precedent, and on a belief that a part gift, part sale characterization would lead to an unacceptable result in computing the donee's new basis in the gift under the treasury regulations; that is, to a double credit for the gift tax paid.\textsuperscript{77} Reliance on either of these appears to be misplaced. With respect to the precedent, the \textit{Johnson} court pointed out that the cases relied on in \textit{Turner} should not control because they tested section 677(a) of the Code which is not the issue under the present circumstances,\textsuperscript{78} and because they never considered the Commissioner's economic benefit approach. With respect to the double credit the donee will get in determining his basis in the gift, the \textit{Turner} court failed to recognize both the nature of a gift tax and a specific federal statute that allows the gift tax paid by the donee to be included twice in the basis calculation.\textsuperscript{79}

The gift tax is part of the cost of giving a gift, regardless of who pays it. The duplication that occurs by including this money once as the gift tax paid (reflecting the cost to transfer property) and once as the amount paid by the donee (reflecting the cost of the property to the donor) is necessary if the new basis is to reflect the true total cost of the gift.\textsuperscript{80} Therefore, neither prece-

\textsuperscript{76} \textit{Id.} at 439.

\textsuperscript{77} \textit{Turner}, 49 T.C. at 364. A simple illustration of Treas. Reg. § 1.1015-4 follows: The donor has property worth $10,000. His basis in the land is $1,000. He gives the donee the land and the donee in turn pays the gift tax of $3,000 (assumed). Under the part sale rules of section 1.1015-4 (1972), the donee's basis would be $3,000 (the amount paid by the transferee because it exceeded the donor's basis) plus $3,000 (the gift tax paid) for a total of $6,000. One would get the same result if, within a family relationship, a son pays the father $3,000 outright for the $10,000 worth of property and the father pays the $3,000 gift tax. See \textit{Ward, Taxation of Gratuitous Transfers of Encumbered Property: Partial Sales and Section 677(a)}, 63 \textit{Iowa L. Rev.} 823, 863-64 (1978) [hereinafter cited was \textit{Ward}].

\textsuperscript{78} 495 F.2d at 1085.

\textsuperscript{79} See I.R.C. § 1015(b), (d); Treas. Reg. § 1.1015-2, -4, -5.

dent nor the fear-of-a-double-credit result supports the Turner court's application of the intent approach. 81

The economic benefit approach developed in Johnson, however, is supported by a recurring guideline that several of the courts follow: the substance of the transaction must control over its form. 82 The intermediate steps that are taken to effect a desired result are not as important as the result itself when determining income tax consequences.

With respect to making a gift, the desired result is the transfer of property as a gift and the payment of the corresponding gift tax. Different types of transactions can affect the same result. For example, assume that a donor has property worth $10,000, his adjusted basis is $1,000, and he wants to give the property to a close family member. Assume further that the gift tax on an $8,000 gift is $2,000. If the donor gives the donee an $8,000 gift and sells the remaining $2,000 in property in order to pay the gift tax, he will realize a $1,000 gain from the sale. 83 As an alternative, the donor can give the entire $10,000 to the donee and under the net gift rule the donee will pay $2,000 in gift tax

pp. 4859-60 (1958) which states:

In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its "cost". In this case the "cost" is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another "cost" incurred in transferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total "costs" incurred with respect to donated property it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it.

Id. at 4859.

81. In fact, applying the Turner approach adds even more of a tax burden on the donee. From the example in note 79 supra, if there is a net gift with no income tax consequences to the donor, there is no money paid for the property and thus the donee's basis is $3,000. When the property is sold, the donee will have to pay tax on an additional $3,000 of income.

82. Hirst, 572 F.2d at 432 (citing Commissioner v. Court Holding, 324 U.S. 331, 334 ("The incidence of taxation depends upon the substance of the transaction."); Johnson, 495 F.2d at 1082 ("The substance of a transaction rather than its form must ultimately determine the tax liabilities of individuals."); Turner, 49 T.C. at 363 ("We are of the opinion that it is the substance rather than the form of the transfers which must be the decisive factor.").

83. Treas. Reg. §§ 1.1001-1(e) (1972) and 1.1015-4 (1973) allow a non-allocated basis approach so that the donor can use the entire amount of his adjusted basis to determine his gain in a part sale, part gift transaction.
for an $8,000 net gift. The resulting gift of property is identical in each case; the form of the transaction is different. But the income tax consequences to the donor differ according to what line of authority is held to control. In the first example, the donor has $1,000 gain that is to be added to his taxable income, while in the second example, if the Turner rational is employed, the net gift results in no gain to the donor. Turner and Hirst would support this result, relying on a hindsight examination of the donor’s intent. But intent to make a net gift, according to Johnson, does not determine the true tax consequences or substance of the transaction. Rather, an examination of the economic effects of the transfers more properly reflect the actual outcome.

The Johnson court relied in part on Crane v. Commissioner in concluding that the economic realities of a gift transaction should control the income tax consequences. In Crane, a tax-

84. The Turner court essentially determined substance by intent. Hirst did not go as far. Recognizing the merits of the Commissioner's economic benefit argument used in the Johnson decision, the Hirst court not only examined the presumed intent of the parties but also looked at the economic benefits from the transfer and concluded that the taxpayer received no funds and thus no taxable income. 572 F.2d at 432.

To show the importance of the family relationship, the Hirst court gave an example of a situation where the father pays back a loan obligation of his son. See supra note 70. The conclusion that the son does not realize any taxable income is correct but the example is distinguishable from the situation with which we are now dealing. In the example, the father is acting with gratuitous intent and generosity but in the gift tax situation, the gift itself is conditioned upon the payment of the gift tax by the transferee, agreed upon in advance. The payment by the discharging party was in anticipation of a benefit, that is, receipt of the gift. Thus the gift exception is inapplicable. See Ward, supra note 77, at 865-66; 52 Temp. L. Q. 139, 149 n.72 (1979); 38 MD. L. REV. 110, 118-19 (1978).

85. The term "net gift" is a word of art and is not black letter law. The concept was developed specifically for determination of gift tax and is not to be carried over into the determination of income tax. Diedrich, 643 F.2d at 501 n.8. Similarly, income tax results don't control gift tax results. "[T]he income tax provisions are not to be construed as though they are in pari materia with the estate tax law or gift tax statutes." Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812, 814-15 (2d Cir. 1947). The reduction in the amount of gift tax owed based on the net gift concept should not preclude the finding of an income tax consequence. Hirst, 572 F.2d at 437 (Thomsen, J., dissenting). If there is an economic benefit for the donor as a result of the transfer, the income tax consequences should be examined separately and apart from the gift tax consequences.

86. 331 U.S. 1 (1947).
payers inherited a building subject to a mortgage of $262,042.50 which was also the assessed value of the property for the estate tax. The taxpayer did not assume the mortgage but instead made an agreement with the mortgagee whereby she would continue to operate the inherited property and remit the net rentals to the mortgagee to cover payment of the mortgage interest. During the next seven years, the taxpayer reported the gross rentals as income and was allowed deductions for taxes, operating expenses, mortgage interest paid, and property depreciation. The net rentals failed to cover the mortgage interest (thus the mortgage principal remained the same) and eventually the mortgagee threatened foreclosure. As a result, the taxpayer sold the property for $2500 net cash, subject to the mortgage. In reporting her gain on the sale, the taxpayer reasoned that her basis in the property was her equity interest, or the amount by which the value of the inherited property exceeded the outstanding mortgage. Because they were equal, she claimed the basis was $0. In addition, because the mortgage was never assumed, the amount realized on the sale was the net cash amount. Thus, she concluded that gain was $2500 less $0, or $2500.87

Noting that the taxpayer realized substantial benefits through the depreciation deductions taken in earlier years, the United States Supreme Court ruled that when the property was sold, the taxpayer had to include its fair market value (which in this instance equaled the original value of the mortgage) in determining her basis and resulting gain.88 Thus, according to Crane, when examining the substance of the transaction and its economic realities, the critical inquiry is whether some economic benefit or something of value was received by the donor. Similarly in the gift situation the question becomes whether payment of the gift tax by the donee constitutes such a recognizable benefit to the donor.

Gift tax is the price a donor must pay in order to pass part of his estate to another party. If there is no transfer prior to death, the property will pass through his estate and be subject to estate tax.89 Hence, the tax scheme imposes some monetary obligation on the donor (or his estate) when property is trans-

87. Id. at 3-4.
88. Id. at 11-13.
ferred. If the donor can avoid paying the gift tax by shifting its burden to the donee or trustee, the donor has essentially passed his property without incurring any tax liability himself. Economically and substantively, the donor has received an economic benefit. In instances such as Johnson where property is encumbered prior to placing it in trust and the trust subsequently assumes the encumbrance, the economic benefit is even more apparent because the donor is able to acquire part of the appreciated value of the property. When his obligation to repay the loan is cancelled by the trust assuming the debt, the taxpayer has received a pecuniary benefit regardless of whether he is personally liable on the encumbrance.

The donee's payment of a gift tax is an economic benefit to the donor. However, because Crane dealt exclusively with mortgaged property, its use as authority for deciding the income tax consequences in gift tax cases for the donor has raised two questions: first, whether Crane should be applied to gift transactions as well as to sales; second, whether the gift tax liability that arises at the time the gift is made can be equated with a pre-existing encumbrance.

Given the more recent decision in Johnson, the first question is answered in the affirmative. The Johnson court refused to make a distinction between part gift, part sale and net gift and thus applied the doctrine regardless of the characterization of the transaction. With respect to the second question, it is the fact that an obligation has been discharged that is significant, not when the obligation was created with respect to its discharge. The Johnson court, which dealt with shedding a debt by transferring encumbered stock, specifically stated that the application of the principles in Crane mandated a finding that the donee's payment of the gift tax liability constitutes income to the donor. Thus, cases involving income tax liabilities resulting

90. The benefit is the difference between the gift tax paid by the donee and the donor's adjusted basis in the transferred property.
91. In Crane, the Supreme Court ruled that when encumbered property is sold, the amount realized on the sale includes any liability that is sold along with the property even if the seller is not personally liable for the encumbrance. 331 U.S. at 13-14.
92. Johnson, 495 F.2d at 1083.
93. Id. See 52 TEMP. L.Q. 139, 150 (1979). But see Hirst, 572 F.2d at 431.
from the donee paying the gift tax fall within the boundaries of Crane.\(^94\)

Although it is conceptually difficult to see economic benefit in a gift situation when no money actually changes hands between the donor and donee, payment of the gift tax is primarily the donor's legal obligation,\(^95\) and *Old Colony Trust* equates the discharge of this obligation with receipt by the donor of an equivalent amount of income.\(^96\) The donor has constructively received taxable income.\(^97\) Although it would be easy to see that there is an economic benefit if there is an actual sale of property, the Supreme Court in *Helvering v. Bruun*\(^98\) has made it clear that a realization of gain "may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."\(^99\)

The court in *Hirst* attempted to use an economic benefit approach but its analysis demonstrated a basic misunderstanding of the realization of gain concept developed in *Helvering*.\(^100\) The court did examine the transaction to see from where the money was coming and to where it was going, but then concluded that the donor was no better off after the transactions than before. The court found that the donor did not intend to sell anything but rather intended to make a gift.\(^101\) It failed to recognize the critical point that a sale is not required for there to be a relief from a liability and a corresponding economic gain. That there was a close family relationship and intent to make a gift cannot


\(^95\) I.R.C. § 2502(d). See *supra* note 1.

\(^96\) *Old Colony Trust*, 279 U.S. at 729.

\(^97\) This doctrine of "constructive receipt" is the exact argument advanced by Judge Thomsen in the dissenting opinion of *Hirst*, 572 F.2d at 438 (Thomsen, J., dissenting).

\(^98\) 309 U.S. 461 (1940).

\(^99\) *Id.* at 469.

\(^100\) See 38 MD. L. REV. 110, 117 (1978).

\(^101\) *Hirst*, 572 F.2d at 430 n.9, 431.
negate the economic reality that the donor received a measurable benefit when the donee assumed the gift tax liability.\textsuperscript{102} As the \textit{Johnson} court stated, the Tax Code should be applied in the same way to similar transactions.\textsuperscript{103} Granted, the form of the transaction may be different, but if the result is the same, then the tax consequences should be the same regardless of intent.

\section*{IV. Conclusion}

Policy considerations favor the application of \textit{Crane} in relief from gift tax situations. Because the taxpayer is enjoying the benefit of passing the property to one he chooses, he should also bear the tax burden. In fact, an inequity arises when the donee must bear the tax burden upon his sale of the appreciated property on gains that were actually received by the donor. In addition, reliance on \textit{Crane} in conjunction with the holdings of \textit{Old Colony Trust} and \textit{Helvering} will create consistency and predictability.\textsuperscript{104} If the economic benefit approach is used, similarly resulting transactions, though formally different, will be treated

\textsuperscript{102} The close family relationship is a factor that is to be considered when determining whether the transfer is indeed a gift to the donee because if it is a gift, it is not included as income to the donee. See I.R.C. § 102.

\textsuperscript{103} \textit{Johnson}, 495 F.2d at 1082-83 n.6.

\textsuperscript{104} \textit{Old Colony Trust} is premised on the fact that the debt is the obligation of the party being credited with the discharge rather than the debt of the party paying the debt. The question arises with respect to gift tax about whether the payment of the gift tax liability by the donee primarily benefits the donor. If the gift tax is not paid when due, the donee can be held personally responsible for its payment to the extent of the value of the gift. I.R.C. §§ 6901(a)(A)(iii), 6324(b). The government can recover the tax from the donor or donee and if it is recovered from the donee, he is not entitled to reimbursement from the donor. Fidelity Union Trust Co. v. Anthony, 13 N.J. Super. 596, 608-09, 81 A.2d 191, 198 (Ch. Div. 1951), aff'd, 18 N.J. Super. 49, 86 A.2d 594 (App. Div. 1952). Thus, in actuality, the government can affix the ultimate tax burden by choosing which party against whom to proceed. Arguably, it follows that the donee’s payment really relieves the possibility that the donor would have to pay the gift tax. Nevertheless, the present policy of the Internal Revenue Service is to proceed first against the donor if there is a gift tax deficiency. I.R.C. § 2502(d) requires that the donor pay the gift tax and it is reasonable to assume that he will pay his statutory liability. In addition, the donee could not be held liable for the tax until it becomes due. Therefore, if the donee pays the gift tax before it is due, he is discharging a liability that up to that point in time is solely the responsibility of the donor. As a result, the donor does receive the primary benefit when the donee pays the gift tax and this payment constitutes a taxable benefit to the donor under \textit{Johnson}. For a more detailed discussion of the donor/donee tax liability, see Ward, \textit{supra} note 77, at 859-61.
equally.\textsuperscript{105} As stated in Johnson; "[W]e find no basis whatsoever in the provisions of the Code for taxpayer's assertion that a donee's discharge of a donor's gift tax liability does not constitute the realization of income if a donor's tax attorneys structure the transactions in a certain manner."\textsuperscript{106}

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\textsuperscript{105} The tax liability resulting from the discharge of income tax liability (\textit{Old Colony Trust}) would not differ from the discharge of a gift tax liability (\textit{Turner and Hirst}) merely because the former involves an employer-employee relationship and the latter has a parent-child relationship.

\textsuperscript{106} 495 F.2d at 1084.