

Part Sale/Part Gift

Diedrich v. Commissioner

- Parents transferred stock to children. The stock was worth \$180,000, and the parents required as a condition of the transfer that the children pay a nondeductible federal tax obligation of the parents in the amount of \$60,000. The parents had an adjusted basis of \$51,000 in the transferred stock.
- The Supreme Court held that the parents were taxed under section 1001(a) on the excess of their amount realized of \$60,000 less their \$51,000 adjusted basis in the transferred property, for a gain of \$9,000. Even though the \$60,000 was not paid directly to the parents, it is imputed to them under *Old Colony*.

Basis to the Children

- While not at issue in the case, it is important to determine the children's basis in the stock.
 - We know that prior to the transfer, there was unrealized appreciation in the stock of \$180,000 - \$51,000, or \$129,000. The parents were taxed on \$9,000 of that gain on the transfer. Because the transfer should not duplicate or eliminate any gain, the remaining \$120,000 of unrealized appreciation should be built into the stock in the hands of the children. Because the stock is worth \$180,000, that means the children should take a basis in the stock of \$180,000 - \$120,000, or \$60,000.
 - Regulation sec. 1.1015-4 provides that the children's basis in the stock is the greater of cost and carryover. On the facts of the case, that is cost of \$60,000. Another way to describe this rule is carryover + gain recognized by the parents.

The Section 1011(b) Approach

- An alternative way to analyze this part gift/part sale transaction is to divide it into a pure gift component and a pure sale component. Accordingly, we can divide the transaction into a gift of \$120,000 of the stock and a sale of \$60,000 of the stock.
- Because the children paid only \$60,000 for stock worth \$180,000, we know that they paid exactly one-third ($\$60,000/\$180,000$) of fair market value for the stock. If we are going to treat the parents as selling only a portion of the stock, then in computing their gain from the sale we must apportion their total basis in the stock (\$51,000) into the gift component (two-thirds, or \$34,000) and the sale component (one-third, or \$17,000).

Taxation of the Parents

- On the gift component, the parents have no gain or loss (because there is no gain or loss on making a pure gift).
- On the sale component, the parents are taxed under section 1001(a) on the excess of their amount realized of \$60,000 over the allocable portion of their adjusted basis, or \$17,000. Thus, the parents recognize a gain of \$60,000 - \$17,000, or \$43,000.
- Recall that the total appreciation in the stock was \$129,000. If the parents are taxed on \$43,000 of that gain, then the remaining gain of \$86,000 (i.e., \$129,000 - \$43,000) must be built into the children's adjusted basis.

Basis to the Children

- On the gift component, the children take a carryover basis of \$34,000 under section 1015(a).
- On the purchased component, the children take a cost basis of \$60,000 under section 1012.
- Accordingly, the children have an aggregate basis in all the shares of \$34,000 + \$60,000, or \$94,000.
- If the children immediately sell the stock for its fair market value of \$180,000, they will recognize a gain of \$180,000 - \$94,000, or \$86,000. This is the right answer (see previous slide).