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# PART GIFT-PART SALE, NET GIFT, AND GIFT OF ENCUMBERED PROPERTY: SPECIALIZED STRATEGIES FOR GIFTS OF UNIQUE PROPERTY

## I. Introduction

Gifts of unique income-producing property, such as closely held stock or real estate, present tax planners with a dilemma: For the donor to obtain the tax advantages<sup>1</sup> from a conventional gift of all the property he must pay a gift tax<sup>2</sup> which will deplete his assets beyond the intended gift property. Moreover, when making a substantial gift, the donor may not have the liquidity to pay the gift tax without converting some other asset into cash through a taxable exchange. These problems may be overcome when giving fungible property by simply selling part of the intended gift property to fund the resulting tax liability. However, when dealing with unique property, the donor may be unable or unwilling to transfer the property outside his family. This note explores three gift strategies which are designed to alleviate these problems of giving gifts of unique property.

Suppose, for example, that a donor wishes to transfer \$500,000 worth of income-producing closely held stock to a trust for the benefit of his children;<sup>3</sup> suppose, further, that the donor wants to limit the depletion of his assets to this \$500,000. While he cannot simply give all the stock to the trust because the gift tax would substantially deplete his other assets, this donor may employ one of the following gift strategies:

(1) *Part Gift-Part Sale*. Here the donor gives a portion of the stock to the trust, which borrows against this gift property in order to purchase the remaining portion of the stock from the donor. If the donor sells the property portion of the stock then his total outlay, including the payment of all taxes, is limited to the \$500,000.

(2) *Net Gift*.<sup>4</sup> Here the donor simply gives the \$500,000 worth of stock and the donee trust contractually agrees to pay the gift tax. The donee again borrows against the gift property and pays the gift tax directly. If the donor does not realize income<sup>5</sup> when the donee pays the gift tax, then his total outlay is again \$500,000.

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1 If the gift is not included in the donor's gross estate under INT. REV. CODE of 1954, §§ 2035-2041 [hereinafter cited by section only], then a gift saves taxes because the gift tax rate is 75 percent of that for an estate. Compare § 2001 with § 2502(a). Income produced by the property is taxed to the donee and thus reduces the taxation of that income to the extent the donee is in a lower income tax bracket. See § 102(b)(1).

2 § 2501.

3 This is a common situation. All but one of the cases discussed in part II B of this note involved gifts of closely held stock. The \$500,000 amount is assumed because a substantial gift is necessary before all this planning is worth the effort.

4 For other treatments of net gifts see Faber, *Gift Tax Planning: The New Valuation Tables; Net Gifts; Political Gifts; and Other Problems*, N.Y.U. 31ST INST. ON FED. TAX. 1217 (1973); Lowenstein, *Federal Tax Implications of Gifts Net of Gift Tax*, 50 TAXES 525 (1972); Crumbley and Seago, *Proper Planning Shifts Gift Tax to Donee*, 111 TRUSTS AND ESTATES 358 (1972); Schriebman, *Structuring a Net Gift That Will Stand Up: How to Satisfy IRS and the Courts*, 39 J. OF TAX. 6 (1973); Kopp, *Gifts Subject to Donee Payment of Tax: Timing, Risks and Computations*, N.Y.U. 27TH INST. ON FED. TAX. 375 (1969); Edwards, *How to Save Money by Making Gifts*, N.Y.U. 32ND INST. ON FED. TAX. 367 (1974).

5 See text accompanying notes 23-32, 39-41 *infra*.

(3) *Gift of Encumbered Property*.<sup>6</sup> Here the donor borrows enough to pay the expected tax cost before making the gift and pledges the potential gift property as security for the loan. He then gives the \$500,000 to the donee trust subject to the donee's assumption of the debt. Again, by borrowing enough before the transfer, the donor can limit his total outlay to \$500,000.

Note that these three gift strategies produce substantially the same result: The donor divests himself of \$500,000, and the trust owns all the stock subject to a debt. If planned properly this debt will provide cash to satisfy the tax cost of the transfer. This tax cost will include not only the gift tax imposed by § 2501, but also the income tax which may be imposed upon the donor when he sells a portion of the property (part gift-part sale) or when he makes a gift of encumbered property. This second component of the tax cost will vary sharply with the donor's basis in the gift property. Part II of this note will consider this income tax component; this examination will center on the manner in which a net gift or a gift of encumbered property reduces (or, more accurately, postpones) this income tax component of the tax cost. Finally, in Part III, the scope of the inquiry will be enlarged to include the basis treatment afforded the donee by each gift strategy.

## II. Alternative Gift Strategies

To provide a basis for comparison of these three gift strategies the following assumptions<sup>7</sup> will be employed: 1) the donor is in the 70 percent income tax bracket and has no capital gains or losses in this tax year;<sup>8</sup> 2) the donor has held the gift property for more than six months;<sup>9</sup> 3) this is the donor's first gift;<sup>10</sup> and 4) the donor will not employ gift splitting with his spouse.<sup>11</sup>

### A. Part Gift-Part Sale

Several examples involving different hypothetical bases will demonstrate the tax cost for a part gift-part sale. This tax cost will include not only the gift tax imposed on the gift portion of the transfer but also the tax on any capital gain realized from the sale portion of the transfer. To simplify this demonstration, it will be assumed that the adjusted basis of the property transferred by sale is

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6 For other treatments of gifts of encumbered property see Palmer, *Tax Savings Through Charitable Giving*, 36 TAXES 40 (1958); Note, *Income Tax Consequences of Property Encumbered in Excess of Basis*, 7 U.C.L.A.L. REV. 770 (1960); Note, *Assumption of Indebtedness by a Donee—Income Tax Consequences*, 17 STAN. L. REV. 98 (1964).

7 In addition to these, we will also assume: 1) If the donee later sells the gift stock his gain will be long term in character, and 2) the stock will not appreciate after the gift and before the donee converts the stock in a later sale or exchange. These assumptions will be important in part III of this note.

8 This assumption is made to allow application of the 25 percent alternate tax rate for the first \$50,000 of donor capital gain. See § 1201.

9 This assumption is made to allow long-term capital gain treatment for the donor's capital gain. See § 1222(3).

10 This assumption facilitates computation of the donor's gift tax. Section 2502(a) places a progressive tax on the total amount of gifts made by a donor throughout his life.

11 This assumption again facilitates calculation but will not affect the comparisons made in this note. In most cases the donor will choose to employ gift splitting because it lowers the gift tax. See Edwards at note 4 *supra*.

one-fifth of that for the entire property. Suppose, first, that the donor has a basis of \$25,000 in the \$500,000 worth of stock. By computations derived from trial and error, our donor will find that he should give \$394,000 worth of stock to the trust. The trust should then borrow against this stock in order to purchase the remaining \$106,000 worth of stock. It happens that the gift tax on a \$394,000 gift for a donor with the assumed characteristics is \$76,000.<sup>12</sup> The income tax on the long-term capital gain<sup>13</sup> produced by selling \$106,000 worth of stock with a \$5,000 adjusted basis is \$30,000.<sup>14</sup> Hence, of the \$500,000 expended by the donor, the donee received \$500,000 worth of stock subject to a loan liability of \$106,000. This liability represents \$76,000 in gift taxes and \$30,000 in income taxes.

As the donor's adjusted basis in the gift property increases, the gain from the sale portion of the transfer decreases; therefore, a larger portion of the property can be transferred by gift. The following chart shows the effect on the tax cost as the donor's adjusted basis in the stock increases for a part gift-part sale.

#### TAX COST PART GIFT-PART SALE

<i>Basis</i>	<i>\$25,000</i>	<i>\$250,000</i>	<i>\$500,000</i>
Gift Portion <sup>15</sup>	\$394,000	\$410,000	\$418,260
Sale Portion <sup>16</sup>	\$106,000	\$ 90,000	\$ 81,740
Gift Tax <sup>17</sup>	\$ 76,000	\$ 80,000	\$ 81,740
Tax on Capital Gain <sup>18</sup>	\$ 30,000	\$ 10,000	—0—
Tax Cost of Transfer <sup>19</sup>	\$106,000	\$ 90,000	\$ 81,740

#### *B. Net Gift*

In a net gift the donee contractually agrees<sup>20</sup> to pay the gift tax resulting from the transfer. Thus, in our example the donor would simply give the entire \$500,000 worth of stock to the trust and the trust would agree to pay the gift tax. If the donee agrees to pay the tax before he receives the gift, then the gift tax is based on the value of the gift exclusive of the gift tax paid by the donee according to a formula provided in Rev. Rul. 75-72.<sup>21</sup> For example, the donee

12 This tax is computed using the tax rates from § 2502(a). Most tax calculations in this note have been rounded to the nearest thousand.

13 The long-term gain here is \$106,000 - \$5,000 basis in the sale portion of the property, or \$101,000.

14 See § 1201.

15 The gift portion is based upon trial and error computations, designed to make the sale portion large enough to generate enough cash to satisfy the entire tax cost.

16 The sale portion is simply the difference between \$500,000 and the gift portion.

17 See § 2502(a).

18 See § 1201.

19 The tax cost is the sum of the gift tax on the gift portion and the income tax on the gain from the sale portion. By selling the proper portion the donor generates cash equal to the tax cost.

20 The gift must be conditioned on donee agreement and the agreement by the donee should be written. Pamela N.W. Lingo, 23 P-H TAX CT. MEM. ¶ 54,145 (1954).

21 1975 INT. REV. BULL. No. 9, at 10.

in our situation would pay a gift tax of \$81,740<sup>22</sup> on a net gift of \$500,000. This gift tax is exactly the same as that for a conventional gift of \$418,260.

Because the gift tax is based on the net value of the gift, the gift tax for a net gift may appear to be less than the gift tax for a conventional gift of the same amount of property. However, any apparent tax savings from this difference in the gift tax is purely illusory: A donee who receives a \$500,000 net gift and pays the \$80,000 gift tax liability is no better off than a donee who simply receives a \$420,000 conventional gift. A \$500,000 net gift incurs less gift tax liability than a \$500,000 conventional gift simply because the net gift is a smaller gift. The net gift, then, does not reduce the gift tax component of the tax cost; but where appreciated property is given, it may eliminate the income tax component and thus result in substantial tax savings.

To structure a net gift properly, the donor must first avoid the trap laid by § 677(a) which reads in part:

The grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is . . . or may be—

(1) distributed to the grantor or the grantor's spouse;

. . . .

*Estate of Craig R. Sheaffer*<sup>23</sup> illustrates the effect which § 677 can have. The taxpayer donor in *Sheaffer* gave stock to a trust on condition that the donee trust satisfy the donor's gift tax liability. The trust paid part of the gift tax liability with income from the stock and paid part with borrowed funds. The court reasoned that by conditioning the gift on donee satisfaction of the gift tax the donor made a reservation of trust income under § 677(a):

We see no material difference in principle between making a gift of stock in trust with a reservation . . . of the first \$150,000 of income, which the settlor intended to use to pay his gift taxes directly . . . and, as in the instant case, the making of a gift of stock in trust with a provision in the trust instrument that the trustee is to pay the gift tax. In both cases, income is reserved for the benefit of the donor and, under section 677, is taxable to the donor.<sup>24</sup>

Note that if the trust uses stock dividends to pay the gift tax, then the donor will realize ordinary income.<sup>25</sup> Unless this result is avoided, the net gift will be undesirable.

Fortunately, the tax court in *Estate of Morgan*,<sup>26</sup> *Richard M. Turner*,<sup>27</sup> and *Victor W. Krause*<sup>28</sup> clarified and limited the operation of § 677. In each of these

22 *Id.*; § 2501.

23 37 T.C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963).

24 *Id.*, 37 T.C. at 106.

25 Since the character of the income for the donor will be the same as that for the donee trust, income earned from stock dividends will be taxed as ordinary income to the donor under § 677.

26 37 T.C. 981 (1962), *aff'd per curiam*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963).

27 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969).

28 56 T.C. 1242 (1971), *appeal dismissed (nolle pros.)*, (6th Cir. June 27, 1972).

cases the taxpayer donor made a gift of stock to a trust and conditioned the gift upon donee satisfaction of the gift tax liability. In *Krause* the trust received a small amount of income from the stock before the gift tax was paid.<sup>29</sup> In each of these cases, however, the donee paid the gift tax from borrowed funds which were then repaid in later years when the gift stock produced substantial dividend income.

In each case, the court rejected the Commissioner's contention that the donee's payment of the gift tax constituted income to the donor under § 677.<sup>30</sup> Instead, the tax court held that only income received by the trust *before* the payment of the gift tax is taxable to the donor under § 677.<sup>31</sup> In fact, the court stated in *Krause* that income received the day after gift tax payment was not taxable to the donor. Since the donor after that day "no longer had any interest in the trusts within the meaning of section 677, none of the trust income received after that date is taxable to him."<sup>32</sup>

These holdings enable a donor to avoid being taxed on trust income when the donee trust pays the gift tax. The donee trust must simply pay the gift tax before it receives any income from the stock. To implement this strategy the gift should be made near the end of a gift tax quarter, so that the trust will receive at most a very small amount of income before payment of the gift tax.<sup>33</sup> And to avoid the adverse effects of any future tax court ruling that all trust income in the tax year of gift tax payment is taxable to the donor, the trust should adopt a tax year ending with the tax quarter in which the gift tax is paid.<sup>34</sup> Thus the trust will earn at most a minimal amount of income during the tax year of the gift and § 677 should be avoided.

The great tax advantage of a net gift is that the donor is not required to sell any portion of the stock to satisfy his gift tax liability; hence, there is no resulting capital gain. Assuming that the trust receives no income before payment of the gift tax, then the tax cost for our hypothetical donor of \$500,000 is simply the net gift tax paid by the donee of \$81,740.<sup>35</sup> Notice that this tax cost is the same as that for a conventional gift when the stock is not appreciated (basis of \$500,000).<sup>36</sup> However, when the adjusted basis of the property was \$25,000 the tax cost of a conventional gift was \$106,000;<sup>37</sup> a net gift of this property reduces the tax cost by \$24,260.<sup>38</sup> Hence, when giving appreciated property, a net gift substantially lowers the tax cost and thereby reduces the donee's debt after the transfer.

Unfortunately, nonrecognition of gain for the donor will be ended if the Commissioner wins his appeal in the latest net gift case, *Edna Bennett Hirst*.<sup>39</sup> In *Hirst*, an 80-year-old widow gave her only son some undeveloped real estate.

29 56 T.C. at 1244.

30 *Morgan*, 37 T.C. at 985; *Turner*, 49 T.C. at 362; *Krause*, 56 T.C. at 1246.

31 *Krause*, 56 T.C. at 1247.

32 *Id.*

33 *See* *Edwards*, *supra* note 4, at 376.

34 *Id.*

35 *See* note 22 *supra*.

36 *See* chart accompanying notes 15-19 *supra*.

37 *Id.*

38 \$106,000 - \$81,740 = \$24,260.

39 63 T.C. No. 27 (Dec. 9, 1974).

Since the taxpayer had a limited amount of liquid assets her son paid the resulting gift tax. The Commissioner argued that since only the net value of the gift is subject to gift taxation, the remaining portion of the gift property is transferred in exchange for the gift tax payment. Therefore, this transaction results in a taxable gain for the donor to the extent that the gift tax paid by the donee exceeds the donor's adjusted basis in the gift property.<sup>40</sup> While noting the strength of the Commissioner's argument, the tax court concluded that it must follow the *Turner* line of cases until they are clearly overruled.<sup>41</sup> Such an overruling would spell the end of the tax advantage currently offered by the net gift.

If the Commissioner's argument is adopted by the circuit court then the net gift will result in some gain for the donor. This gain may be determined in a manner similar to the gain from a part gift-part sale or it may be treated similarly to a gain from a gift of encumbered property.

### C. Gift of Encumbered Property

With a gift of encumbered property the donor first uses the potential gift property to secure a loan to pay the tax cost and then gives the property to the donee subject to the loan liability. This should be contrasted both with the part gift-part sale, where the donor first gives a portion of the property and the donee then borrows against that property to purchase the remaining property; and also the net gift, where the donee borrows to pay the net gift tax. These gifts all produce the same result: The donor expends \$500,000 worth of stock, and the trust owns all the stock subject to a liability.

The taxpayers in *Joseph W. Johnson, Jr.*<sup>42</sup> relied upon the similarity between this gift strategy and a net gift to argue that they received no income from this transaction<sup>43</sup> and that a gift of encumbered property should be treated as a net gift.<sup>44</sup> However, the tax court rejected this argument in favor of "the 'Crane doctrine': in broad terms, that the shedding of a liability constitutes the realization of income. . . ."<sup>45</sup> Significantly, the *Johnson* court held that where the donor gave stock already subject to a liability, the transfer "constituted in part a gift and in part a sale."<sup>46</sup> That is, the transfer constituted a gift to the extent the fair market value of the transferred property exceeded the encumbrance, but it constituted a sale to the extent that the assumed liability exceeded the donor's adjusted basis in the property.<sup>47</sup>

Notice that the gift of encumbered property is substantially different in form from the traditional part gift-part sale discussed earlier. In fact, a close reading of *Johnson* reveals that the gift of encumbered property is afforded a more favor-

40 *Id.*

41 *Id.*

42 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 95 S. Ct. 527 (1974).

43 The taxpayers actually borrowed in excess of their gift tax liabilities, and to the extent that this exceeded their respective bases they conceded that they did realize gain. 495 F.2d at 1080.

44 *Id.* at 1081.

45 *Id.*

46 *Id.*; 59 T.C. at 812.

47 59 T.C. at 812.

able basis treatment than the traditional part gift-part sale.<sup>48</sup> With the traditional part gift-part sale, the basis used to calculate the donor's gain on the sale portion of the transfer is only the basis in that portion sold. But in *Johnson*, the basis used to determine the donor's gain was the donor's basis in the entire amount of transferred stock.<sup>49</sup> Since the *Johnson* computation of gain involves a much larger basis it inevitably results in a much smaller gain and therefore a lower tax.

Suppose, for example, that the donor has a basis of \$25,000 in the \$500,000 worth of stock. By computations involving trial and error, our donor will find that he should borrow \$99,000 before making his gift. The gift portion of the transfer will then be the amount by which the fair market value of the stock exceeds the loan liability or \$401,000. It happens that the gift tax on a \$401,000 gift, for a donor with the assumed characteristics, is \$78,000.<sup>50</sup> The gain from the sale portion of the transfer is the amount by which the assumed liability exceeds the donor's adjusted basis, or \$74,000.<sup>51</sup> Such a long-term capital gain will result in an income tax of \$21,000.<sup>52</sup> Hence, from the \$99,000 loan, the donor will pay \$78,000 in gift taxes and \$21,000 in income taxes, or \$99,000 in total. Since the tax cost for a conventional gift of property with the same basis was \$106,000<sup>53</sup> the gift of encumbered property will yield a substantial tax savings.

This \$99,000 tax cost for the gift of encumbered property does not compare favorably with the \$81,740<sup>54</sup> tax cost for a net gift. However, as the donor's basis in the gift property increases, the tax cost of a gift of encumbered property approaches that of a net gift. For example, suppose that the donor's basis in the stock is \$81,740. If the donor borrows \$81,740 before the transfer then the gift portion will be \$418,260. It happens that the gift tax on a \$418,260 gift, for a donor with the assumed characteristics, is \$81,740.<sup>55</sup> Since the assumed liability in this case does not exceed the donor's basis in the transferred property, there is no capital gain.<sup>56</sup> Thus, whenever the basis in the gift property equals or exceeds the net gift tax for a net gift of the property these two strategies result in the same tax cost.

In fact, if extended to its logical conclusion, this *Johnson* reasoning that a donor recognizes gain only to the extent the assumed liability exceeds his adjusted basis would appear to indicate that a donor might borrow substantially more than the tax cost if his basis were substantially greater than the tax cost. To illustrate, suppose that the donor is giving \$1,000,000 worth of stock with a basis of at least \$581,740. If the donor borrows \$581,740 before the transfer then the gift portion of the transfer will be \$418,260.<sup>57</sup> As before, the gift tax for

48 *Id.*; 495 F.2d at 1084; see also Treas. Reg. § 1.1001-1(e)(1) (1957).

49 Treas. Reg. § 1.1001-1(e)(1) (1957).

50 See § 2502(a).

51  $\$99,000 - \$25,000 = \$74,000$ .

52 See § 1201.

53 See chart accompanying notes 15-19 *supra*.

54 See text accompanying note 22 *supra*.

55 See § 2502(a).

56 See Treas. Reg. § 1.1001-1(e)(1) (1957).

57  $\$1,000,000 - \$581,740 = \$418,260$ .

a \$418,260 gift is \$81,740.<sup>58</sup> Since the assumed liability (\$581,740) does not exceed the donor's basis (\$581,740) there is no gain recognized by the donor. The tax cost is then simply the gift tax of \$81,740 which, after payment, leaves the donor with \$500,000 in cash. Again, the donor has limited his total outlay to \$500,000 because even though he made a gift of \$1,000,000 worth of stock he realized \$500,000 in cash after the transfer.

Thus, according to the *Johnson* logic, when the trust repays this \$581,740 debt from income produced by the stock in the future, the donor will not be subject to any tax liability. It would appear that the donor has converted one-half of his stock into cash without realizing any gain; or, more accurately, he has transferred his stock to the trust while realizing immediately income the stock will earn in the future.<sup>59</sup> Whether this result will be sanctioned by the courts depends on the basis treatment afforded the donor when calculating the gain from a gift of encumbered property. If the donor continues to receive the favored *Johnson* basis treatment<sup>60</sup> then the gift of encumbered property will be a useful gift strategy.

### III. Donee's Basis: The Offsetting Factor

In each of our examples illustrating the three gift strategies, the donor parts with \$500,000 worth of stock and the donee trust owns all the transferred stock subject to a debt which represents the tax cost of the transfer. This debt, however, ranged from a low of \$81,740 for the net gift<sup>61</sup> to a high of \$106,000 for the part gift-part sale of stock with a \$25,000 basis.<sup>62</sup> On the surface it may appear that this differential marks the relative tax costs for the three gift strategies. However, a more accurate inquiry will take into account the basis of the donee's property after the transfer.

For the part gift-part sale, the donee's basis in the sale portion is the amount paid by him for the stock;<sup>63</sup> his basis in the gift portion is the donor's basis in that portion of the stock increased by the gift tax.<sup>64</sup> Thus, if the \$500,000 worth of stock had a \$25,000 basis in the hands of the donor, the donee's new basis in the \$106,000 sale portion would be \$106,000 and his basis in the \$394,000 gift portion would be \$96,000.<sup>65</sup> This two-part basis contrasts sharply with the donee's basis after a net gift transfer. This time the donee's basis is simply the basis of the property in the hands of the donor plus the net gift tax.<sup>66</sup> If the

58 See note 12 *supra*.

59 However, it would appear that this income is properly taxed to the trust because the trust is the taxpayer that earns the income from the stock. Since the donor has no further claim to the assets of the trust, § 677 should have no application to this situation. See text accompanying note 32 *supra*.

60 Perhaps the strongest argument for a similar basis treatment between a gift of encumbered property and a traditional part gift-part sale is based on the similarity between the gift of encumbered property and the "bargain sale to charity." See § 1011(b).

61 See text accompanying note 22 *supra*.

62 See text accompanying note 14 *supra*.

63 § 1012.

64 § 1015.

65 The donor's basis in the gift portion was \$20,000. This plus the \$76,000 gift tax is the donee's basis.

66 § 1015. See also *Turner*, 49 T.C. at 363.

donor's basis was \$25,000, then the donee's new basis will be \$106,740.<sup>67</sup> Finally, the basis after a gift of encumbered property is the greater of either the debt assumed by the donee or the donor's basis in the stock plus the gift tax paid.<sup>68</sup> Thus, where the donor had a \$25,000 basis in the property the donee will have a \$177,000<sup>69</sup> basis in the \$500,000 worth of transferred stock.

Not surprisingly, then, the difference in the tax costs among the three strategies is more or less balanced by the difference in basis<sup>70</sup> treatment for the donee. Where a higher tax liability is incurred in making the gift transfer, the donee receives a more favorable basis after the transfer. To demonstrate the impact of this difference in basis treatment, assume that the donee in each case immediately sells the entire \$500,000 worth of stock.<sup>71</sup> Assume, moreover, that the donee has no other income in this tax year. The following chart then shows the total tax cost after the donee converts the gift property.

### TOTAL TAX COST

	<i>Part gift- part sale</i>	<i>Net gift</i>	<i>Encumbered</i>
I. Donor's Basis	\$ 25,000	\$ 25,000	\$ 25,000
Donee's basis <sup>72</sup>	-----	106,740	177,000
\$394,000 sale portion	96,000	-----	-----
\$106,000 gift portion	106,000	-----	-----
Tax upon transfer from donor to donee <sup>73</sup>	106,000	81,740	99,000
Tax upon donee's subsequent sale <sup>74</sup>	84,790	118,130	93,540
Total tax cost <sup>75</sup>	190,790	199,870	192,540
Net Amount Retained—Donee <sup>76</sup>	309,210	300,120	307,460

67 The donee's basis is simply the sum of the donor's basis (\$25,000) plus the gift tax (\$81,740).

68 See Treas. Reg. § 1.1015-4 (1963).

69 The donee's basis in this case is the sum of the greater of the donor's basis (\$25,000) or the amount of the assumed liability (\$99,000) plus the amount of the gift tax (\$78,000): \$99,000 + \$78,000 = \$177,000.

70 In each case the basis of the property in the hands of the donee cannot be increased beyond the fair market value of the property by the gift tax. § 1015(d).

71 Since the donor's gain was assumed to be long term in character the donee's gain will also be long term in character because the donee's holding period tacks onto the donor's. § 1223(2); *The Citizens National Bank of Waco v. United States*, 417 F.2d 675 (5th Cir. 1969).

72 a) Part gift-part sale. The donee's basis in the \$394,000 gift portion is the sum of the donor's basis (\$20,000) plus the gift tax (\$76,000). See note 64 *supra*. The donee's basis in the \$106,000 sale portion is \$106,000. See note 63 *supra*.

b) Net gift. The donee's basis is the sum of the donor's basis (\$25,000) plus the net gift tax (\$81,740). See note 66 *supra*.

c) Encumbered. The donee's basis is the sum of the greater of the assumed liability (\$99,000) or the donor's basis (\$25,000) plus the gift tax paid (\$78,000). See note 68 *supra*.

73 See text accompanying notes 14, 22, and 52 *supra*.

74 This tax is calculated pursuant to § 1201.

75 The total tax cost is simply the sum of the tax paid upon the transfer from the donor to the donee plus the tax paid upon the donee's subsequent sale.

76 The net amount retained by the donee is simply the difference between \$500,000 and the total tax cost. This number represents how much the donee actually has after paying all taxes.

II. Donor's Basis	250,000	250,000	250,000
Donee's basis <sup>77</sup>	-----	331,740	331,740
\$410,000 gift portion	280,000	-----	-----
\$90,000 sale portion	90,000	-----	-----
Tax upon transfer from donor to donee <sup>78</sup>	90,000	81,740	81,740
Tax upon donee's subsequent sale <sup>79</sup>	28,170	40,750	40,750
Total tax cost <sup>80</sup>	118,170	122,490	122,490
Net Amount Retained—Donee <sup>81</sup>	381,830	377,510	377,510

With a \$500,000 basis, there is no capital gain in any case and the total tax cost is the same for all three strategies.

In conclusion, then, each of these three strategies has its own advantages. The traditional part gift-part sale incurs the highest tax cost upon the initial transfer from the donor to the donee; but in exchange for this high initial tax cost the donee receives the most favorable basis treatment. If the donor anticipates that the trust will be selling the gift stock, as in an investment-type trust,<sup>82</sup> then this gift strategy offers the lowest total tax cost. On the other hand, the net gift offers the lowest taxation after the initial transfer from the donor. Although this is offset by an unfavorable basis treatment given the donee, the potential for tax postponement makes the net gift a highly attractive strategy. However, the Commissioner has continued to argue that the donor recognizes income from a net gift and Rev. Rul. 75-72 makes it clear that the Internal Revenue Service does not accept the current case law.<sup>83</sup> A net gift donor may have to litigate his potential tax savings. Finally, if the courts continue to follow the basis treatment used in *Johnson* and apparently supported by Treasury Regulations<sup>84</sup> then the gift of encumbered property offers an interesting possibility: The donor with a substantial basis may be able to borrow cash over and above the tax cost and to shift the repayment obligations to the trust.

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77 a) Part gift-part sale. The donee's basis in the \$410,000 gift portion is the sum of the donor's basis (\$200,000) plus the gift tax (\$80,000). See note 64 *supra*. The donee's basis in the \$99,000 sale portion is \$99,000. See note 63 *supra*.

b) Net gift. The donee's basis is the sum of the donor's basis (\$250,000) plus the net gift tax (\$81,740). See note 66 *supra*.

c) Encumbered. The donee's basis is the sum of the greater of the assumed liability (\$81,740) or the donor's basis (\$250,000) plus the gift tax (\$81,740). See note 68 *supra*.

78 See text accompanying notes 14, 22, and 56 *supra*.

79 See note 74 *supra*.

80 See note 75 *supra*.

81 See note 76 *supra*.

82 An "investment type trust" is one in which the trustee will be buying and selling securities to produce income as opposed to a "holding-type trust" that holds the stock (probably closely held stock) and then merely distributes the income.

83 1975 INT. REV. BULL. No. 9, at 10 concludes cryptically as follows: "This Revenue Ruling is concerned only with the gift tax consequences of the above transaction and not with the income tax consequences thereof."

84 Treas. Reg. § 1.1001-1(e) (1) (1957).