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INTERNAL REVENUE — NET GIFTS MAY RESULT IN TAXABLE INCOME TO THE DONOR

The taxpayers[1] made gifts of stock[2] and voting trust certificates[3] to their children. The donors conditioned the gifts upon the donees' agreements to pay the resulting gift taxes.[4] The gift taxes paid by the donees[5] exceeded the donors' adjusted bases[6] in the transferred property.[7] The Commissioner of Internal Revenue determined that the difference between the gift taxes paid by the donees and the donors' bases in the transferred property was taxable income to the donors.[8]

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1. Diedrich v. Commissioner, 1979 T.C.M. (P-H) ¶ 79,441, and Grant v. Commissioner, 1980 T.C.M. (P-H) ¶ 80,050, *on appeal sub. nom.*, United Missouri Bank v. Commissioner, were consolidated by the United States Court of Appeals for the Eighth Circuit, *rev'd*, 643 F.2d 499 (8th Cir. 1981), *aff'd*, 102 S. Ct. 2414 (1982).

2. Diedrich v. Commissioner, 102 S. Ct. 2414, 2416 (1982). Victor and Frances Diedrich made gifts of approximately 85,000 shares of stock to their three children. *Id.*

3. *Id.* Frances Grant gave 90,000 voting trust certificates to her son. *Id.*

4. *See generally* Windin, *CA-8 Holds Net Gifts Can Create Taxable Gain: What Are the Effects of This Decision?*, 54 J. TAX'N 354 (1981) (the donor of a net gift is charged with gain to the extent that the gift taxes paid by the donee exceed the donor's basis). For gift tax purposes a gift conditioned upon the donee's payment of gift taxes is a net gift. *Id.*

5. 102 S. Ct. at 2416. The Diedrich children paid gift taxes of $62,992 as a condition of the gift. Mrs. Grant's son paid gift taxes of $232,620.09. *Id.*

6. *Id.* The adjusted basis for determining gain or loss from the sale or other disposition of property is cost plus or minus certain adjustments. I.R.C. § 1011 (West 1982) (adjusted basis for determining gain or loss); *id.* § 1012 (defines the basis of property as cost). Examples of adjustments include depreciation, improvements, and tax-exempt interest. *Id.* § 1016 (West 1982 & Supp. 1982) (provides the adjustments to basis).

7. 102 S. Ct. at 2416. The Diedrichs' adjusted basis in the transferred stock was $51,073. *Id.* Mrs. Grant's adjusted basis in the transferred stock was $8,742.60. *Id.*

8. *Id.* at 2416-17. The Commissioner determined that the Diedrichs' taxable income should increase by $5,959. *Id.* at 2416. Also, the Commissioner determined that Mrs. Grant's taxable income should increase by approximately $112,000. *Id.* at 2417.

The assessed deficiencies were computed in the following manner. The Diedrich children paid gift taxes of $62,992. *Id.* The Diedrichs' adjusted basis in the property was $51,073. *Id.* The difference between these two amounts is $11,919. The $11,919 is the amount of gain realized by the Diedrichs. *Id.* at 2416 n.1. *See* I.R.C. § 1001 (West 1982 & Supp. 1982) (determining the amount of gain or loss); *id.* § 1221 (defining capital asset); *id.* § 1222 (defining long-term capital gain). The $11,919 gain is reduced by 50% because of the deduction for capital gains. I.R.C. § 1202 (1976) (amended in 1978). Therefore, the Diedrichs' increase in taxable income is $5,959. I.R.C. § 63 (West 1982).

The Tax Court found for the taxpayers, holding that the transfer constituted a net gift[9] that resulted in no income tax liability to the donors.[10] The United States Court of Appeals for the Eighth Circuit reversed[11] the decision of the Tax Court.[12] The United States Supreme Court affirmed[13] the decision of the Eighth Circuit and *held* that donors, who make gifts of property on the condition that the donees pay the resulting gift taxes, realize taxable income[14] to the extent that the gift taxes paid by the donees exceed the donors' adjusted bases in the property.[15] *Diedrich v. Commissioner,* 102 S. Ct. 2414 (1982).

A net gift arises out of the donor's unwillingness or inability to pay[16] the resulting gift tax.[17] The donor and the donee enter into an agreement whereby the donee agrees[18] to pay the gift taxes that

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Mrs. Grant's son paid gift taxes of $232,630.09. 102 S. Ct. at 2416. Mrs. Grant's adjusted basis in the property was $8,742.60. *Id.* Accordingly, Mrs. Grant's realized gain, the difference between these two amounts, is $223,887.49. *Id.* at 2417 n.2. After the 50% capital gain deduction, Mrs. Grant's taxable income is increased by $111,943.75. *Id.*

9. *Id.* at 2416-17. For gift tax purposes a gift conditioned upon the donee's payment of gift taxes is a net gift. *See generally* Windin, *supra* note 4 (the term net gift arises because the gift is valued net of tax).

10. 102 S. Ct. at 2416-17. The Tax Court applied the donor intent standard and found that the donors intended to make a gift. *Id.* Gifts are not subject to income tax, but are subject to gift tax. I.R.C. § 102 (West 1967).

11. 102 S. Ct. at 2417. The Eighth Circuit consolidated the two appeals. *Id.*

12. *Id.* The Eighth Circuit held that when the donors' gift tax liabilities are discharged by the donees, the benefits conferred result in taxable income to the donors. *Id.* The Eighth Circuit reasoned that a donor receives a benefit when a donee discharges a donor's legal obligation to pay gift taxes. *Id. See* I.R.C. § 2502 (c) (West Supp. 1982) (the donor is responsible for the payment of gift tax).

13. 102 S. Ct. at 2420. Chief Justice Burger delivered the opinion of the Court, in which Justices Brennan, White, Marshall, Blackmun, Powell, Stevens, and O'Connor joined. *Id.* at 2416. Justice Rehnquist filed a dissenting opinion. *Id.* at 2420.

14. *Id.* Taxable income is gross income less all the deductions allowable under the Internal Revenue Code. I.R.C. § 63 (West 1982).

15. 102 S. Ct. at 2420. The Supreme Court stated that treating conditional gifts as a discharge of indebtedness is consistent with economic reality. *Id.* at 2419.

16. *See generally* Faber, *Gift Tax Planning: The New Valuation Tables; Net Gifts; Political Gifts; and Other Problems,* 31 INST. ON FED. TAX'N 1217 (1973) (the basic concepts of net gifts and the reasons for making net gifts). The reasons for making net gifts are numerous. Often the donor will lack liquid assets to raise the cash needed to pay the gift tax. When making a gift of stock of a closely held corporation, the donor's liquid assets may be insufficient to pay the tax. Also, the donor may be unwilling to use his liquid assets for that purpose. The donee may agree to pay the tax if he has sufficient liquid assets. *Id.* at 1234.

In other situations the donor may have holdings consisting primarily of appreciated securities. The donor could sell the securities to pay the gift tax but only at a heavy cost in capital gain taxes. If the donee is in a lower income tax bracket than the donor, it might be advisable to make a gift of the securities and have the donee sell the securities to pay the taxes. *Id.* at 1235.

Finally, there may be psychological reasons for making a net gift. Often one of the objectives of parents in giving property to their children is to pass on the family wealth. Another objective is to give the children experience in managing their investments and financial matters. Making their children pay the gift tax accentuates the need for careful tax planning and may serve an educational function. *Id.*

17. *See generally* Kopp, *Gifts Subject to Donee Payment of Tax: Timing, Risks and Computations,* 27 INST. ON FED. TAX'N 375 (1969) (liability for gift tax is primarily on the donor). The federal gift tax is an excise tax levied upon the donor's privilege of making transfers of property. I.R.C. § 2501 (West 1982 & Supp. 1982).

18. *See generally* Windin, *supra* note 4 (the donor of a gift will realize gain to the extent that the gift taxes paid by the donee exceed the donor's basis). A gift conditioned upon the donee's agreement to pay the resulting gift taxes is a net gift. *Id.*

arise from the transfer.[19] The donee's payment of the gift taxes reduces the value of the gift,[20] and the donee pays the gift tax on the net amount of the gift.[21]

The gift tax consequences of a net gift are clear.[22] The income tax treatment of net gifts, however, has been the subject of continuous litigation.[23] The question of the income tax impact on a donor upon a donee's payment of gift taxes first arose in connection with gifts to trusts.[24] A problem arose when the donor transferred property to a trust and used income from the trust to pay the gift tax.[25]

The income tax consequences of net gifts to individuals first arose in *Turner v. Commissioner.*[26] Pamela Turner transferred 18,980 shares of low basis securities to three individuals and six trusts.[27] The gifts of stock were conditioned upon the donees' agreement to pay the resulting gift taxes.[28] The Commissioner contended that the transfers to the individuals were part sale-part gift[29] transfers; that is, they were sales to the extent that the gift taxes paid by the donees exceeded the donor's adjusted basis in the transferred securities.[30] The Tax Court rejected the Commissioner's theory and held that the donor intended and made a net gift to each

19. I.R.C. § 2501 (West 1982 & Supp. 1982). The payment of gift taxes is the primary responsibility of the donor. *Id.*

20. Rev. Rul. 75-72, 1975-1 C.B. 310. The gift tax paid by the donee is deducted from the value of the transferred property when it is expressly shown or implied that payment of the tax by the donee or from the property itself is a condition to the transfer. *Id.* at 311.

21. *Id.* If the gift is made subject to a condition that the gift tax be paid by the donee, the value of the gift is measured by the fair market value of the interest transferred minus the amount of the gift tax paid by the donee. *Id.*

22. *Id.* The gift tax is computed on the net value of the gift. *Id.*

23. *See, e.g.,* Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) (donor's transfer of property to her son conditioned upon his payment of the gift taxes did not result in taxable income to the donor); Johnson v. Commissioner, 495 F.2d 1079 (6th Cir.) (taxpayer received a taxable benefit upon transferring encumbered stock into a trust), *cert. denied,* 419 U.S. 1040 (1974); Turner v. Commissioner, 49 T.C. 356 (1968) (taxpayer intended a net gift that did not give rise to income tax liability), *aff'd per curiam,* 410 F.2d 752 (6th Cir. 1969).

24. *See* Estate of Sheaffer v. Commissioner, 313 F.2d 738 (8th Cir. 1963) (dividends used by the trustee to pay the gift taxes were taxable income to the donor); Estate of Staley v. Commissioner, 136 F.2d 368 (5th Cir. 1942) (trust income used by the donor to pay the gift taxes was taxable income to the donor), *cert. denied,* 320 U.S. 786 (1943).

25. Estate of Staley v. Commissioner, 136 F.2d 368 (5th Cir. 1942), *cert. denied,* 320 U.S. 786 (1943). In *Estate of Staley* the donor created a trust for each of his five children. 136 F.2d at 369. The trustee agreed to pay the donor $150,000 from the trust income that the donor intended to use to pay the gift tax on the transfer. *Id.* The circuit court, in affirming the holding of the Tax Court, held that the entire $150,000 was income taxable to the donor. *Id.* at 370.

26. 49 T.C. 356 (1968), *aff'd per curiam,* 410 F.2d 752 (6th Cir. 1969).

27. Turner v. Commissioner, 49 T.C. 356, 358, *aff'd per curiam,* 410 F.2d 752 (6th Cir. 1969).

28. 49 T.C. at 358. Prior to the transfer each transferee signed a letter agreeing to pay his or her share of the gift tax. *Id.*

29. *Id.* at 362. On brief the Commissioner conceded that the transfers in trust were not sales. *Id.* The Commissioner's theory was that the donor was economically better off when the donees paid the gift taxes. *Id.* at 357.

30. *Id.* at 362-63. The Commissioner's part sale-part gift argument was premised on the donees' personal promises to pay the gift taxes in exchange for the donor's retained interest in the property. *Id.* Therefore, the Commissioner thought that the donees' promises to pay the gift taxes were sufficient consideration for the sale portion of the transfer. *Id.*

recipient[31] and that such a transfer did not result in a taxable gain to the donor.[32]

In reaching its decision the Tax Court in *Turner* examined the earlier trust cases.[33] The court concluded that the condition imposed by the donor that the donees pay the gift tax did not alter the result that the transfer constituted a gift.[34] The *Turner* court stated that this conclusion, based on the facts of the case and the close family relationship, correctly reflected the intent of the donor.[35] Therefore, the *Turner* decision clearly established a net gift standard based solely on the intent of the parties.[36]

The Commissioner's part sale-part gift theory succeeded in *Johnson v. Commissioner.*[37] In *Johnson* the donors transferred 50,000 shares[38] of stock to a trust for the benefit of their children.[39] Prior to the transfer the stock was pledged as security for a bank loan.[40] As a condition to the transfer the trustees agreed to assume payment of the loan by substituting their note for that of the donors.[41] The donors filed their federal gift tax return without reporting a gain on the transfer.[42] The Commissioner determined that the donors realized a long-term capital gain[43] on the transfer to the extent that the amount of the loan obtained exceeded the adjusted basis[44] of the

31. *Id.* at 363. The Tax Court stated that Pamela intended a net gift. It is clear that, on these facts, Pamela wished to make gifts to her children and grandchildren. She acted upon this intent and transferred certain shares of stock to each of them. She made all the transfers subject to the condition that the donees pay the resulting gift tax. *Id.*

32. *Id.* at 364.

33. *Id.* at 361-62. The court examined Estate of Sheaffer v. Commissioner, 313 F.2d 738 (8th Cir. 1963) (dividends used by the trustee to pay the gift taxes were taxable income to the donor); Estate of Staley v. Commissioner, 136 F.2d 368 (5th Cir. 1942) (trust income used by the donor to pay the gift taxes was taxable income to the donor), *cert. denied,* 320 U.S. 786 (1943); and Estate of Morgan v. Commissioner, 37 T.C. 981 (1962) (trust income used to repay a loan that was obtained to pay the gift tax was not income to the donor), *aff'd,* 316 F.2d 238 (6th Cir.), *cert. denied,* 375 U.S. 825 (1963).

34. *Turner,* 49 T.C. at 362. The Tax Court was of the opinion that the taxpayer intended to make a net gift with no resulting income tax liability. *Id.* at 363.

35. *Id.*

36. *See, e.g.,* Krause v. Commissioner, 56 T.C. 1242, 1248 (1971) (the taxpayer intended to make a gift as evidenced by his complete divestment of all interest in the property), *appeal dismissed,* (6th Cir. 1972); Estate of Davis v. Commissioner, 40 T.C.M. (P-H) ¶ 71,318 (1971) (the taxpayer intended and made a net gift of stocks to a trust), *aff'd per curiam,* 469 F.2d 694 (5th Cir. 1972).

37. 495 F.2d 1079 (6th Cir.), *cert. denied,* 419 U.S. 1040 (1974).

38. Johnson v. Commissioner, 495 F.2d 1079, 1080 (6th Cir.), *cert. denied,* 419 U.S. 1040 (1974). The stock had a basis of $10,812.50 and a fair market value of $500,000. *Id.*

39. *Id.* The taxpayers established irrevocable trusts for their children's benefit. *Id.*

40. *Id.* The taxpayers received $200,000 from a bank. The stock was pledged as collateral for the loan. *Id.*

41. *Id.* The bank cancelled the taxpayers' note and in its place accepted the trustees' note, secured by the same collateral. *Id.*

42. *Id.* The federal gift tax return reported the difference in the value of the 50,000 transferred shares less the principal indebtedness of $200,000 outstanding on the stock. *Id.* The gift tax of approximately $150,000 was paid out of the proceeds of the loan, leaving the donors a balance of approximately $50,000. *Id.*

43. *Id.* at 1081. Long-term capital gain is defined as the gain realized from the sale or exchange of a capital asset held for more than one year. I.R.C. § 1222(3) (West 1982).

44. *Johnson,* 495 F.2d at 1081. Adjusted basis is cost plus or minus adjustments to cost. I.R.C. § 1012 (West 1982) (defining the basis of property as cost); *id.* § 1016 (West 1982 & Supp. 1982) (providing the adjustments to basis).

stock.[45]

The donors in *Johnson* challenged the Commissioner's findings in the Tax Court.[46] The Tax Court found for the Commissioner and held that the transfer of stock was a part sale-part gift that resulted in taxable income to the donors to the extent that the loan proceeds exceeded their basis in the property.[47]

On appeal the Sixth Circuit affirmed[48] the holding of the Tax Court in *Johnson,* but rejected the Tax Court's reasoning.[49] The circuit court stated that the proper inquiry was to look at the substance of the transaction.[50] The circuit court concluded that income tax liability was dependent upon whether the taxpayers received something of value upon transferring the encumbered stock into trust.[51]

The Sixth Circuit in *Johnson* explained its finding of income tax liability by relying on three theories. First, the receipt of something of value, free and clear of any obligation to repay that amount, is income under section 61[52] of the Internal Revenue Code. Second, the gift tax liability is the legal obligation of the donor.[53] If a third party discharges this obligation, the donor realizes income under the rule of *Old Colony Trust v. Commissioner*.[54] Third, the taxpayers shed a $200,000 debt by transferring the encumbered stock into a trust.[55] Under the rule of *Crane v. Commissioner*[56] a taxpayer realizes

45. 495 F.2d at 1081. The Commissioner determined that the taxpayers realized a long-term capital gain of $190,000 (the $200,000 loan proceeds less the $10,000 basis of the stock). *Id.*

46. *Id.* The taxpayers, relying on *Turner,* sought to classify the transaction as a net gift with no income tax consequences. *Id.*

47. *Id.* The circuit court reasoned that the making of the loan and the transfer of stock to the trusts were not separate unrelated transactions. The court stated that this was an overall plan whereby the taxpayers sought to realize a substantial portion of the stock without incurring tax liability and at the same time make gifts to their children. *Id.* at 1082.

48. *Id.* at 1086.

49. *Id.* at 1082. The Tax Court concluded that the transfers were in reality part sales and part gifts. *Id.* According to the circuit court, that statement was merely conclusory. *Id.*

50. *Id.* The *Johnson* court stated that "[t]he substance of the transactions in this case was a gift of $500,000 worth of stock in exchange for $200,000, $150,000 of which was used to pay the donors' gift taxes." *Id.*

51. *Id.* at 1083. Dr. Johnson received $200,000 free and clear of any obligation to repay that amount from any property in his possession. *Id.*

52. *Id.* Gross income means "all income from whatever source derived." I.R.C. § 61 (West 1967).

53. *Johnson,* 495 F.2d at 1083. The payment of gift taxes is the legal obligation of the donor. I.R.C. § 2502 (West Supp. 1982).

54. 279 U.S. 716 (1929). In *Old Colony Trust* the employer paid the taxpayer-employee's income tax liability. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 719 (1929). The Supreme Court held that the taxes paid by the employer were income to the taxpayer. *Id.* at 729. This holding established the principle that the discharge of a taxpayer's obligation by a third person is equivalent to the receipt of income by the taxpayer.

55. *Johnson,* 495 F.2d at 1083.

56. 331 U.S. 1 (1947). In *Crane* the taxpayer sold property previously acquired by gift. Crane v. Commissioner, 331 U.S. 1, 3 (1947). He sold the property subject to a mortgage and failed to include the mortgage in his gain. *Id.* at 4. The Supreme Court held that the amount of the mortgage on the seller's property for which the seller had no personal liability was, nonetheless, a part of the amount realized by the seller on the sale of the property. *Id.* at 14.

income equal to the amount of the encumbrance disposed of, even if he was not personally liable on the debt.[57] The Sixth Circuit concluded that the taxpayers realized income under any of these three theories.[58] Thus, the Sixth Circuit in *Johnson* abandoned the intent standard[59] and used a new standard that consisted of a more objective determination of the economic benefit accruing to the donors as a result of the transactions.[60]

Four years later in *Hirst v. Commissioner*,[61] however, the Fourth Circuit reapplied the intent standard.[62] The Fourth Circuit agreed with the Tax Court's opinion that the intent standard of *Turner* remained a viable precedent and controlled the decision in the case.[63] The *Hirst* court did acknowledge the objective benefit standard,[64] but based its decision for the donor on the *Turner* intent standard.[65]

In *Hirst* the donor gave her son and his family three tracts of undeveloped land.[66] Because this gift required the payment of substantial gift taxes, the donor and her son agreed that he would pay the gift taxes.[67] The Commissioner determined that the donor had failed to include in her federal income tax return the long-term capital gain recognized from the transfer.[68]

The *Hirst* court was unwilling to hold for the Commissioner by overruling the intent standard of *Turner*.[69] Thus, the court held that the donor did not realize any taxable income as a result of the transfer of the property and the son's payment of the gift taxes.[70]

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57. *Johnson*, 495 F.2d at 1083.

58. *Id.*

59. *Id.* at 1082 n.6. The *Johnson* court did not expressly overrule the *Turner* intent standard, but limited *Turner* to its particular fact situation. *Id.* at 1086.

60. *Id.* at 1082-83. The *Johnson* court stated that the substance of a transaction, rather than its form, must determine tax liability. *Id.* at 1082.

61. 572 F.2d 427 (4th Cir. 1978).

62. Hirst v. Commissioner, 572 F.2d 427, 428 (4th Cir. 1978). The court noted that *Johnson* was distinguishable because the transfer in *Johnson* was not conditioned upon the donee's payment of the gift taxes. *Id.* at 429. Whereas, the donee in *Hirst*, like the donees in *Turner*, agreed to pay the gift tax that resulted from the transfer. *Id.* at 430-31.

63. *Id.*

64. *Id.* The *Hirst* court stated that Mrs. Hirst owed nothing before the transactions, and she received nothing by virtue of the transactions. *Id.*

65. *Id.* at 430. The court noted that Mrs. Hirst only intended to give her property to her family. *Id.*

66. *Id.* at 431. The three tracts of land were not producing any income. *Id.* To eliminate the real estate tax burden on her limited liquid assets, the donor decided to give her interest in these tracts to her son and his family. *Id.*

67. *Id.* The total federal gift tax liability arising from these transfers was $68,277. *Id.*

68. *Id.* The Commissioner's computations were as follows: the difference between the total gift tax paid by the son and the donor's adjusted basis in the property was $77,092.55; the 50% capital gain deduction was $38,546.28; therefore the donor's income increased by $38,546.28. Hirst v. Commissioner, 63 T.C. 307, 309-10 (1978).

69. *Hirst*, 572 F.2d at 430-31. The Tax Court in *Hirst* noted that *Turner* represented the "intricate and consistent pattern of decision that has evolved over the years in this field." 63 T.C. at 315. The Tax Court concluded that "[t]hings have gone too far by now to wipe the slate clean and start all over again." *Id.*

70. *Hirst*, 572 F.2d at 431.

The income tax effect of net gifts was at issue again in *Diedrich v. Commissioner.*[71] With little discussion the Tax Court held that the transfers constituted net gifts that resulted in no income tax liability to the donors.[72] The Commissioner appealed to the United States Court of Appeals for the Eighth Circuit.[73] The Commissioner argued that the taxpayers realized income in the amount of the gift taxes paid by the donees.[74] To support his argument the Commissioner cited section 1001 of the Internal Revenue Code,[75] *Crane v. Commissioner,*[76] and *Old Colony Trust v. Commissioner.*[77]

Section 1001 provides that the gain from the sale or disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property.[78] The amount realized is the sum of any money received plus the fair market value of any property received.[79] The Commissioner contended that because the payment of the gift taxes was the legal obligation of the donors,[80] the donors received the amount of the gift taxes paid by the donees as the amount realized.[81]

The Commissioner supported his proposition that the amount realized by a taxpayer can include noncash consideration by relying on the rules of *Crane*[82] and *Old Colony Trust.*[83] In *Crane* the Supreme Court held that the amount of a mortgage on the seller's property for which the seller had no personal liability was a part of the amount realized on the sale of the property.[84] In *Old Colony Trust* the Supreme Court held that an employee's income taxes paid by the employer were income to the employee.[85] Therefore, the

71. 102 S. Ct. 2414 (1982).

72. Diedrich v. Commissioner, 1979 T.C.M. (P-H) ¶ 79,441, *rev'd,* 643 F.2d 499 (1981), *aff'd,* 102 S. Ct. 2414 (1982). The Tax Court based its decision on a long line of cases that have repeatedly held that the donor does not realize income as a result of the transfer. 1979 T.C.M. (P-H) ¶ 79,441.

73. 643 F.2d 499 (1981).

74. *Id.* at 500.

75. *Id.* at 500-01. Section 1001 of the Internal Revenue Code provides that the gain from the sale or disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property. I.R.C. § 1001 (West 1982).

76. 331 U.S. 1 (1947). The Commissioner used *Crane* to illustrate that income is realized by indirect means. *Diedrich,* 643 F.2d at 501.

77. 279 U.S. 716 (1929). The Commissioner used *Old Colony Trust* to support his proposition that an amount realized can include noncash consideration. *Diedrich,* 643 F.2d at 501.

78. I.R.C. § 1001 (West 1982).

79. *Id.* § 1001(b).

80. *Id.* § 2502(c) (West Supp. 1982).

81. *Diedrich,* 643 F.2d at 501. The Commissioner stated that the donees' payment of the gift taxes discharged the donors' legal obligations to pay the gift tax. *Id.* Therefore, the Commissioner concluded that the donors realized a taxable economic benefit. *Id.*

82. Crane v. Commissioner, 331 U.S. 1 (1947).

83. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

84. 331 U.S. at 14. The Supreme Court noted that if a seller transfers property subject to a mortgage, the benefit realized by the seller is as real and substantial as if the mortgage were discharged. *Id.*

85. 279 U.S. at 731. The Court stated that the employer's payment of the tax was in consideration of the services rendered by the employee. *Id.* at 729. The form of payment makes no difference. *Id.*

Commissioner concluded that the taxpayers in *Diedrich*, by having their gift taxes paid, received a real and substantial economic benefit that was a taxable accretion to wealth.[86]

On appeal the Eighth Circuit accepted the Commissioner's argument, reversed the decision of the Tax Court, and held that the donors realized taxable income to the extent that the gift taxes paid by the donees exceeded the donors' adjusted bases in the property.[87] In affirming the holding of the Eighth Circuit,[88] the Supreme Court rejected the *Turner* intent standard[89] and adopted the economic benefit standard of the *Johnson* decision.[90]

In rejecting the subjective intent standard, the Court stated that although intent is relevant in determining whether a gift is made, subjective intent is not a factor in determining if an individual has realized income.[91] Therefore, the Supreme Court agreed with the Eighth Circuit and overruled *Turner* and the subjective intent line of cases.[92]

The *Diedrich* Court reached its decision by adopting the economic benefit standard of *Johnson*.[93] First, the Court examined section 61 of the Internal Revenue Code,[94] which provides that "gross income" includes "income from whatever source derived."[95] The Court also examined *Old Colony Trust*[96] and *Crane*[97] and noted that income is realized by a variety of indirect means.[98] For example, income is realized by an employee when an employer pays the employee's income tax liability.[99]

The *Diedrich* Court also noted that the substance of the

86. *Diedrich*, 643 F.2d at 501.

87. *Id.* at 504. The taxpayers appealed to the United States Supreme Court. Diedrich v. Commissioner, 102 S. Ct. 2414 (1982).

88. 102 S. Ct. at 2420.

89. *Id.* at 2418-19. The *Turner* intent standard examined the donor's intent in making the gift. *Turner*, 49 T.C. at 363. If the donor intended to make a gift, the donor would escape any income tax liability arising from the transfer. *Id.*

90. 102 S. Ct. at 2419. The *Johnson* economic benefit standard examines the benefit derived by the donor in making the gift. *Johnson*, 495 F.2d at 1083. If the donor is monetarily better off as a result of the transfer, the donor must realize income. *Id.*

91. 102 S. Ct. at 2418-19. The Court further stated that even if intent were a factor, the donor's intent in shifting the gift tax obligation to the donee was plainly to relieve the donor of a debt owed to the United States. *Id.* at 2419.

92. *Id.* at 2417.

93. *Id.* The economic benefit standard requires that the donor realize a monetary benefit as a result of the transaction. *Id.*

94. *Id.*

95. I.R.C. § 61 (West 1967). Discharge of indebtedness has been deemed to be income under "income from whatever source derived." *Id. See* Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

96. *Diedrich*, 102 S. Ct. at 2417. In *Old Colony Trust* the Court held that when an obligation is discharged by a third person the discharge is equivalent to receipt of income by the person taxed. *Old Colony Trust Co.*, 279 U.S. at 729.

97. *Diedrich*, 102 S. Ct. at 2417-18. In *Crane* the Court noted that the exchange of money is not necessary to realize income. *Crane*, 331 U.S. at 14.

98. 102 S. Ct. at 2417.

99. *Id.*

transaction must ultimately determine the recognition of income.[100] Applying these principles to the facts of *Diedrich,* the Court concluded that the donors realized taxable income as a result of the donees' assumptions of the donors' gift tax obligations.[101] Thus, the Supreme Court settled the issue of the income tax consequences of net gifts.[102]

As a result of the *Diedrich* decision, tax planners should carefully scrutinize gifts of highly appreciated securities or other property.[103] The goal in gifting for tax purposes is to transfer the property with the least tax impact.[104] Assuming that the donor is indifferent about how he disposes of his property, there are three alternatives that should be considered when contemplating a gift of property.[105]

The first alternative available to the donor is to sell the property outright, reserve enough of the proceeds to pay the gift tax, and make a gift of the remaining proceeds.[106] The advantage of this alternative is that it provides the donor with sufficient cash to pay the gift taxes.[107] The disadvantage of this alternative, however, is that it subjects the donor to both income tax liability, as a result of the gain on the sale, and gift tax liability, as a result of the gift.[108]

The second alternative available to the donor is to make the gift and pay the resulting gift tax.[109] One advantage of this alternative is that the donor escapes income tax liability.[110] Another advantage of this alternative, assuming that the gifted asset is depreciable or otherwise deductible, is that the basis to the donee will increase by the amount of the gift taxes paid[111] and the donee will realize a larger tax deduction.[112] This alternative may not be feasible, however, if the donor does not have sufficient cash to pay the gift tax.

100. *Id.* at 2418. The Court stated that it was the "reality" of the transaction that governed. *Id.*

101. *Id.* Justice Rehnquist disagreed with the majority. *Id.* at 2420. (Rehnquist, J., dissenting). He noted that both the donor and donee may be liable for the gift tax. *Id.* at 2421. Thus, Justice Rehnquist stated that there could be no discharge of indebtedness in this case. *Id.* Therefore, the donors did not realize income as a result of the transaction. *Id.*

102. *Id.* at 2420. The donor realizes an immediate economic benefit upon the donee's payment of the gift taxes. *Id.* at 2418.

103. *See generally* 2 E. FIORE, N. FRIEDLICH, T. MCINEMEY & A. CHEVAT, MODERN ESTATE PLANNING § 4.26 (1982) (examples of net gifts).

104. *See generally* S. KESS & B. WESTLIN, CCH ESTATE PLANNING GUIDE ¶ 131 (1977) (providing the goals of tax planning).

105. 1 PRENTICE-HALL, SUCCESSFUL ESTATE PLANNING IDEAS AND METHODS ¶ 2006.3 (1981).

106. *Id.* The best course in a particular case depends upon all the circumstances. There may be a need to keep the property in the family. *Id.*

107. *Id.*

108. *Id.*

109. *See* I.R.C. § 2501 (West 1982 & Supp. 1982) (imposition of gift tax).

110. 1 PRENTICE-HALL, *supra* note 105.

111. I.R.C. § 1015(d) (West Supp. 1982). The increase in basis for the gift tax paid will bear the same ratio as the net appreciation of the gift bears to the fair market value of the gift. *Id.*

112. 1 PRENTICE-HALL, *supra* note 105, ¶ 2006.4.

The third alternative available to the donor is to make a gift of the property with the condition that the donee pay the resulting gift tax.[113] The Diedrichs chose this alternative.[114] The advantage of this alternative is that it relieves the donor of his obligation to pay the gift tax.[115] As the *Diedrich* case illustrates, however, the donor does not necessarily escape income tax liability.[116]

Thus, a tax planner should consider the following factors when analyzing the tax effects of gifts. First, the tax planner should examine the total tax situations of both the donor and the donee[117] by reviewing their previous income tax returns to determine their approximate income tax brackets.[118] Then the tax planner should compute the donor's and the donee's income tax and gift tax for each of the alternatives outlined above.[119] When calculating the donor's income tax, the tax planner should remember that long-term capital assets qualify for capital gains treatment.[120] Also, when examining the total tax situation, he should consider the donee's future depreciation or other deductions.[121]

In North Dakota land is highly appreciated property. Thus, if a farmer wishes to give land to his children, the tax planner should prepare an analysis of the three alternatives to determine which alternative produces the most favorable tax treatment.

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113. 1 PRENTICE-HALL, *supra* note 105.

114. 102 S. Ct. at 2416.

115. 1 PRENTICE-HALL, *supra* note 105.

116. 102 S. Ct. at 2420. The Supreme Court held that the donors realized income to the extent that the gift taxes paid exceeded the donors' adjusted bases in the property. *Id.*

117. 1 PRENTICE-HALL, *supra* note 105.

118. S. KESS & B. WESTLIN, *supra* note 104. A donor will realize a tax advantage in shifting taxable income from a high bracket donor to a low bracket donee. *Id.*

119. 1 PRENTICE-HALL, *supra* note 105, ¶ 2006.4. It is rarely possible to make a reliable estimate of tax savings without the help of written computations. *Id.*

120. I.R.C. § 1202 (West 1982). If property qualifies for capital gains treatment the taxpayer reports only 40% of the gain. *Id.*

121. *Id.* §§ 167, 168 (West 1978 & Supp. 1982) (providing the rules for depreciation).