Part Gift/Part Sale

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PART GIFT / PART SALE

— by Neil E. Harl

Relatively few make major gifts of property, but a greater number transfer property to children and others in transactions that combine a sale with a gift. Part gift/part sale transactions may involve— (1) a sale of property at a price below fair market value, (2) a gift of an asset coupled with the sale of another asset— such as a sale of one 80-acre tract and a gift of another 80 acres, (3) a sale of property at a below market rate of interest, or (4) a gift of principal amounts due in an installment obligation.

Special basis problem. For transactions involving a sale at less than fair market value, the income tax basis of the property to the purchaser-donee is the greater of the purchase price or the transferor's income tax basis. This rule can lead to a "loss" of income tax basis compared to a gift of part of the asset and a sale of the rest of the asset.

Example (1): Parents holding 160 acres of land with a fair market value of $300,000 and a basis of $50,000 are willing to sell the land to the children for $150,000. The basis to the children would be the greater of $150,000 (the purchase price) or $50,000 (the transferor's income tax basis). The greater, of course, is $150,000. The parents would have a gain of $100,000 on the transaction ($150,000 selling price less a basis of $50,000).

Example (2): The parents in Example (1) decide to sell one 80-acre tract to the children for $150,000 and to make a gift of the other 80 acres. If the two tracts are of equal value and each carries a basis of $25,000, the basis to the children would be $175,000.

1. For the tract sold to the children, the basis would be the purchase price of $150,000.
2. For the gift tract, the basis would be the carryover basis from the donor (one-half of the original $50,000 basis) or $25,000. Thus, the total basis for the quarter section of land would be $150,000 plus $25,000 or $175,000. The parents would have a gain of $125,000.

Cancellation of principal amounts. Any forgiveness or cancellation of principal amounts due under installment obligations may result in both income tax and gift tax consequences.

Since 1980, cancellation or forgiveness of principal amounts of an installment obligation has been treated as a disposition of the obligation by the holder. If the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not less than the face amount of the installment obligation. For unrelated parties, the calculation uses the fair market value of the obligation. Thus, the cancellation or forgiveness of installment payments results in recognized gain to the seller forgiving payment except, possibly, for forgiveness to assist a financially troubled buyer.

Existence of a fixed and definite plan with donative intent to forgive payments may result in the value of periodic gifts considered a present gift at the time of the transfer. In the 1958 case of Deal v. Comm'r, Mrs. Deal transferred remainder interests in land to her daughters with the transaction characterized and reported as a sale. Mrs. Deal then proceeded to forgive all payments as they came due. Upon audit, IRS took the position that the transaction was improperly characterized as a sale and was in reality a gift transaction. The Tax Court agreed with IRS with the result that Mrs. Deal had a gift of the entire amount of the transfer to report in the year of the transaction (inasmuch as there is no concept of installment making of gifts) and the gift was a future interest not eligible for the federal gift tax annual exclusion. The daughters as donees rather than as purchasers lost the new income tax basis from the characterization as a sale and instead acquired a carryover of the mother's basis as donor.

The holding in Deal was weakened by the 1964 case, Hoygood v. Comm'r, which involved the use of enforceable vendor's lien notes with the original characterization as a sale upheld. Deal was further weakened by the 1974 case of Estate of Kelley v. Comm'r which involved a transfer of remainder interests with the original characterization as a sale upheld. In 1977, however, IRS issued Rev. Rul. 77-299 which embraced the holding in Deal. In the ruling, real property was transferred to grandchildren in exchange for several non-interest bearing notes with mortgage, each note in the amount of $3,000. The transaction was held to be a taxable gift rather than a sale. Because the transferor intended to forgive the payments annually as part of a pre-arranged plan, the forgiveness was not a gift of a present interest.

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A transaction stands the greatest chance of being treated as a sale if initially characterized as a sale, reported as a sale transaction and handled in good faith and if it represents a valid business obligation. \(^5\) Any cancellation or forgiveness of a contract or mortgage payment should be carefully established with evidence in writing to prove the cancellation. \(^6\)

Because forgiven payments must basically be reported as though received, for income tax purposes, the best strategy may be to collect all payments, pay the income tax due and give back in a separate transaction part or all of the remaining amount.

**Below market interest rate.** For bargain purchase transactions on an installment sale basis, the Tax Court and the IRS maintain that the present value of the difference between the interest rate used and the market rate of interest at the time is a gift. \(^7\) The Seventh Circuit Court of Appeal disagrees and has held that an installment obligation using an interest rate acceptable under the income tax rules does not involve a gift. \(^8\) The latest Tax Court decision, *Krabbenhoft v. Comm'r*, \(^9\) is on appeal to the Eighth Circuit Court of Appeal. At present, except for the Seventh Circuit states of Illinois, Indiana and Wisconsin, the *Krabbenhoft* decision should be examined carefully from a perspective of potential gift tax liability.

Example: Parents sell land for $402,000 on a 20-year installment contract at 6 percent interest to their son. At the time, the market rate of interest is determined to be 11 percent. Figured at 11 percent, the value of the contract is only $252,000. Thus, the difference or $150,000 is a gift from the parents to the son.

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**FOOTNOTES**

7. See I.R.C. § 2512.
10. See note 8 supra.

14. See note 8 supra.
16. See Hudspeth v. Comm'r, 509 F.2d 1224 (9th Cir. 1975).
18. Krabbenhoft v. Comm'r, 94 T.C. No. 56 (1990). See Ltr. Rul. 8804002, Sept. 3, 1987 (installment sale of stock to shareholder's children at below market rate was gift unless and to extent purchase price included premium sufficient to increase effective interest rate); Ltr. Rul. 8512002, Nov. 28, 1984 (promissory notes for purchase of stock with interest rate 2.355 percentage points below interest rate of equivalent U.S. Treasury obligations constituted gift unless purchase price of stock contained premium for reduced interest rate). See Fox v. U.S., 88-1 U.S.Tax Cas. (CCH) ¶ 13,770 (W.D. Va. 1988) (transfer of real property in exchange for promissory note was gift to extent fair market value of property exceeded amount of note).
19. Comm'r v. Ballard, 854 F.2d 185 (7th Cir. 1988) (sale of property at below market interest rate was not gift to extent interest rate below market rate; for federal gift tax purposes, market rate of interest equal to interest rate established in regulations under I.R.C. § 483 which applied to tax treatment of installment sales).
20. Supra note 18.

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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**ADVERSE POSSESSION**

**CONTINUOUS POSSESSION.** The plaintiff asserted ownership of a one acre strip of land by adverse possession. The court held that the plaintiff's occasional use of the property to maintain a fence and to pick blackberries was not sufficiently continuous possession for title to be acquired by adverse possession. *Harmon v. Ingram*, 572 So.2d 411 (Ala. 1990).

**FENCE.** When the defendant acquired a tract of farm land bordering the plaintiff's land, a fence was placed around the tract. More than 20 years later the plaintiff was awarded neighboring land in a court judgment, and after a survey of the land, the fence was discovered to encroach upon the land awarded in the judgment. The court held that the more than 20 years open, continuous, hostile, exclusive and notorious possession of the land by the defendant established ownership by adverse possession before the court judgment; therefore, the court judgment could not grant the disputed land to the plaintiff. *Sashinger v. Wynn*, 571 So.2d 1065 (Ala. 1990).

**HOSTILE POSSESSION.** The plaintiff's and defendant's lands had been separated by a fence for over 70 years, including the more than 20 years that the parties owned their lands. The plaintiff alleged that when the defendant rebuilt the fence, the defendant had asked...