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Donee Payment of Gift Tax: *Crane, Old Colony Trust*, and the Need for Congressional Action

Section 2501 of the Internal Revenue Code (the Code) imposes a tax on "the transfer of property by gift," and section 2502(c) obligates donors to pay the tax. Most donors satisfy this obligation with income, savings, or proceeds from the sale of property that would have been given to the donee if gifts were untaxed. Some donors, however, are unwilling or unable to pay gift taxes, and the tax burden then falls on the donee. Whether donors realize taxable gain when their donees pay gift taxes has troubled tax planners for several years.

_Diedrich v. Commissioner_, on which the Supreme Court has already heard oral arguments, squarely presents this issue. Relying on _Crane v. Commissioner_ and _Old Colony Trust Co. v. Commissioner_, the courts have defined this term differently for income tax and gift tax purposes. See _Farid-Es-Sultaneh v. Commissioner_, 160 F.2d 812, 814 (2d Cir. 1947); Commissioner v. Beck's Estate, 129 F.2d 243, 246 (2d Cir. 1942). For income tax purposes, a "gift" is excludable from the donee's gross income under I.R.C. § 102 only if the donor gives with "detached and disinterested generosity." Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). For gift tax purposes, "[T]here must be a cessation of the transferor's dominion and control over the item or items which comprise the subject matter of the transfer." Estate of Mandels v. Commissioner, 64 T.C. 61, 67 (1975) (citations omitted); Weil v. Commissioner, 31 B.T.A. 899, 906 (1934), aff'd, 82 F.2d 561 (5th Cir.), cert. denied, 289 U.S. 552 (1936); Ross v. Commissioner, 28 B.T.A. 39, 43, appeal dismissed, 67 F.2d 989 (7th Cir. 1933).


3. Comment, _The Tax Consequences of Net Gifts_, 48 TENN. L. REV. 404, 404-05 (1981) (citing Faber, _Gift Tax Planning: The New Valuation Tables: Net Gifts; Political Gifts; and Other Problems_, 31 N.Y.U. INST. FED. TAX. 1217, 1234-35 (1973), and Kopp, _Gifts Subject to Donee Payment of Tax: Timing, Risks and Computations_, 27 N.Y.U. INST. FED. TAX. 375, 375-76 (1969)), lists several reasons why donors may refuse to pay gift taxes: (1) "insufficiency of cash or other liquid assets"; (2) "inability or unwillingness to liquidate property to produce the necessary cash"; (3) a desire "to limit the value of the gift"; (4) a desire "to shift the realized gain on the sale of appreciated gift property to a donee in a lower marginal income tax bracket"; and (5) a desire to give the donee experience in financial matters. _See Suwalisky, Net Gifts — A Critical Look at Johnson v. Commissioner_, 75-5 TAX MNGMT. (BNA) 2, 5-6 (1975).

4. _See I.R.C. §§ 6324(b), 6901(a)(1)(A)(iii); Treas. Reg. §§ 301.6324-1(b), 301.6324-1(d)._

5. Under I.R.C. § 1001(a), gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis in the property. I.R.C. § 1001(b) states that the amount realized is "the sum of any money received plus the fair market value of the property (other than money) received." The adjusted basis in property is computed under I.R.C. § 1016.


8. 331 U.S. 1 (1947) (basis in property is not reduced by non recourse indebtedness, and
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The Eighth Circuit held that a donor whose donee paid the gift tax realized gain to the extent that the tax payment exceeded the donor’s adjusted basis in the transferred property. Underlying this holding was the court’s belief that the transaction was in part a sale and in part a gift. Viewing the gift tax payment as consideration received by the donor, one can find the elements of a sale. After that payment has been subtracted from the value of the property transferred, however, there remains a pure gift.

Among the courts of appeals, only the Eighth Circuit has adopted the part-sale, part-gift theory. Most of the courts that have addressed this issue have applied the net gift theory and held that

upon sale of the property, the amount realized includes the amount of indebtedness from which the seller is relieved).


11. The term “part-gift and part-sale” is a judicial creation used to describe the federal income tax consequences of a transaction where the donor transfers property in return for consideration less than the fair market value of the property. The donor is viewed as having a dual intent: first, he is seen as having the intent to give a gift in the amount by which the value of the property exceeds the value of the consideration; second, he is seen as entering the transaction with the intent of deriving economic benefit from the consideration received, namely, the payment of his gift tax liability. Owen v. Commissioner, 652 F.2d Adv. Sh. 1271, 1274 n.6 (6th Cir. 1981) (2-1) (case vacated Sept. 11, 1981, and ordered held in abeyance pending the disposition of Diedrich v. Commissioner, 643 F.2d 499 (8th Cir.), cert. granted, 102 S. Ct. 89 (No. 80-2204)) (citation omitted).

Treas. Reg. § 1.1001-1(e) (1972) states: “[W]here a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property.”

The Commissioner developed the part-sale, part-gift theory because he was unsuccessful in taxing gain to trust settlers under I.R.C. § 677(a) when trustees discharged the gift tax liability. For a review of those cases, see, Rutgers Comment, supra note 10, at 392 n.24; Comment, supra note 3, at 409-11.

12. “A net gift is a gratuitous transfer of property in which the donor transfers property to the donee conditioned upon the donee’s agreement to pay the applicable gift tax resulting from the transfer.” Comment, supra note 3, at 404 (citations omitted); see Suwalsky, supra note 3, at 2 (“a gift of property subject to some encumbrance or obligation which may be either preexist-
the donor does not have taxable income. Under the net gift theory, gifts are measured by subtracting the donee's gift tax payment from the value of the property that he received. If the donor intended to convey a gift, possible benefits to him from the donee's tax payment are overlooked.

Neither of these approaches, this Note argues, is consistent with both the Code and the broad policies underlying Congress' treatment of donative transactions. The net gift theory achieves results that comport with congressional policy, but its focus on donative intent finds little support in the Code. The part-sale, part-gift theory undermines Congress' policy toward gifts, but follows logically from the Supreme Court's decision in Old Colony Trust. The Note concludes, therefore, that Congress should amend the Code to make clear that liability for gift taxes is shared by donors and donees. By ensuring that donee payments of gift taxes would not constitute taxable gain to donors, this amendment would eliminate the inconsistency between Congress' goals and its operative language.


I. THE NET GIFT AND PART-SALE, PART-GIFT THEORIES

A. The Net Gift Theory

Net gift theorists look solely at the donor's intent to determine whether a donee's gift tax payments are income to his donor. When a donor intends to make a gift, the Tax Court has reasoned, he does not intend to sell anything. A donee's satisfaction of his donor's gift tax liability does not alter the overall nature of a donative transaction. In *Hirst v. Commissioner*, the Fourth Circuit adopted the Tax Court's approach and held that no taxable benefit accrued to the donor:

The predominant circumstance here is that this taxpayer did not intend to sell anything; she intended only to give her property to her progeny. She did not receive anything for herself, there was no economic gain of any kind accruing to her, except release from the normal tax burden of an owner of real estate. This conclusion, however, ignores both the language of the Code and economic reality.

At the most basic level, the net gift theory fails to explain why a donor's subjective intent should determine the income tax consequences of his actions. Taxpayers' subjective intent, one must concede, has little evidential value: Most taxpayers will claim to have intended the course of action that minimizes their tax liability, and neither the Internal Revenue Service nor the Supreme Court has devised a foolproof method for rebutting these claims. The Court has thus concluded: "[T]he donor's characterization of his action is not determinative . . . . It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." 19

The net gift theory also fails to recognize that a disposition of property can exhibit elements of both a sale and a gift. A donor's intent "to give her property to her progeny" is not evidence that she

15. *See Turner v. Commissioner, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969).* In *Turner*, the donor transferred appreciated stock to nine donees. Three of these gifts were made directly to the recipients while the other six gifts were made to trust accounts. Each individual recipient and trustee signed a letter agreeing to pay the resulting gift tax as a condition for receiving the gift.

The *Turner* court's intent argument has been perceived as the crux of its decision. *See, e.g., Hirst v. Commissioner, 572 F.2d 427, 430 (4th Cir. 1978) (en banc); Florida Note, supra note 10, at 943; Comment, supra note 3, at 413.

16. *Turner v. Commissioner, 49 T.C. at 362 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969) ("[A] condition imposed by the transferor that the transferee will pay the gift tax resulting therefrom does not alter the result that the transfer constituted a gift.").

17. 572 F.2d 427 (4th Cir. 1978) (en banc). The Fourth Circuit originally decided *Hirst* for the government on the part-sale, part-gift theory. *See 572 F.2d at 434 (Winter and Butzner, JJ., dissenting).* On rehearing en banc, the court reversed its position.

18. 572 F.2d at 430 (emphasis added).

received nothing for herself. Section 2502(c) of the Code imposes a tax on persons who make gifts. Some donors, however, induce their donees to pay this tax by conditioning the transfer on the donee's payment of the gift tax.\textsuperscript{20} Despite the donative nature of the overall transaction, this bargained-for discharge of the donor's tax liability may constitute taxable gain.\textsuperscript{21}

Finally, because net gift theorists emphasize only the donor's intent, they often overlook the economic effects of a donee's agreement to pay gift taxes.\textsuperscript{22} Donors are unlikely to condition gifts on their donees' payment of gift taxes unless they believe that their action will produce tax savings to the family or other unit.\textsuperscript{23} Donees are typically less wealthy than donors; if part of the property must be sold to pay the gift tax, and the donee is in a lower tax bracket than the donor, a net gift will reduce the unit's total tax liability.\textsuperscript{24} Alternatively, the donee, but not the donor, may have access to sufficient


\textsuperscript{21} See Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929). The applicability of Old Colony Trust to the net gift situation is discussed in Part II supra infra.

Under § 1001(a), gain on a sale or other disposition of property is the excess of the amount realized over the adjusted basis of the transferred property. I.R.C. § 1001(a). The amount realized includes "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b). Any amount realized must be recognized unless the Code provides for nonrecognition. I.R.C. §1001(c). Since no provision authorizes nonrecognition when a donee pays the gift tax, donors must recognize any gain that they realize.

\textsuperscript{22} See, e.g., Diedrich v. Commissioner 643 F.2d 499, 504 (8th Cir.), cert. granted, 102 S. Ct. 89 (1981) (No. 80-2204); Estate of Levine v. Commissioner, 634 F.2d 12, 17 (2d Cir. 1980); Johnson v. Commissioner, 495 F.2d 1079, 1083 (6th Cir.), cert. denied, 419 U.S. 1040 (1974); Temple Note, supra note 10, at 151; Tennessee Note, supra note 3, at 424-29; Rutgers Comment, supra note 10, at 406-11.

\textsuperscript{23} Congress generally treats the donor and donee as a single unit for tax purposes. See text at notes 53-55 infra.

\textsuperscript{24} One could argue that the analysis of the taxable unit's tax liability does not properly include an examination of income taxes. The amount of the gift tax paid on the transfer is the same regardless of which party pays the tax. The only benefit to the unit is income tax savings that result from having the donee pay the gift tax. But Congress has expressly sanctioned donees' paying income taxes at their own lower tax rate on gain that accrues while in the hands of the donor. See notes 53-55 infra and accompanying text. That the donees use these proceeds to pay the gift tax should therefore be irrelevant when measuring benefit to the taxable unit. The proper inquiry, therefore, is whether the government receives less in gift tax proceeds; since the gift tax payment is the same, there is no benefit to the unit from having the donee pay the gift tax.

This argument, while appealing at first blush, is unpersuasive. Congress does tax gain that accrues in the donor's hands at the donee's tax rate when the donee sells the appreciated property, but it does so because the code provisions governing the transfer, \S\S 102 and 1015, make the underlying transfer a nontaxable event (for income tax purposes). The provision in question here, \S 2502(c), forces realization because it imposes an obligation that must be satisfied at the time of the transfer. Satisfaction of that obligation necessarily diverts resources that could be used for other purposes. Those resources, in turn, must be earned, and an income tax must be paid on those earnings. The proper inquiry includes an examination of both the income tax
funds to pay the tax without selling the property; a net gift would enable the unit to defer recognition of gain until the donee disposed of the property in a taxable transaction.

B. The Part-Sale, Part-Gift Theory and the Crane Doctrine

The part-sale, part-gift theory recognizes the multidimensional nature of some donative transactions. Courts adopting this theory argue that both parties benefit from a gift conditioned on the donee’s payment of the gift tax. The benefit to the donee is clear, but non-taxable if the donor has satisfied the requirements of section 102. The benefit, if one exists, to the donor lies in the discharge of the obligation imposed on him by section 2502(c). In Diedrich, the Eighth Circuit relied in part on the principle established in Crane v. Commissioner to hold that such a discharge conferred a taxable benefit on the donor. This Section establishes that the analogy to

and gift tax consequences of having the donee pay the gift tax, for to limit the inquiry to the gift tax would ignore the donor's principal motivation for having the donee pay the gift tax.

This analysis is proper regardless of the source of money used to satisfy the gift tax because the benefit to the unit results from the difference in the tax rates of the donor and donee, not from how the money is raised to pay the gift tax.

25. I.R.C. § 102(a) states that a donee's “gross income does not include property acquired by gift.”

26. See Diedrich v. Commissioner, 643 F.2d 499, 501 (8th Cir.), cert. granted, 102 S. Ct. 89 (1981) (“the payment of federal gift taxes is the legal responsibility of the donor”); Hirst v. Commissioner, 572 F.2d at 438 (Thomsen, J., dissenting) (“taxpayer was primarily responsible for the payment of those gift taxes”); Estate of Levine v. Commissioner, 634 F.2d 12, 17 (2d Cir. 1980) (dictum) (“the gift tax ..•. is a personal liability of the donor”).


29. A pure net gift situation exists where the donee pays the gift tax for the donor. The two cases before Diedrich that applied the part-sale, part-gift theory involved pre-existing encumbrances. See Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980); Johnson v. Commissioner, 59 T.C. 791 (1973), affd., 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974). The Diedrich court found that the lack of a pre-existing encumbrance did not distinguish the case before it from Johnson and Estate of Levine and held for the Commissioner based on those two cases. 643 F.2d at 503-04.

In Johnson, three taxpayers took out nonrecourse loans against highly appreciated stock and transferred the encumbered stock to a trust set up for their children’s benefit. The trustees replaced the taxpayers’ notes with their own notes, again pledging the stock as collateral. This gave the taxpayers the loan proceeds free from any obligation to repay the loan. The taxpayers used part of the loan proceeds to pay their gift taxes. 495 F.2d at 1080. They conceded that the money not used to pay the gift taxes was income to them, but argued that the money used to pay gift taxes was not income to them under the Turner net gift theory. 495 F.2d at 1081. The Sixth Circuit, while rejecting the part-sale, part-gift label, 495 F.2d at 1082 n.6, held against the taxpayers because the transfer of stock had produced an economic benefit to them equal to the amount of the loan proceeds. 495 F.2d at 1083. The court went on to state that the receipt of the loan proceeds used to pay the gift tax could be viewed as payment of the taxpayers' obligation by the trusts and thus constituted income to the donors-taxpayers under Old Colony Trust. Alternatively, the transfer could be viewed as a shedding of a debt by transferring the encumbered stock, and therefore income under Crane. 495 F.2d at 1083. Moreover, the court limited Turner: “[T]he Turner case does not support the taxpayers' position. Turner has no precedential value beyond its peculiar fact situation, in view of the Com-
Crane is imperfect and that the Crane doctrine does not justify the Eighth Circuit's conclusion.

The Supreme Court held in Crane that the basis of inherited property could not be reduced by the amount of nonrecourse indebtedness and that the amount realized on a sale of encumbered property includes the remaining indebtedness. Release from nonrecourse indebtedness, the Crane Court argued, gives the seller an economic benefit "as real and substantial as if the mortgage was discharged or as if a personal debt in an equivalent amount had been assumed by another." Once basis is not reduced by nonrecourse indebtedness, the Court added, "the functional relation[ship]" between the Code's basis and the amount realized provisions requires that such indebtedness also be included in the amount realized on a disposition of the property. If the indebtedness were included only in basis, taxpayers could offset income tax liability by depreciating property purchased with borrowed funds, sell the property subject to

missioner's concessions in that case both in the Tax Court and on appeal to this Court." 495 F.2d at 1086.

In Estate of Levine, the taxpayer made gifts of real estate in trust for three grandchildren in return for the trustee's assumption of mortgage and interest payments on nonrecourse loans against the property. The trustee also assumed the obligation to pay certain operating expenses previously incurred by the donor. 634 F.2d at 13. The Commissioner contended that the donor owed income taxes on the amount by which the assumed liabilities exceeded the donor's adjusted basis in the transferred property. Judge Friendly held for the Commissioner, finding that the trustee's assumption of the donor's personal obligations provided the requisite "sale element" to allow the transaction to be governed by Crane. 634 F.2d at 16.

Although Judge Friendly agreed with the Johnson decision and the Hirst dissent, he reserved judgment on whether Crane applies when property is donated subject to a nonrecourse debt and there is no "sale element." 634 F.2d at 17.

30. 331 U.S. at 11.
31. 331 U.S. at 13 ("amount of the mortgage is properly included in the 'amount realized' on the sale").
32. 331 U.S. at 14
33. 331 U.S. at 12 ("[T]he functional relation of the two sections [the basis and the amount realized sections] requires that the word [property'] mean the same in one section that it does in the other."). See Simmons, Nonrecourse Debt and Amount Realized: The Demise of Crane's Footnote 37, 50 OR. L. REV. 3, 9-10 (1980). In a purchase money mortgage situation like that in Crane, depreciation deductions are an important tie between the two sections. The Court acknowledged that "[t]he crux of this case, really, is whether the law permits her [Mrs. Crane] to exclude allowable deductions from consideration in computing gain." 331 U.S. at 15 (footnote omitted). See Adams, Exploring the Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion, 21 TAX L. REV. 159, 169-70 (1966); Bittker, Tax Shelters, Nonrecourse Debt, and the Crane Code, 33 TAX L. REV. 277, 282 (1978) ("the tax consequences of the taxpayer's dealings with her property [are brought] into harmony with economic reality by recapturing her depreciation deductions to the extent that they exceed her investment"); Del Cotto, Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing, 18 U. Pa. L. REV. 69, 74 (1969) ("The controlling force behind the Court's decision in Crane was probably its concern for depreciation policy.").

the encumbrance, and never be forced to account for the proceeds of the loan.

Most commentators agree that the rationale underlying Crane applies in two situations. Transferors of property realize gain when they take out nonrecourse loans against the property's appreciated value and then transfer the property subject to the indebtedness. Transferors also realize gain when they acquire property with a purchase money mortgage and then dispose of the property after taking depreciation deductions in excess of their cash investment. These situations share one characteristic: the transfer eliminates a pre-existing indebtedness and thus violates the premise — that loans must be repaid — on which the transferor was granted tax immunity on the proceeds of the loan. Although loan proceeds are not taxable, they do produce current economic benefits to borrowers. Crane's realization principle may thus be understood as seeking to ensure that transferors account for the tax-free benefits previously derived from borrowed funds.

34. See, e.g., Bacas, Gifts of Property Subject to Indebtedness: Johnson v. Commissioner, 44 GEO. WASH. L. REV. 86, 110 (1975); Bittker, supra note 33, at 284; Del Cotto, supra note 10, at 95.

35. See, e.g., Estate of Levine v. Commissioner, 634 F.2d 12 (2d Cir. 1980); Johnson v. Commissioner, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974); First Natl. Indus. v. Commissioner, 26 T.C.M. (CCH) 608, 610, 616 (1967); Woodsam Assocs. v. Commissioner, 16 T.C. 649 (1951), affd., 198 F.2d 357 (2d Cir. 1952); Malone v. United States, 326 F. Supp. 106, 111, 113 (N.D. Miss. 1971), affd., 455 F.2d 502 (5th Cir. 1972) (donor has taxable gain when donee assumes mortgage taken out against appreciated value of property; Crane not applied).

36. See, e.g., Evangelista v. Commissioner, 629 F.2d 1218, 1224-25 (7th Cir. 1980); Parker v. Delaney, 186 F.2d 455, 459 (1st Cir. 1950); Guest v. Commissioner, 77 T.C. 9, 24-25 (1981); Mendham Corp. v. Commissioner, 9 T.C. 320, 324 (1947); Simon v. Commissioner, 285 F.2d 422, 425 (3d Cir. 1980) (release from mortgage taxable gain to seller; Crane not applied).

37. See, e.g., Woodsam Assocs. v. Commissioner, 198 F.2d 357, 359 (2d Cir. 1952); Mendham Corp. v. Commissioner, 9 T.C. 320, 323 (1947); Simmons, supra note 33, at 16.

38. See, e.g., Bacas, supra note 34, at 110; Bittker, supra note 33, at 282-84; Simmons, supra note 33, at 4, 17.

No less than five different theories have been offered to explain Crane. Professor Simmons argues that the Crane doctrine taxes borrowed funds that had previously escaped taxation because of the expectation that the funds would be invested in the property. Simmons, supra note 33, at 21, 34. Professor Bittker argues, in a slightly different vein, that Crane should be viewed as a balancing entry made at the time of the transfer to bring "the tax consequences of the taxpayer's dealings . . . into harmony with economic reality by recapturing depreciation deductions to the extent that they exceeded her investment in the encumbered property." Bittker, supra note 33, at 282; cf. Adams, supra note 33, at 169-70 (depreciation deductions must be accounted for). Professor Del Cotto offers an alternate interpretation: Crane only applies when the fair market value of the transferred property exceeds the amount of the indebtedness; when this is not the case, and the debt is nonrecourse, the transferor realizes gain under Crane up to the fair market value of the property and the remaining benefit to the taxpayer is taxed under the tax benefit rule. If the debt is personal, the discharge of indebtedness doctrine governs. Del Cotto, supra note 10, at 317-26.

Bacass suggests that Crane is designed to make the taxpayer account for past advantages of owning property, which was either acquired with borrowed funds or borrowed against after acquisition. Bacas, supra note 34, at 110-11.

Chief Judge Magruder, in a concurring opinion in Parker v. Delaney, 186 F.2d 455, 459-60
support the Eighth Circuit's conclusion that a donee's payment of the gift tax conferred a taxable benefit on the donor.

The facts of Diedrich, typical of the gift tax cases, differ substantially from the two paradigmatic applications of the Crane doctrine; no tax-free benefit had accrued to the donor prior to the transfer of property. A taxpayer who transfers property subject to a loan taken out against its appreciated value or subject to a purchase money mortgage has an obligation to repay the loan that predates the transfer. A transfer removes this obligation, and the previously untaxed benefit becomes properly taxable under Crane. But a donor whose donee makes gift tax payments receives an economic benefit only after he makes the transfer, for only then does gift tax liability accrue. Because no antecedent obligation is removed or previous tax-free benefit enjoyed, the Crane doctrine, as generally interpreted, does not apply when the donee pays the gift tax.

C. The Part-Sale, Part-Gift Theory and Old Colony Trust

The Eighth Circuit also drew support for its part-sale, part-gift theory from Old Colony Trust Co. v. Commissioner, where the Supreme Court considered whether a taxpayer received taxable income when his employer paid his income tax pursuant to a corporate

(1st Cir. 1950), cert. denied, 341 U.S. 926 (1951), suggests that these realization problems could be avoided if basis equaled equity, with depreciation deductions in excess of equity producing a negative basis. See Simmons, supra note 33, at 34-35 for criticism of the judge's suggestion.

All but Judge Magruder's theory address the question of whether footnote 37 of Crane should limit the amount realized from a transfer. In footnote 37 the Court stated that the fair market value of the encumbered property could limit the amount realized:

If the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case. 331 U.S. at 14 n.37.

According to Professors Simmons and Bittker and Mr. Adams, the Crane Court's economic benefit argument does not adequately explain the tax consequences of transferring property subject to nonrecourse indebtedness. See Bittker, supra note 33, at 285 n.14 ("the economic benefit theory should be rejected as wholly fallacious"); Simmons, supra note 33, at 10 ("the Court was misled to believe that the value of encumbered property at the time of disposition was significant"); Adams, supra note 33, at 169-70. The Service has also repudiated footnote 37. See Treas. Reg. § 1.1001-2(b). This Note agrees with these authorities that footnote 37 and the economic benefit theory do not adequately explain the tax consequences of transfers of encumbered property.

39. See Bacas, supra note 34, at 110-11; Bittker, supra note 33, at 282-83; Simmons, supra note 33, at 21. Professor Del Cotto, however, argues that Crane applies when the donee pays the gift tax. According to Del Cotto, the donor sheds a debt — the gift tax obligation — at the time of the transfer, receiving a debt cancellation benefit that is an amount realized under Crane. Del Cotto, supra note 10, at 313. Del Cotto's debt cancellation argument is tantamount to an economic benefit analysis because it focuses on the amount of the liability at the time of transfer and limits the amount realized to the fair market value of the property. See id. at 296, 318, 322-23. This Note expressly rejects the economic benefit analysis and its footnote 37 limitation because it fails to account for the previous economic benefits to the donor. See note 38 supra.

40. 279 U.S. 716 (1929).
resolution. The Court ruled out the possibility that the payment constituted a gift and held that relief of income tax liability should be treated as income. “The discharge by a third person of an obligation to him,” the Court argued, “is equivalent to receipt by the person taxed.” On its face, Old Colony Trust seems to require holding that a donor has taxable gain when his donee pays the gift tax, but several objections must be addressed before finalizing this conclusion.

One could, for example, attempt to distinguish Old Colony Trust on the ground that the obligation to pay gift taxes is shared by donors and donees, while taxpayers are solely responsible for their income taxes. The gift tax is an “excise levied upon the donor’s privilege of making transfers of property,” for which the donor is personally and primarily liable. Although donees become personally liable for payment of the gift tax if their donors fail to pay when the tax comes due, this secondary liability does not amount to a shared obligation. The “special lien” created by section 6324(b) does

41. 279 U.S. at 729. Accord, United States v. Hendler, 303 U.S. 564, 566 (1937); cf. Minnesota Tea Co. v. Helvering, 302 U.S. 609, 612-13 (1937) (requiring a corporation to recognize gain on cash transferred to its shareholders in exchange for the shareholders’ agreement to assume the corporation’s debts where the cash transferred equaled the debts assumed); Douglas v. Willcuts, 296 U.S. 1, 9 (1935) (holding that payments to a beneficiary from trust income were income to the settlor because the payments were in discharge of the settlor’s legal obligation to make payments to the beneficiary).

42. The commentators who favor the application of the part-sale, part-gift theory when the donee pays the gift tax disagree on whether the theory is based on Old Colony Trust, Crane, or both decisions. Most argue that both decisions are applicable. See, e.g., Del Cotto, supra note 10, at 310-13; Florida Note, supra note 10, at 944-47; Rutgers Comment, supra note 10, at 408 n.136, 409-11; Temple Note, supra note 10, at 148-50; Comment, supra note 3, at 431. Two Notes suggest that Old Colony Trust alone is the proper basis for decision. Cornell Note, supra note 10, at 1081-82; Maryland Note, supra note 12, at 115-19 (discharge of debt).


44. See I.R.C. §§ 2502(c), 6321 (imposing a lien on all of a taxpayer’s personal property whenever a tax is not paid when due); Treas. Reg. § 25.2502-2 (1973); see also Mississippi Valley Trust Co. v. Commissioner, 147 F.2d 186, 187 (8th Cir. 1945); Baur v. Commissioner, 145 F.2d 338, 339 (2d Cir. 1944); Fletcher Trust Co. v. Commissioner, 141 F.2d 36, 39 (7th Cir.), cert. denied, 323 U.S. 711 (1944).

45. I.R.C. § 6324(b) (“If the tax is not paid when due, the donee of any gift becomes personally liable for the tax to the extent of the value of his gift.”); Treas. Reg. § 301.6324-1(b) (1973); see Mississippi Valley Trust Co. v. Commissioner, 147 F.2d 186, 187 (8th Cir. 1945); Baur v. Commissioner, 145 F.2d 338, 339 (2d Cir. 1944); Fletcher Trust Co. v. Commissioner, 141 F.2d 36, 39 (7th Cir.), cert. denied, 323 U.S. 711 (1944) (liability of donee is secondary).

The only condition precedent to the donee’s liability is the donor’s failure to pay the gift tax. See Mississippi Valley Trust Co. v. Commissioner, 147 F.2d at 187-88. The donor’s solvency is immaterial, see Baur v. Commissioner, 145 F.2d at 340; Winton v. Reynolds, 57 F. Supp. 565, 567 (D. Minn. 1944), and the Commissioner need not first proceed against the donor, see Moore v. Commissioner, 1 T.C. 14, 15 (1942), aff’d., 146 F.2d 824 (2d Cir. 1945). One court has even held that the donee has no cause of action against the donor for reimbursement. Fidelity Union Trust Co. v. Anthony, 13 N.J. Super. 596, 609, 81 A.2d 191, 198 (Super. Ct. Ch. Div. 1951) (“mere making of a gift does not carry with it any implied promise by the donor that he will pay any taxes due on the gift.”).
not create an indebtedness to the government; it "is merely a security established by statute for the benefit of the taxing authority in the event of a default in payment of the tax." 

One might also distinguish *Old Colony Trust* and *Diedrich* based on how the tax obligations arose. In *Old Colony Trust*, the income tax liability arose from an exchange of services for money; "[t]he payment of the tax by the employers was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor." Even if the employer had not assumed responsibility for paying the employee's income tax, there was an exchange that produced income tax consequences. If the *Old Colony Trust* doctrine is applied in gift tax cases, it will create income tax consequences in an otherwise tax-free transfer. While one could argue that *Old Colony Trust* should not be extended to cases where there is no exchange of benefits between the parties other than payment of the tax that arises from the initial transfer, this objection seems groundless. The Code expressly requires that the donor pay the gift tax, and the donees in cases like *Diedrich* discharged that obligation "upon a valuable consideration." 

A final objection to applying *Old Colony Trust* is that donors do
not necessarily receive an economic benefit from their donee's gift tax payments. It has already been demonstrated, however, that gifts conditioned on the donee's payment of the gift tax produce economic benefits to family or other units.\textsuperscript{50} These benefits, moreover, may not accrue solely to donees. Donors who are aware of the tax savings that donees in lower tax brackets realize when disposing of appreciated property could, in effect, finance part of their gifts with these savings. A smaller conditional transfer could produce the same after-tax gift to the donee and thus the same level of satisfaction to the donor while allowing the donor to conserve a larger share of his assets.

In conclusion, the Eighth Circuit's part-sale, part-gift theory is properly grounded in the Supreme Court's opinion in \textit{Old Colony Trust}. Part II will argue, however, that the Court's theory is inconsistent with Congress' general approach to donative transfers.

II. RECONCILING CONGRESSIONAL POLICY AND THE INTERNAL REVENUE CODE

Although the sparse legislative record\textsuperscript{51} reveals some ambivalence, Congress has traditionally tailored tax policy to encourage gift giving.\textsuperscript{52} The net effect of most of Congress' policies toward gifts has

\textsuperscript{50}. See text at notes 22-24 \textit{supra}. Congress generally treats the donor and donee as a single unit for tax purposes. See text at notes 53-55 \textit{infra}.

\textsuperscript{51}. The problem with interpreting the congressional intent behind \S 2502(c) is that the provision's wording has not changed since it was enacted in 1924. Accordingly, the legislative history on the provision is concentrated in the 1920s and 1930s. But that legislative history reveals little. The predecessor to \S 2502(c) read: "Time of Payment — The tax imposed by section 319 shall be paid by the donor on or before the 15th day of March." Gift Tax Act of 1924, Pub. L. No. 68-176, \S 324, 43 Stat. 253, 316 (1924). In 1932, when the gift tax was reenacted, the section imposing liability on the donor used most of the language of the 1924 version. Revenue Act of 1932, Pub. L. No. 72-154, \S 509(a), 47 Stat. 169, 253 (1932). The legislative history only stated that "[t]he tax is payable on or before the due date of the return." H.R. REP. No. 708, 72d Cong., 1st Sess. 30 (1932), \textit{reprinted in} 7 \textit{LAW, REPORTS, MISCELLANY} 30 (Revenue Act of 1932) (Carlton Fox Collection of the University of Michigan Law Library). During the 1939 codification the section number was changed, but the wording remained the same. Internal Revenue Code, Pub. L. No. 76-1, \S 1008(a), 53 Stat. 1, 148 (1939). In 1954, the section was changed to read: "The tax imposed by section 2501 shall be paid by the donor." Internal Revenue Code of 1954, Pub. L. No. 83-591, \S 2502(d), 68A Stat. 3, 404. Without discussion, the date of payment provision was moved to another subsection of \S 2502. \textit{See} S. REP. No. 1622, 83d Cong., 2d Sess. 478, \textit{reprinted in} [1954] \textit{U.S. CODE CONG. & AD. NEWS} 4621, 5122 ("This section is derived from section . . . 1008(a) of the 1939 code. No change in substance has been made."); H.R. REP. No. 1337, 83d Cong., 2d Sess. A321, \textit{reprinted in} [1954] \textit{U.S. CODE CONG. & AD. NEWS} 4017, 4465 (same). In 1981, Congress moved the provision from I.R.C. \S 2502(d) to I.R.C. \S 2502(c), without explanation. \textit{See} Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, \S 442, 95 Stat. 172, 320 (1981) (codified at I.R.C. \S 2502(c)).

\textsuperscript{52}. Since the reenactment of the gift tax in 1932, Gift Tax Act of 1932, Pub. L. No. 72-154, \S 501-32, 47 Stat. 169, 245-59 (1932), gift giving has been given preferential treatment over the transfer of property at death, though this preference was reduced by the Tax Reform Act of 1976. Before 1976, \textit{inter vivos} gifts had five advantages over transferring property at death. First, gift tax rates were 75% of estate tax rates. Second, unlike estate taxes, the gift tax was not included in the tax base. \textit{See} Harrison v. Commissioner, 17 T.C. 1350 (1952), \textit{acq.}, 1952-2
been to treat the donor and donee as a single unit for tax purposes.\(^{53}\) Section 102, for example, excludes gifts from the donee’s gross income,\(^{54}\) and section 1015 requires the donee to assume the donor’s basis in the transferred property.\(^{55}\) Section 2502(c)’s statement that the donor is to pay the gift tax is inconsistent with this single unit analysis, but it may not entirely reflect Congress’ thinking on the subject. Congressmen have generally assumed that the donor would usually pay that tax;\(^{56}\) during the debates on the original gift tax,

C.B. 2; Lingo v. Commissioner, 13 T.C.M. (CCH) 436 (1954). Third, because gift and estate taxes were computed on separate rate schedules, the total estate and gift tax bill could be reduced by splitting property transfers between inter vivos gifts and passing property at death. Fourth, the exemptions and multiple exclusions for gifts could be used without affecting the estate tax exemption. Fifth, income from gifts of property could be shifted from a taxpayer in a high income tax bracket to one in a lower tax bracket. For a discussion of these advantages, see Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 526-27, reprinted in 1976-3 C.B. 338-39; Eisenstein, The Rise and Decline of the Estate Tax, 11 Tax L. Rev. 223, 243-45 (1956); Harriss, Gifts During Life, in Federal Estate and Gift Taxes 174 (C. Shoup ed. 1966).


53. Under the single unit analysis, the underlying transfer of property escapes taxation. See notes 54-55 infra. In essence, the donee steps into the shoes of the donor. The tax treatment reflects an attitude that gift giving is not a transaction that produces income, unlike transfers in the marketplace for goods, services, and capital, and therefore is not one that should be taxed. Most commentators disagree with this analysis. See, e.g., H. Simons, Personal Income Taxation 127-45 (1938) (gift should be income to the donee because it increases donee’s wealth); Dodge, Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income, 91 Harv. L. Rev. 1177, 1177 (1978); Klein, An Enigma in the Federal Income Tax: The Meaning of the Word Gift, 48 Minn. L. Rev. 215, 215 (1963). But see R. Goode, The Individual Income Tax 98-100 (rev. ed. 1976) (suggesting that gift giving should be viewed as the sharing of income among dependents and close relatives, not creation of new income).

The repeal of I.R.C. § 102 is unlikely. See Osgood, Carryover Basis Repeal and Reform of the Transfer Tax System, 66 Cornell L. Rev. 297, 299 (1981) (“Section 102 appears to have wide support and no serious attempts have been made in recent years to alter it.”) (footnote omitted).

54. I.R.C. § 102(a) states that “gross income does not include the value of property acquired by gift.”

55. The donee assumes the donor’s basis for computing gain on a subsequent sale of the property. I.R.C. § 1015(a). The donee can reduce his basis while he holds the property. See I.R.C. §§ 1016(a), 1016(b). For computing losses on the sale of the property, the donee’s basis is the lesser of the donor’s basis and the fair market value of the property at the time of transfer. I.R.C. § 1015(a). This prevents a donor from giving a loss on property to a taxpayer who could better use the loss to avoid tax liability. See H.R. Rep. No. 704, 73d Cong., 2d Sess. 27 (1934); S. Rep. No. 558, 73d Cong., 2d Sess. 33 (1934); M. Charlestein, Federal Income Taxation, ¶ 4.01, at 56-58 (2d ed 1979); 3A J. Mertens, supra note 46, at § 21.48, at 130 n.1.

however, the sponsor of the gift tax amendment that eventually became law stated that "[i]t is immaterial whether the donor or the donee pays it." 57

The Eighth Circuit's part-sale, part-gift theory, while consistent with section 2502(c)'s language, undermines Congress' preferential treatment of gifts by forcing donors to realize gain on their transfers. Family or other units do receive economic benefits when the donee pays the gift tax, 58 but Congress has sanctioned the receipt of such benefits; it allows the donor to decide both who realizes gain from the one who receives it). 

reprinted in 4 LAW, REPORTS, MISCELLANY 61 (Revenue Act of 1924) (Carlton Fox Collection of the University of Michigan Law Library); 65 CONG. REC. 3173 (1924) (statement of Rep. Mills) ("Why do you impose a tax on the donor?"). President Roosevelt proposed a succession, inheritance, and legacy tax in 1935. The bill containing the proposal stated that the tax was "in addition to the gift tax on the donors." H.R. 8974, 74th Cong., 1st Sess. 9 (1935), reprinted in 16 BILL IN ITS VARIOUS FORMS 59 (Revenue Act of 1935) (Carlton Fox Collection of the University of Michigan Law Library); cf. H.R. REP. No. 1681, 74th Cong., 1st Sess. 10 (1935), reprinted in 9 LAW, REPORTS, MISCELLANY 10 (Revenue Act of 1935) (bill imposes tax "upon the right to receive property by gift") (Carlton Fox Collection of the University of Michigan Law Library).

Apparently, all commentators also assumed that the donor would pay the gift tax. See, e.g., A.L.I., FEDERAL GIFT & ESTATE TAXATION RECOMMENDATIONS 89 (1969); Alexander, Federal Estate & Gift Taxation: The Major Issues in the American Law Institute Project, 22 TAX L. REV. 635, 651 (1967); Faber, supra note 3, at 1234 ("the law . . . has developed on the assumption that the gift tax liability is that of the donor"); Miller, The Federal Gift Tax: Rate Revision, 51 A.B.A. J. 333, 333 (1965).

57. MR. MILLS. As a matter of information who is to pay the tax?

MR. GREEN of Iowa. The gentleman said that the man who receives the gift should pay on it. It is not clear, because now the gentleman says the donor will pay the tax.

MR. MILLS. Surely the gentleman has not introduced an amendment so indefinite that he can not say whether the donor or the donee will pay the tax?

MR. GREEN of Iowa. Oh, the donor will have to pay the tax if it is not paid by the donee.

MR. LONGWORTH. I am in the same situation as the gentleman from New York [Mr. MILLS] seems to be. Suppose the gift were real estate. Who would pay the tax in that case, and what would it be?

MR. MILLS. It would be paid by the donor if the donee does not pay it. I would think the donee would be content to pay it.

MR. GREEN of Iowa. It is immaterial whether the donor or the donee pays it. The Government will get the money in any event; but the donor is responsible under the amendment, for the reason that it is drawn to correspond with the estate tax. There is no reason why the donor should not. If a man keeps the property until the time of the death of the decedent, his estate would have to pay it. These large gifts are made in a large number of cases for the purpose of evading the tax, and they would have the effect of defeating the tax imposed on an estate.

65 CONG. REC. 3120 (1924).

58. See text at notes 23-24 supra.
the transfer of appreciated property and when that gain will be realized. Most donors make the first decision by comparing their tax rates with the rates of their donees:

If the donee's tax rate is lower than the donor's, the property can be transferred in kind and then sold by the donee at a lower tax cost than the donor would incur. If the donor's tax rate is lower than the donee's, the property can be sold in advance of the gift and the cash proceeds transferred net of tax.

Similarly, the donor can either sell the property and give cash or simply transfer the property depending on when it is most advantageous to realize gain.

Congress' intent to allow donors to transfer property without realizing gain is strikingly evinced in the recapture provisions, sections 1245 and 1250. Section 1245, which basically applies to depreciable personal property, seeks to prevent taxpayers from converting ordinary income into capital gains by first taking depreciation deductions to offset ordinary income and then obtaining capital gains tax rates on the amount realized when the property is sold. Subject to certain exceptions, section 1250 applies the same principle to depreciable realty when depreciation deductions exceed straight line depreciation for property disposed of within ten years. Sections 1245(b)(1) and 1250(d)(1), however, exempt donative transfers from the recapture of depreciation provisions. The House Report on section 1250 explained: "The effect . . . is to treat the donor and donee for purposes of this provision as if they were one person."

Because the part-sale, part-gift theory forces donors to realize

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59. See M. Chirelstein, supra note 55, at 54-57; cf. Taft v. Bowers, 278 U.S. 470 (1928) (donee taxed on appreciation that took place while donor held property); Rice v. Eisner, 16 F.2d 358 (2d Cir. 1926), cert. denied, 273 U.S. 764 (1927) (same).

60. M. Chirelstein, supra note 55, at 56-57.

61. I.R.C. §§ 1245, 1250.


64. I.R.C. §§ 1245(b)(1), 1250(d)(1). See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 67 (1962), reprinted in 1962-3 C.B. 471 ("no gain is recognized at the time of disposition. . . . the ordinary income potential . . . carries over into the hands of the donee."); S. Rep. No. 1881, 87th Cong., 2d Sess. 97 (1962), reprinted in 1962-3 C.B. 707, 803 ("the depreciation deductions of the donor must be taken into account by the donee, and may result in ordinary income to him if he sells the property.").

gain when they transfer appreciated property, it flies in the face of Congress' desire to ensure that gifts would not create income tax liabilities for donors. It does this, moreover, even though the purposes of the gift tax are fulfilled without making donors realize gain. The gift tax supplements the income and estate taxes. It is intended, first, to prevent donors from avoiding estate taxes by making inter vivos gifts and, second, to prevent donors from avoiding income taxes by splitting income among family members or trusts.

By virtue of its supplementary role, the gift tax assumes the purposes of the estate and income taxes. The primary functions of the estate tax include preventing undue accumulations of wealth, tax-

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The first exemption is for gifts. Thus, the making of a gift for this purpose will not be a taxable event. However, the depreciation deductions of the donor in such a case are carried over to the donee. If the donee subsequently sells the real property, there may be ordinary income recognized by him as a result of depreciation deductions taken by the donor. The donee, in such a case, however, will receive the benefit of the holding period of the donor. The effect, therefore, of this is to treat the donor and donee as if they were one person with the result that upon subsequent sale by the donee of the property, the same amount (if any) will be treated as ordinary income as if the donor held the property throughout the entire period.

Id. (emphasis added); see S. REP. No. 830, 88th Cong., 2d Sess. 135, reprinted in [1964] U.S. CODE CONG. & AD. NEWS 1809.


67. See, e.g., Estate of Sanford v. Commissioner, 308 U.S. 39, 44 (1939) ("gift tax is supplementary to the estate tax"); H.R. Rep. No. 708, 72d Cong., 1st Sess. 8 (1932), reprinted in 1939-1 C.B. 477 ("gift tax will supplement both the estate tax and income tax"); Harriss, Legislative History of Federal Gift Taxation, 18 TAXES 531, 538 (1940).


69. See Estate of Sanford v. Commissioner, 308 U.S. 39, 47 (1939) (e.g., "compensate for the loss of surtax upon income"); S. REP. No. 665, 72d Cong., 1st Sess. 11 (1932), reprinted in 1939-1 C.B. 504; W. Shultz & C. Harriss, supra note 68, at 452.

The American Law Institute presents the most comprehensive list of objectives:

(1) to produce revenue;
(2) to impose reasonable restrictions on the inheritance of wealth;
(3) to guard against the destruction of incentives to accumulate wealth;
(4) to reduce, if not eliminate, the circumstances under which the form of transfer will affect the tax result;
(5) to have a tax system that is readily understandable in normal and routine transfer situations;
(6) to treat taxpayers similarly situated in the same manner; and
(7) to produce a tax structure that will be regarded as fair.

READINGS IN DEATH & GIFT TAX REFORM 1 (G. Goldstein ed. 1971) (citing ALI, RECOMMENDATIONS ON ESTATE AND GIFT TAXATION 78 (1969)).

ing property once a generation, and taxing windfalls to the recipient. When the donee pays the gift tax, these purposes are satisfied even though the donor does not recognize gain. The gift tax is also designed to reduce that loss of income tax revenue that accompanies gifts. The attainment of this goal is similarly unaffected by the source of the gift tax payment. Although forcing the donor to recognize gain would marginally increase income tax receipts, it does so only by undermining other important goals.

Despite the inconsistency of the part-sale, part-gift theory and

71. See, e.g., Federal Estate and Gift Taxes, supra note 70, at 100-01; Kurtz & Surrey, supra note 70, at 1367.
72. See, e.g., B. BITTKER & L. STONE, supra note 43, at 984; Federal Estate and Gift Taxes, supra note 70, at 100-01; Casner, supra note 70, at 518; Kurtz & Surrey, supra note 70, at 1367.
73. When the donee receives a gift of property the government can lose revenue in four ways. First, the income tax on the donee's subsequent sale of the property will be less than if the donor sold the property because donors are usually in higher tax brackets than donees. See notes 53-55 supra and accompanying text. A second loss of income taxes arises if the property continually produces income, because that income is taxed at the donee's lower rate. Third, these income tax losses are increased when the donor divides property among many donees who are all in a lower tax bracket than the donor. The final loss of income to the government results from the loss of the time value of the income tax the donor would have paid had he sold the property.

Congress reenacted the gift tax in 1932 to compensate for these revenue losses: "[The gift tax] will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons with the result that the taxes imposed by the higher brackets of the income tax law are avoided." H. R. REP. No. 708, 72d Cong., 1st Sess. 28 (1932), reprinted in 1939-1 C.B. 477; accord, Estate of Sanford v. Commissioner, 308 U.S. 39, 47 (1939) ("compensate for loss of surtax upon income"); Smith v. Shaughnessy, 318 U.S. 176, 179 n.1 ("prevent income tax avoidance . . . through . . . escaping the effect of progressive surtax rates" (citations omitted)); Harriss, supra note 67, at 534 ("gift tax . . . should have rates . . . high enough to protect the surtaxes"); Magill, supra note 68, at 773.
74. The part-sale, part-gift theory might even cause a decrease in tax revenues. The theory's realization requirement forces donors to realize gain regardless of how the transaction is structured. As a consequence, a donor may choose to hold property until he has sufficient capital losses to minimize the tax impact of the gift. The donor may well hold the property until death. In the former situation, the government loses the time value of the gift tax and income tax; in the latter situation, the loss of gift tax revenue is compensated for by the estate tax, but the government loses income tax revenue because the appreciated value of the property escapes taxation when the heirs receive a stepped up basis in the property. Thus, the part-sale, part-gift theory's realization requirement may produce a "lock-in" effect similar to that caused by § 1014, which could cause a loss in total tax revenues.

75. Incentives for gift giving, see note 52 supra, are justified on several policy grounds. The first is that incentives are needed to encourage the transfer of society's productive assets to a younger generation at an earlier date, which will, in turn, produce a more aggressive, dynamic economic system. See Alexander, supra note 56, at 645; Jantscher, Death and Gift Taxation in the United States After the Report of the Royal Commission, 22 NATL. TAX J. 121, 129 (1969); Miller, supra note 56, at 333-36. A second reason, which was advanced for excluding the gift tax from the tax base, is that the "omission . . . is a partial offset to the disadvantage of paying a tax at an earlier date than if the transfer had been postponed to death." Federal Estate and Gift Taxes, supra note 70, at 127; cf. Jantschner, supra, at 129-30 (criticizing the above argument when it is made in favor of separate rate structures, but later accepting the concept of incentives so long as there is a single progressive tax system). The third explanation, which is a corollary to the second reason given above, is that the government may be willing to discount gift taxes in order to increase revenues at an earlier date. See Harriss, supra note 67,
congressional policy, the current Code requires courts to apply that theory.\footnote{76} But Congress can act to make the income tax consequences of donees' gift tax payments consistent with its overall policy toward gifts.\footnote{77} In particular, Congress should amend the Code to make the gift tax a shared obligation of the donor and donee, so that neither party would realize income when the other pays the tax.\footnote{78} This solu-

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58. See Crane v. Commissioner, 331 U.S. 1, 6 (1947) ("interpret [words] in their ordinary, everyday senses" (citation omitted)); McFeely v. Commissioner, 296 U.S. 102, 111 (1935); Lang v. Commissioner, 289 U.S. 109, 113 (1933) ("if [tax is imposed] in plain words, as it [is] here, the courts are not at liberty to modify the act by construction in order to avoid special hardship"); Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1931) (plain meaning preferred); United States v. Ryan, 284 U.S. 167, 175 (1931) (apply literal meaning unless result absurd); Crooks v. Harrelson, 282 U.S. 55, 60-61 (1930) (rule of strict construction applies with special force to tax statutes); Eisenstein, Some Iconoclastic Reflections on Tax Administration, 58 HARV. L. REV. 477, 521, 522 (1945) (solution to statutory interpretation must come under words of statute). Contra, Radin, Statutory Interpretation, 43 HARV. L. REV. 883 (1930). See also, Llewellyn, Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to be Construed, 3 VAND. L. REV. 395 (1950) (suggesting that for every rule of statutory construction there is corollary that reaches the opposite result).

71. See Note, Inheritance, Estate and Gift Taxes — Gift Tax — Income Tax — The Donor of a Gift Made Subject to the Condition that the Donee Pay State and Federal Gift Taxes on the Transfer Does Not Realize Taxable Income Even Though Gift Taxes Paid Exceed the Property's Adjusted Basis. — Hirst v. Commissioner, 372 F.2d 427 (4th Cir. 1967) (en banc), 47 U. Cin. L. REV. 341, 347-48 (1978) (criticizing Hirst court for usurping legislative prerogative to establish tax policies by providing donor with nonrecognition of gain). But see Cornell Note, supra note 10, at 1085-86 (nonrecognition of donor's gain should not be allowed because "objections to taxation of appreciation at the time of a net gift do not outweigh the benefits achieved in the form of equal and fair administration of the income tax system").

78. The Regulations currently call for an increase in the donee's basis regardless of who pays the gift tax. Treas. Reg. § 1.1015-5(b)(2) (1964) ("It is immaterial whether the gift tax is paid by the donor or the donee."). The Treasury was following Congress' intent when it promulgated the regulation. S. REP. No. 1983, 85th Cong., 2d Sess., 199, reprinted in [1958] U.S. CODE CONG. & AD. NEWS 4791, 4988 ("It is immaterial whether the gift tax is paid by the donor or donee."). Congress wanted to increase the basis to avoid double taxation:

In this case the "cost" is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another "cost" incurred in transferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer.

S. REP. No. 1983, 85th Cong., 2d Sess. 70, reprinted in [1958] U.S. CODE CONG. & AD NEWS 4791, 4859. See Groh, New Basis for Property Acquired by Gift, 37 TAXES 545 (1959) (stating that § 1015(d)(1)(B) remedies the "inequality" that results when the donee pays the gift tax and no adjustment is allowed).

In 1976, Congress reduced the basis of the amount increase to that percentage of the gift tax attributable to the appreciation of the property's value in the hands of the donor. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(c), 90 Stat. 1520, 1877 (1976) (codified at I.R.C. § 1015(a)(6)). Congress enacted this limitation because, under prior law, the basis increase included the amount of the gift tax payment attributable to the donor's original basis in the property. Double taxation, the concern that prompted adoption of the provision allowing a basis increase for the gift tax payment, only affected the appreciated value of the gift. Thus, Congress limited the basis increase to that amount. See Joint Committee on Taxation, supra note 52, at 561, 1976-3 C.B. at 573; H.R. REP. No. 1380, 94th Cong., 2d Sess. 44, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3398. This Note's solution would not double the same appreciation. The donee's basis would still be increased to reflect the original gift tax payment.
tion would reconcile congressional policy and the language of the Code.

Although one could object that the proposed amendment produces a windfall to donors, this argument is unpersuasive. Even though the donor's supposed gain escapes taxation, the gift tax is paid. The amendment reduces only the potential income tax liability that arises from having to sell part of an appreciated asset to pay the gift tax. But the possibility of such a reduction inheres in a single unit analysis, and Congress has been willing to forgo income tax revenue in other contexts to preserve single unit treatment for donors and donees.\textsuperscript{79}

\textbf{Conclusion}

\textit{Diedrich v. Commissioner}\textsuperscript{80} poses a dilemma that only Congress should resolve. Section 2502(c) requires donors to pay gift taxes, and the Supreme Court's decision in \textit{Old Colony Trust} suggests that donors incur taxable gain when their donees pay those taxes. The conclusions logically demanded of the Court in \textit{Diedrich} — that the part-sale, part-gift theory applies and that the donors have received taxable gains to the extent that their donees' gift tax payments have exceeded their adjusted bases — are inconsistent with Congress' present tax treatment of gifts. But the tax law is not properly subjected to judicial activism, and the Court should, therefore, leave it to Congress to reconcile its policies with the Code's language.

\textsuperscript{79} See text at notes 53-55, 61-65 supra.

\textsuperscript{80} 643 F.2d 499 (8th Cir.), \textit{cert. granted}, 102 S. Ct. 89 (1981) (No. 80-2204).