Tax Consequences of Donations of Encumbered Property

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TAX CONSEQUENCES OF DONATIONS OF ENCUMBERED PROPERTY

Although gifts offer possible tax benefits to donors when properly made, they involve subtle pitfalls which may result in significant adverse tax consequences if careful tax planning is not undertaken. The purpose of this comment is to outline the basic income, gift and estate tax principles appertaining to the different methods of making donations of encumbered property.

Donations of Unencumbered Property

Simple Gift to an Individual

A donor's simple gift to an individual creates no income tax consequences at the time of transfer; however, the donor subsequently may suffer adverse tax consequences if he has made an anticipatory assignment of income. The assignment of income doctrine is traditionally discussed in terms of a "tree" (the income mechanism) and its "fruit" (the right to receive the income produced). If the donor transfers a tree with ripened fruit or the fruit alone, he will be taxed on the income in the year the donee receives it. But if the donor transfers only the tree, he will not be taxed on the income subsequently received by the donee.

In a simple gift the property transferred is free of any encumbrances, and the donor pays the resultant gift taxes. The Internal Revenue Code of 1954 (the Code) provides that the amount of the gift for tax purposes is the value of the property at the date of donation and that the donor is

2. Bishop v. Shaughnessy, 195 F.2d 683 (2d Cir. 1952); Austin v. Commissioner, 161 F.2d 666 (6th Cir. 1947), cert. denied, 332 U.S. 767 (1947); Rev. Rul. 102, 1969-1 CUM. BULL. 32.
primarily liable for the gift taxes arising out of the donation.\textsuperscript{6} However, to the extent of the value of the gift, a donee is personally liable for taxes on other gifts made by his donor if the taxes are not paid by the donor when due, even though the gift to the particular donee was not taxed.\textsuperscript{7} The donee's liability is not contingent upon a determination of a deficiency against the donor or upon an action to collect the unpaid taxes from the donor;\textsuperscript{8} furthermore, the donor's primary liability for the tax continues even after the donee becomes additionally liable.\textsuperscript{9} The statute of limitations for assessment of a deficiency for gift taxes against the donor is three years after the return is filed,\textsuperscript{10} and a donee's liability for assessment of gift taxes lapses one year after the statute of limitations for assessment against the donor expires.\textsuperscript{11}

\textit{Simple Gift to a Trustee}

Simple gifts in trust are substantively identical to outright gifts,\textsuperscript{12} and as a result, the income and gift tax consequences are largely the same. Although the trustee is not personally liable for taxes assessed against the donor, he does commit trust corpus and income, to the extent of the value of which such property would change hands between a willing buyer and a willing seller . . . ."

\textsuperscript{6} INT. REV. CODE OF 1954, § 2502(d).

\textsuperscript{7} Fred J. LaFortune, 29 T.C. 479 (1957), a/f'd, 263 F.2d 186 (10th Cir. 1958); Fletcher Trust Co. v. Commissioner, 1 T.C. 798 (1943), a/f'd, 141 F.2d 36 (7th Cir. 1944), cert. denied, 323 U.S. 711 (1944). INT. REV. CODE OF 1954, § 6324(b). For example, § 2503(b) of the Code allows the donor a $3,000 annual exclusion for gifts made to each donee. If the donor has made other gifts that result in his owing gift taxes and he fails to pay the gift taxes, a donee who received a $2,000 gift is personally liable to the extent of $2,000 for the donor's gift taxes due even though his gift did not lead to the imposition of the tax.

\textsuperscript{8} Mississippi Valley Trust Co. v. Commissioner, 147 F.2d 186 (8th Cir. 1945).


\textsuperscript{10} INT. REV. CODE OF 1954, § 6501(a). Returns filed before the last day prescribed by law shall be considered as filed on such last day. INT. REV. CODE OF 1954, § 6501(b)(1).

\textsuperscript{11} INT. REV. CODE OF 1954, §§ 6901(c)(1), 6901(h).

\textsuperscript{12} A gift to a trustee and a gift to an individual differ in that a trustee receives legal title and the beneficiaries of the trust receive equitable title to the property, while an individual receives both legal and equitable title to the donated property. P. HASKELL, PREFACE TO THE LAW OF TRUSTS 1 (1975).
the gifts the trust receives, for any gift taxes not paid by the
donor when due.  

Donations of Encumbered Property

Donations of encumbered property typically involve
mortgaged land or securities already pledged as collateral for
loans made by the donor. The tax consequences of these dona-
tions vary depending upon whether the encumbrance is
greater or less than the donor's adjusted basis in the gift
property and whether the donee assumes the encumbrance or
takes the property subject to the encumbrance.

Income Taxation Upon Transfer

When the donor transfers property encumbered in excess
of his adjusted basis\textsuperscript{14} to an individual who assumes the en-
cumbrance, ultimate primary liability on the debt shifts from
the donor to the donee;\textsuperscript{15} when burdened property is donated
to a trustee who assumes the encumbrance, the trust be-
comes primarily liable on the debt, and the trustee commits
trust income to payment of the debt.\textsuperscript{16} Since donations to
trustees and individuals are substantively identical transfers,
the income tax consequences of both types of donations will
be the same when the encumbrance exceeds the donor's basis.
The courts have accepted the Internal Revenue Service's
argument that an assumption results in a pecuniary benefit
to the donor that constitutes consideration for the gift.\textsuperscript{17} Be-

\textsuperscript{13} See Malone v. United States, 326 F. Supp. 106 (N.D. Miss. 1971).
\textsuperscript{14} INT. REV. CODE OF 1954, § 1016.
\textsuperscript{15} The mortgagee may treat as his debtor the vendee of mortgaged
property who has assumed payment of the vendor's debt without thereby
creating a novation and discharging the mortgagor. In the absence of
a novation, it is presumed that the mortgagor has retained the liability of
the mortgagor at the same time he accepts the new debtor. LA. CIVIL CODE arts.
2185-94; Latiolais v. Citizen's Bank, 33 La. Ann. 1444 (1881); Jacobs v. Cal-
derwood, 4 La. Ann. 509 (1849). However, if there is a foreclosure and the
mortgagor has to pay any deficiency, he is subrogated to the mortgagee's
rights against the transferee who has assumed the debt. As a result, when
the transferee assumes an encumbrance, he is ultimately primarily liable on
the debt. Wilkinson v. Adams, 179 La. 630, 154 So. 630 (1934); Isaacs v.
\textsuperscript{17} Id., aff'd per curiam, 455 F.2d 502 (5th Cir. 1972); Oates v. United
cause these transfers cannot be considered wholly gratuitous, the Service has characterized them successfully as part sales and part gifts.\textsuperscript{18} The sale portion is the amount by which the value of the liability assumed exceeds the donor's adjusted basis in the property, and the donor realizes taxable gain to that extent.\textsuperscript{19}

When a donee assumes an encumbrance less than the donor's adjusted basis in the gift property and becomes primarily liable on the debt,\textsuperscript{20} the assumption results in a pecuniary benefit to the donor that constitutes consideration for the gift. However, although the Service classifies transfers in which the donee assumes an encumbrance as part sales and part gifts, because the debt assumed does not exceed the donor's adjusted basis there is no sale portion, and thus no taxable gain is realized by the donor.\textsuperscript{21}

When the donee does not assume, but takes the property subject to an existing encumbrance, the income tax consequences are not settled. Under the rationale of the United States Supreme Court in \textit{Crane v. Commissioner},\textsuperscript{22} the donor

\begin{footnotesize}
\textsuperscript{18} See discussion in note 17, \textit{supra}.
\textsuperscript{19} Whether the gain will be accorded capital gains treatment or will be taxed as ordinary income depends upon the nature of the property and the length of time the donor has held the property. See \textit{INTERNAL REV. CODE OF 1954}, §§ 1221-23 for rules on capital gains. In determining the holding period a trustee may tack onto the settler's holding period. \textit{Citizen's Nat'l Bank v. United States}, 417 F.2d 675 (5th Cir. 1969). Contra, \textit{Rev. Rul. 232}, 1971-1 \textit{CUM. BULL.} 275.
\textsuperscript{20} See discussion in note 15, \textit{supra}.
arguably realizes taxable gain upon the transfer whether he created the encumbrance, assumed an existing encumbrance or purchased the property subject to it.23 In Crane the taxpayer inherited real property subject to a mortgage securing a debt equal to its value. She later sold the property for $3,000 cash to a purchaser who took the property subject to the mortgage. The taxpayer argued that the amount realized upon the sale did not include the amount of the mortgage. The Supreme Court disagreed, however, and explained:

[We are no more concerned whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property . . . . If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.24

Thus an argument could be made that whether a donee takes subject to the mortgage or assumes it, the benefit to the donor is "real and substantial" upon the transfer. However, the argument ignores the part sale, part gift decisions which place primary emphasis upon whether a donee took the property subject to a mortgage or personally assumed the debt the mortgage secures.25 Moreover, in Malone v. United States,26 the court expressed doubt that Crane established the broad position asserted by the Service "that taxable gain is always realized when a taxpayer disposes of property mortgaged in excess of the taxpayer's adjusted basis."27 When the donee takes the property subject to an encumbrance, the donor realizes no pecuniary benefit upon the transfer in the form of a release from primary liability on the encumbrance. Hence the transaction is wholly gratuitous, and no taxable


23. In Johnson v. Commissioner, 59 T.C. 791 (1973), the court in dicta said it was immaterial for income tax purposes whether stock was transferred subject to loans or whether the donees assumed the loans, since in either case the benefit to the transferor was real and substantial. Rev. Rul. 626, 1970-2 CUM. BULL. 158.

24. 331 U.S. at 14 (emphasis added).


27. Id. at 113.
gain upon the transfer should exist under the rationale of the part sale, part gift decisions. Also, double taxation would occur if a donor were taxed at the time of the transfer on the difference between the value of the encumbrance and the donor's adjusted basis and then later taxed on trust income used to discharge the debt.\(^28\)

**Income Taxation Subsequent to Date of Donation**

When the donor transfers property encumbered either in excess of or less than his adjusted basis to a trustee who assumes the encumbrance and uses trust income to discharge the debt, the Service contends that the donor has not divested himself of that portion of the trust income used to pay his debt.\(^29\) Therefore, it asserts that if the donor remains liable in "any capacity" on the indebtedness assumed by the trustee, he will be treated as an owner of that portion of trust income used to pay his debt.\(^30\)

In *Douglas v. Willcuts*\(^31\) the grantor had established a trust to pay his divorced wife an annual sum in lieu of alimony. The United States Supreme Court held the trust income taxable to the grantor, reasoning that the grantor constructively received the income used to discharge his legal obligation to support his wife, for which he remained primarily liable.\(^32\)

In *Hays' Estate v. Commissioner*\(^33\) the decedent donor had

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28. See discussion in text at note 42, infra.
29. INTERNAL REV. CODE OF 1954, § 677(a) (restraints on the assignment of income and trusts). Treas. Reg. § 1.677(a)-1(d), T.D. 7148, 1971-2 CUM. BULL. 251 (donor is not treated as owner of a portion of the trust under section 677(a) of the Code when an adverse party must consent to discharge the assumed debt).
32. Accord, Lucy A. Blumenthal, 30 BTA 591 (1934), rev'd, 76 F.2d 507 (2d Cir. 1935), rev'd per curiam, 296 U.S. 552 (1935) (United States Supreme Court apparently agreeing with trial court that grantor remained primarily liable on the debt and was therefore taxable on trust income).
33. 181 F.2d 169 (5th Cir. 1950). Section 2036(a) of the Internal Revenue
transferred land encumbered by a mortgage to a trustee who assumed the mortgage. The issue before the court was whether the trustee's discharge of the mortgage with trust income was a discharge of a legal obligation of the donor that would cause the land to be included in the donor's gross estate for estate tax purposes. The Fifth Circuit found the controlling factor to be whether primary liability for the debt had shifted from the donor to the trustee, and since under applicable state law primary liability for the debt did shift to the trustee, the donor remained contingently liable for any deficiency after a foreclosure sale. The court decided, however, that the donor's contingent liability was so remote that discharge of the debt with trust income did not constitute reservation by him of an income interest sufficient to cause the land to be included in the donor's gross estate.34

Another Fifth Circuit decision, Edwards v. Greenwald,35 involved donations of partnership interests to trusts on the condition that the trustee assume payment of the debts incurred by the donors in acquiring the donated partnership interests. In rejecting the contention of the Service that trust income used to discharge the debts was taxable to the donors on the basis of §§ 32 and 167 of the Internal Revenue Code of 193936 and the Wilcuits decision,37 the court found that the donors incurred the debts contemporaneously with the creation of the trusts and incurred them solely for the benefit of the trusts. Significantly, the court determined that because under applicable state law primary liability for the debts shifted to the trustee, discharge of the debt was not a dis-

Code provides that a decedent's gross estate includes transfers in which the decedent has retained a life interest, and Treas. Reg. § 20.2036-1(6)(2), T.D. 6501, 1960-2 CUM. BULL. 271 further provides that a decedent retains a life estate in property transferred in trust or otherwise (except to the extent that the transfer was for adequate consideration in money or money's worth) when the income from the property so transferred is used to discharge a legal obligation of the decedent. This estate tax regulation and the regulations under § 677 of the Internal Revenue Code are similar since the donor in either instance is taxed with the portion of trust income which is used to discharge his legal obligations.

34. 181 F.2d at 171.
35. 217 F.2d 632 (5th Cir. 1954).
36. These provisions correspond to §§ 61 and 677 of the Internal Revenue Code of 1954, respectively.
37. The Service also relied on Blumenthal, which is discussed at note 32, supra.
charge of the donor's obligation but was rather satisfaction of
the trustee's legal obligation.\(^{38}\)

Thus, the cases apparently do not support the Service's
position that continued liability of the donor in "any capac-
ity" should result in taxation to him of trust income used to
discharge the obligation.\(^{39}\) Since Edwards emphasized a shift
of primary liability for the debt, the donor's liability for in-
come tax on trust income the trustee uses to pay the debt
should hinge solely upon his continued primary liability on
the debt. Therefore, to secure favorable tax consequences
when making donations of encumbered property to a trust,
with trust income to apply toward the debt, one should insure
that primary liability for the debt shifts to the trustee, the
donor incurs the debt contemporaneously with the creation of
the trust, and the debt is incurred solely for the benefit of the
trust.

If property is donated subject to a preexisting mortgage,
the donor remains primarily liable on the debt and the en-
cumbrance remains his legal obligation.\(^{40}\) Furthermore,
§ 677 of the Code treats the donor as the owner of trust in-
come used to discharge his legal obligations, and this trust
income is taxable to the donor. Since the tax implications
subsequent to the date of transfer are well-defined in these
types of donations,\(^{41}\) the danger of double taxation exists if
the donor is also taxed at the time of transfer;\(^{42}\) he should not
be taxed upon the transfer. On the other hand, if the donor
has taken property subject to an encumbrance on which he
was never personally liable and later donates the property to
a trustee who likewise takes the property subject to the en-
cumbrance, trust income used to discharge the debt is not
taxable to the donor under § 677(a) of the Code since the
payment is not a discharge of his primary legal obligation.\(^{43}\)

\(^{38}\) 217 F.2d at 634-35.

\(^{39}\) See Jack Wiles, 59 T.C. 289 (1972), aff'd per curiam, 33 AFTR 2d
74-1075 (5th Cir. 1974); Jenn v. United States, 25 AFTR 2d 70-756 (D.C. Ind.
1970).

\(^{40}\) Balfour v. Chew, 4 Mart. (N.S.) 154 (La. 1826); HEP Development
Corp. v. Mouton, 256 So. 2d 744 (La. App. 1st Cir. 1972).

\(^{41}\) See INT. REV. CODE OF 1954, § 677(a).

\(^{42}\) See discussion in text at notes 22-28, supra.

\(^{43}\) Anytime a donor transfers encumbered property to an individual who
takes the property subject to the encumbrance or assumes it, care must be
taken to avoid an anticipatory assignment of income and the resultant ad-
verse income tax consequences. See discussion in text at notes 1-4, supra.
Gift Taxation

When a donee assumes the donor's debt, the formula for determining the gift tax due from the donor is the same whether the donor's adjusted basis is greater or less than the encumbrance assumed. The transfer is classified as part sale and part gift; the gift portion of the transfer is the amount by which the fair market value of the property exceeds the debt assumed. Therefore, the encumbrance is deducted from the value of the property and the donor pays gift taxes on the remainder.

If the donor has placed an encumbrance on property or has taken property by assuming a preexisting encumbrance, and he later transfers the property to a donee who takes the property subject to the encumbrance, the donor remains primarily liable on the debt. For reasons previously discussed, the donor receives no pecuniary benefit upon the transfer and as a result the transfer is wholly gratuitous; therefore, the donor owes gift taxes on the full value of the property unreduced by the encumbrance. On the other hand, if the donor has taken property subject to an encumbrance for which he is not personally liable, a later donation of the property is in actuality merely a transfer of his equity, and thus the amount of the gift is the value of the property reduced by the encumbrance.

Net Gifts to Individuals and Trustees

A net gift is a donation in which the donee agrees to pay the donor's gift taxes resulting from the donation. Possible reasons for making net gifts are that the donor may possess illiquid assets and be unable to obtain readily the cash needed to pay his gift taxes, or that he may be forced to sell a portion

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45. Id.
46. See discussion in text at notes 22-28, supra.
47. In Oates v. United States, 24 AFTR 2d 69-5628 (N.D. Tex 1969), the Service contended in the alternative that if the donees were found not to have assumed the encumbrance, then the value of the gift for gift tax purposes should not have been reduced by the encumbrance.
of highly appreciated property to pay the gift taxes so that to have a donee in a lower tax bracket sell the property and pay the taxes may be more advantageous.

**Income Taxation Upon Transfer**

*Turner v. Commissioner,* the first net gift decision, involved donations of stock to three individuals and to six trusts, conditioned upon each donee's payment of his pro rata share of the donor's gift taxes resulting from the transfers. In its deficiency notice, the Service contended that the transfers to the trusts and to the individuals were part sales and part gifts; however, on brief the Service conceded that the transfers to the trusts were in no part sales. The Service attempted to distinguish the transfers to the trusts and the transfers to the individuals on the basis that "the trustees were not personally liable for the tax while the individual transferees personally promised to pay the tax."50

As to the transfers to the individuals, the Service attempted to classify the donor's potential gift tax liability as an encumbrance, i.e. a gift subjecting the donee to payment of the gift tax was partly a sale and partly a gift. The Tax Court rejected this classification and held that the donor did not have taxable gain upon the transfer.51 Moreover, the court stated that the transfers to individuals and to trusts are substantively identical and cannot be characterized differently for income tax purposes on the basis of the type of promise obtained from the donee.52

Net gift decisions subsequent to *Turner* uniformly reject the Service's attempt to classify the donor's potential gift tax liability as an encumbrance.53 However, the predictability of

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49. 49 T.C. 356 (1968), aff'd *per curiam*, 410 F.2d 752 (6th Cir. 1969), *non-acquiesced* 1971-1 CUM. BULL. 3.
50. *Id.* at 362-63.
51. *Id.* at 364.
52. *Id.* at 363. The court set forth two reasons for its decision in the donor's favor. First, the court stated that the donor intended only to make a net gift, i.e., a gift of the value of the stock less the amount of the gift tax payable on the transfers. *Id.* Additionally; the court was concerned over the fact that the donee would receive double credit in computing his basis under Treas. Reg. § 1.1015-4, *T.C. 7207*, 1972-2 CUM. BULL. 106, if the transactions were characterized as part sales, part gifts, and reasoned that this was a "persuasive indication that the part sale/part gift characterization is not appropriate to the facts of the instant case." *Id.* at 364.
53. *E.g.*, Estate of Kenneth W. Davis, 30 T.C.M. 1363 (1971), aff'd *per
income tax consequences upon the transfer of net gifts has been disturbed by the recent decision of the Sixth Circuit in Johnson v. Commissioner.\textsuperscript{54} Dr. Johnson had obtained a non-recourse loan in the amount of $200,000, pledging 50,000 shares of stock as collateral. The fair market value of the stock was in excess of $500,000 and Dr. Johnson's adjusted basis in the stock was $10,812.50. Within two days of the loan he transferred the stock to trustees who subsequently substituted their own notes for Dr. Johnson's promissory note. The loan proceeds received by the donor exceeded his ultimate gift tax liability. Since the donor secured the loan and actually paid the gift taxes himself with the loan proceeds the decision did not involve a net gift \textit{per se}. However, the results of transactions like the one in Johnson and net gifts are the same, since the donee in actuality pays the donor's gift taxes in both situations.

The Tax Court found the instant case similar to those decisions in which the donor transfers property encumbered in excess of basis to a trustee who assumes the encumbrance and stated that a similar result was required.\textsuperscript{55} The court found that the donor obtained real and substantial benefits upon the trustee's assumption of the debt,\textsuperscript{56} and as a result held that the transfer was part sale and part gift. To the extent that the debt the donee assumed exceeded the donor's adjusted basis, the transfer was a sale and the donor realized taxable gain. The Tax Court distinguished the case before it from Turner,\textsuperscript{57} apparently, intending to preserve the income tax advantages available through the use of net gifts.


55. See discussion in text at notes 14-19, \textit{supra}, for a discussion of the income tax consequences of these types of donations.

56. 59 T.C. at 812.

57. The Tax Court distinguished Johnson and Turner as follows: (1) the transfers in Johnson were not conditioned on the donees' payment of the gift tax; (2) in Johnson the donors did not receive any right or interest in trust income or corpus as was found in Turner; (3) the loans in Johnson were not to be equated with the gift tax liability in Turner, the court being impressed with the fact that the loans in Johnson exceeded the gift taxes due; and (4) on the basis of all the facts presented the transfers in Johnson were in reality part sales and part gifts, and not net gifts as in Turner. 59 T.C. at 812-13.
On appeal to the Sixth Circuit the donor argued that the loan proceeds he used to pay his gift taxes should escape taxation on the basis of Turner. The Sixth Circuit obviously was frustrated by fine distinctions in prior cases and cast doubt upon their validity by holding that the donor realized gain upon the transfer and that whether the transfer was described as a part sale, part gift or as a net gift was of no importance.

Edna Bennett Hirst, the first net gift decision by the Tax Court subsequent to Johnson, involved bona fide net gifts to individuals and to trusts. The Service argued that as a consequence of Johnson, the donor's potential gift tax liability was an encumbrance and, therefore, a gift subjecting the donee to payment of the gift tax was part sale and part gift. While noting the conceptual correctness of the Service's contention that the portion of the value of the gift equal to the gift taxes escapes taxation, the court nevertheless rejected it and held that the donor incurred no taxable gain upon the transfers. Thus, the Tax Court seems willing to continue allowing donors to escape income taxation upon the gift tax portion of net gifts "in the absence of any clear cut overruling of prior law [Turner] by a Court of Appeals."61

Income Taxation Subsequent to Date of Donation

When a donor makes a net gift to a trustee, the Service contends that trust income used to discharge the donor's gift tax liability is taxable to the donor under § 677(a) of the Code. Furthermore, it asserts that when the trustee uses borrowed funds to pay the donor's gift taxes, the donor is taxable with

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58. For illustrations of the varied tax consequences resulting from fine distinctions in tax planning, see Note, 50 NOTRE DAME LAWYER 880 (1975).
59. 495 F.2d at 1083. It has been suggested that analyzing the transfer as other than a part sale, part gift could result in taxation at ordinary income tax rates since the sale or exchange requirement of § 1222 of the Code does not appear to be met. Duhl & Cohen, The Net Gift Technique: A Current Analysis of the Requirements for Its Successful Use, 42 J. TAXATION 158, 163 (1975).
60. 63 T.C. No. 27 (1974). At the time of this writing this appears to be the only net gift decision by the Tax Court since Johnson.
61. Id. at No. 27. At the time of this writing Hirst is on appeal to the Fourth Circuit. Some suggest that even if Johnson should become the law as regards net gifts, the courts might not apply Johnson retroactively if the donor has undertaken his transfers in reliance upon Turner. Duhl & Cohen, The Net Gift Technique: A Current Analysis of the Requirements for Its Successful Use, 42 J. TAXATION 158, 162 (1975).
trust income used to discharge the loans in years subsequent to the year in which the gift taxes are paid.\textsuperscript{62}

In \textit{Estate of Annette S. Morgan}\textsuperscript{63} the trustee borrowed funds to pay the gift taxes, which he had agreed to pay as a condition to the gift. The court held the donor taxable under § 677(a) on all income earned by the trust in the year in which his gift taxes were paid. However, it also held that trust income used to repay the loan in years subsequent to that in which the gift tax liability was discharged was not taxable to the donor.\textsuperscript{64}

\textit{Victor W. Krause},\textsuperscript{65} another case in which the trustee borrowed funds to discharge the donor's gift taxes the trust had assumed, subsequently extended the rationale of \textit{Morgan}. In \textit{Krause} the Tax Court rejected the Service's contention that the donor was taxable on all trust income earned in the year the gift taxes were paid under § 677(a), and held that a donor is taxable only with trust income earned up to the date on which gift taxes were paid.\textsuperscript{66} The court further held that the donor is not taxable with trust income earned subsequent

\textsuperscript{62} Rev. Rul. 564, 1957-2 \textit{CUM. BULL.} 328. The only support found for this Revenue Ruling is \textit{Estate of Annette S. Morgan}, 37 T.C. 981, 986 (1962) (Tietjens, J., dissenting).


\textsuperscript{64} The grantor should avoid making personal loans to the trust in order for the trustee to pay the grantor's gift taxes, because his interest in the trust will not terminate upon payment of the gift taxes and he will be taxed with trust income used to discharge the loan in years subsequent to that in which the gift taxes were paid. \textit{See} Clifton B. Russell, 5 T.C. 974 (1945), \textit{appeal dism'd}, 154 F.2d 829 (1st Cir. 1946). Furthermore, when the donor secures the trustee's promise to pay a specified sum from trust income to enable the donor to pay his gift taxes, the donor is taxable with the trust income. \textit{Estate of A. E. Staley, Sr.}, 47 B.T.A. 260 (1942), \textit{aff'd}, 136 F.2d 368 (5th Cir. 1943).

\textsuperscript{65} 56 T.C. 1242 (1971).

\textsuperscript{66} When a net gift is made to an individual, care must be taken to avoid an anticipatory assignment of income. \textit{See} discussion in text at notes 1-4, \textit{supra}. Since the transfer of net gifts involves no income tax consequences and income taxation subsequent to the date of transfer can be avoided, net gifts offer significant tax benefits to donors. Also, substantial tax savings are possible through proper planning of the date of the donation and the timing and manner of the gift taxes. The donation should be made as near to the end of the calendar quarter as possible and the gift taxes should be paid as soon as possible in order for the donor to avoid income taxation of trust income under § 677(a) of the Code. \textit{See} Kopp, \textit{Gifts Subject to Donee Payment of Tax: Timing, Risks, and Computation}, \textit{N.Y.U. 27TH INST. ON FED. TAXATION} 375 (1969); \textit{Note}, 50 \textit{NOTRE DAME LAWYER} 880 (1975).
to the date on which the gift taxes were paid since the donor had no further obligation to which trust income could be applied within the meaning of § 677(a). The Service has further argued that payment by the donee of the donor's gift taxes with borrowed funds constitutes a purchase or liquidation of the donor's income interest; however, to date the courts have rejected this argument consistently.

Gift Tax Consequences

The Service finally has conceded that when a net gift is made, the amount of the gift is the value of the property less the gift taxes due on the donation, and it has provided an algebraic formula for determining the gift taxes due. However, the donation must meet two conditions in order to reduce the value of the gift by the gift taxes due. First, the gift must be made subject to the condition that the gift taxes will be paid by the donee or out of the transferred property. If, for example, such a provision is lacking, and after the donation all parties in interest join in a direction to the trustee to pay the gift taxes from trust corpus, the value of the gift property cannot be reduced by the gift tax liability. Second, the gift tax must actually be paid by the donee or out of the gift property.

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67. Estate of Craig R. Scheaffer, 25 T.C.M. 646 (1966), is, therefore, overruled to the extent the court stated that a taxpayer found to be a substantial owner of a portion of a trust under §§ 671-77 of the Code was taxable on all income attributable to such portion for the entire taxable year. However, Scheaffer's holding that trust income used to pay subsequent gift tax deficiencies is taxable to the donor still appears to be good law.

68. Estate of Kenneth W. Davis, 30 T.C.M. 1363 (1971); Victor W. Krause, 56 T.C. 1242 (1971). In Davis the court also rejected the Service's further contention that the donor retained an income interest in the trust to the extent of the gift tax paid and that payment of the tax itself resulted in ordinary income to the donor under §§ 671 and 677.

69. Rev. Rul. 72, 1975-1 CUM. BULL. 310.

70. There should be a written agreement to insure that this condition is met. Schriebman, Structuring a Net Gift That Will Stand Up: How to Satisfy I.R.S. and the Courts, 39 J. TAXATION 6 (1973).

71. Estelle Mary Affelder, 7 T.C. 1190 (1946). Also, if no agreement that the donee will pay the gift taxes exists when the transfer is made and the statute of limitations for a deficiency assessment against a solvent donor has expired, the value of the gift cannot be reduced to the extent of the gift tax lien in determining the amount of the gift. Evelyn N. Moore, 1 T.C. 14 (1942), aff'd 146 F.2d 824 (2d Cir. 1945).

Basis Considerations

The Code provides that the donor's basis in his property is his cost, which must be adjusted in accordance with other sections of the Code.73 The basis includes debt obligations created by a purchase-money mortgage74 and, also, preexisting liens on the property even though not personally assumed.75

In transactions characterized as part sales and part gifts the donor has taxable gain to the extent the amount realized exceeds his adjusted basis.76 Since this formula for computing gain does not allocate the donor's basis between the sale portion and the gift portion but rather applies the donor's full basis against the amount realized, the donor realizes less gain than would be the case under an allocation formula.77 Some criticize this non-allocation formula for part sale, part gift transactions and suggest that legislation be adopted requiring a donor to allocate his basis in a manner similar to the allocation formula for bargain sales to charity.78

To date no reported case has considered a trust's basis in property transferred to it subject to the condition that the trustee pay the donor's gift taxes. Furthermore, since the courts consistently have rejected the Service's contention that net gifts to individuals are part sales and part gifts, the individual donee's basis is determined in accordance with sections 1015(a) and 1015(d) of the Code.79

73. INT. REV. CODE OF 1954, § 1012. However, in a taxable exchange, the fair market value of the property is the basis. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

74. Manuel D. Mayerson, 47 T.C. 340 (1966). However, after the property has been purchased, subsequent borrowings do not change the basis regardless of whether the owner is primarily liable on the debt. Woodsam Associates, Inc., 16 T.C. 649 (1951), aff'd, 198 F.2d 357 (2d Cir. 1952).


79. Section 1015(a) provides that "the basis shall be the same as it would
When a trustee or an individual assumes an encumbrance on a donation, the Service has been successful in characterizing such donations as part sales and part gifts. A trustee's basis in the donated property is the same as the donor's basis increased by the amount of gain or decreased by the amount of loss recognized on the transfer. An individual's basis in the donated property is the greater of the sale portion of the transfer or the donor's adjusted basis in the property at the date of donation plus the amount of increase, if any, authorized by § 1015(d) of the Code for gift taxes paid. Since the basis formula for an individual donee does not allocate the donor's adjusted basis between the sale portion and the gift portion, the donee receives a more favorable tax basis than if an allocation formula were employed.

Estate Tax Consequences

The Code provides that if a donor has retained an income interest in property transferred in trust or otherwise, and the interest has been retained for life “or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death,” then upon his death his gross estate shall include the value of the property transferred to the extent of his interest therein. The donor retains an income interest to the extent that the trustee uses the right to income, possession, use or enjoyment of the property to discharge the donor's legal obligations.

Since the donor remains primarily liable for his gift taxes be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis...
even though the donee agrees to pay them, the donor presumably will be deemed to have retained an income interest within the meaning of § 2036(a) if the gift taxes are not paid prior to his death. Consequently a portion of the donated property will be included in the decedent-donor's gross estate. However, the Code provides some relief since it allows a credit against the federal estate tax for gift taxes paid on a gift subsequently included in the donor's gross estate. Moreover, if the donee assumes payment of the gift taxes and pays them before the donor's death, no estate tax consequences should arise under § 2036(a) by reason of the donee's assumption, since the donor's income interest terminates when his legal obligation for gift taxes ceases.

When the donee has assumed an encumbrance, determination of primary liability for the indebtedness appears to be decisive in determining whether the donor has retained an income interest in the donated property. In Hays' Estate the court found that upon the transfer the trust became primarily liable for the debt and, since the donor did not receive a pecuniary benefit from repayment of the debt, it concluded that the donor did not retain an income interest in the property.

The Code provides that gifts made within three years of the donor's death are rebuttably presumed to have been made in contemplation of death and are included in the donor's gross estate unless a showing is made that the gift in fact was not made in contemplation of death. Presumably, transfers of property within three years of death charac-

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86. INT. REV. CODE OF 1954, § 2502(d).
88. The gross estate perhaps would include the amount of trust corpus needed to produce the income necessary to discharge the donor's gift tax liability. Kopp, Gifts Subject to Donee Payment of Tax: Timing, Risks, and Computations, N.Y.U. 27TH INST. ON FED. TAXATION 375, 393-94 (1969).
89. INT. REV. CODE OF 1954, § 2012(a). Furthermore, Treas. Reg. § 20.2012-1(a) (1958), allows this credit even though the gift tax is paid after the donor's death. Also, a credit is allowed even though the gift tax was paid by the donee. Rev. Rul. 363, 1974-2 CUM. BULL. 290.
90. See text at notes 33-34 for a discussion of the decision.
91. INT. REV. CODE OF 1954, § 2035. Furthermore, no gift is treated as having been made in contemplation of death when the donor dies more than three years after the date of the gift. Treas. Reg. § 20.2035(I)(d) (1958). Also, these provisions apply to all gifts and not merely to donations of encumbered property or net gifts.


terized as part sales and part gifts are includable in the donor's gross estate only to the extent of the gift portion of the transfer, which is the excess of the fair market value of the property over the encumbrance assumed. Furthermore, credit is allowed against the federal estate tax for gift taxes paid on gifts included in the donor's gross estate by reason of their being made in contemplation of death.

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93. Int. Rev. Code of 1954, § 2012. When under applicable state law gifts are subsequently included in the donor's gross estate as gifts made in contemplation of death and the gift taxes previously paid on the gifts are considered as an advance payment of the state inheritance tax, the Service takes the position that such prepayment of state gift taxes constitutes an asset inuring to the benefit of the donor's estate, the value of which is includable in his gross estate under § 2033. Rev. Rul. 63, 1975-1 Cum. Bull. 294. Presumably, the Louisiana credit against the inheritance tax for gift taxes paid on gifts subsequently determined to be gifts in contemplation of death constitutes such an advance payment and falls within the scope of this recent Revenue Ruling. See La. R.S. 47: 1211, 2406 (1950).