Basis and Bargain Sales: Income Tax and Other Concerns

Bridget J. Crawford
Jonathan G. Blattmachr

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Basis and Bargain Sales: Income Tax and Other Concerns

BRIDGET J. CRAWFORD*
JONATHAN G. BLATTMACHR**

Abstract

This Article explores the income tax consequences of the sale of property during a taxpayer's lifetime and at death for less than fair market value. The analysis focuses in particular on the tax consequences of a bargain sale by a transferor who wishes to confer some financial benefit on a family member but leave the rest of her estate to charity. From an income tax perspective, generally speaking, death-time bargain sales may be preferable to similar lifetime transactions, if the assets have a low basis pre-death, because of the step-up in income tax basis under section 1014. Depending on the tax clause of the will, a death-time bargain sale may generate more or less overall tax liability than a lifetime bargain sale would.

The Article also discusses in detail an understudied provision of section 1015 that requires adjustments to the basis of property acquired in a lifetime bargain sale to an individual. Basis must be increased by a certain portion of the gift tax paid by the transferor. Different rules govern the allocation of the transferor's basis in lifetime bargain sales to individuals (allocating the entire basis to the sale) on the one hand, and those to a charity (allocating basis pro rata to the sale portion) on the other. This difference gives rise to a statutory ambiguity that the authors believe should be resolved in a way that gives the transferee the greatest increase in basis. As a policy matter, a pro rata basis rule would simplify tax administration and lead to parity in treatment between bargain sales to individuals and to charities. The Article concludes by noting multiple other contexts in which bargain sales might be part of an effective estate plan.

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* Bridget Crawford is a Professor of Law at the Elisabeth Haub School of Law at Pace University.
** Jonathan Blattmachr is a Principal at Pioneer Wealth Partners and a retired member of Milbank LLP and the Alaska, California, and New York Bar Associations.
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I. Introduction

With respect to lifetime transfers of property, section 1015(a) generally provides that a donee takes the donor’s basis in the property (i.e., a carryover basis), except for purposes of determining a loss.\(^1\) With respect to transfers

\(^1\)I.R.C. § 1015(a). This section is relatively easy to follow for purposes of determining gain (the donee takes the donor’s basis) and loss (the donee takes the lesser of two amounts: the transferor’s basis or the fair market value of the property at the time of the gift from the donor to the donee). From these two rules, a third is implied: when, at the time of the transfer from the donor to the donee, the fair market value of the property is less than the donor’s adjusted basis and the donee subsequently sells to another party (other than the donor) for an amount in between the donor’s higher adjusted basis for gain purposes and the lower fair market value at the time of the

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on the donor's death, section 1014 provides that the basis of property acquired from a decedent is its fair market value as of the date of the decedent's death, unless the executor makes an election under section 2032 to have the estate valued as of the date that is six months after the decedent's date of death (known as the alternate valuation date). The beneficiary who acquires property that had a low basis in the transferor's hands during the transferor's lifetime receives, upon the transferor's death, not only the property itself but also the benefit of a step-up in basis.

There is nothing natural or inevitable about the step-up in basis at death. Stepped-up basis is a legislative choice. It is often justified in the name of simplification, as there is no need to track down records to establish the decedent's basis, and the decedent's administrator or executor can more equitably allocate basis between or among beneficiaries. Indeed, the tax law's two short-lived experiments with carryover basis (that is, having the decedent's basis in an asset carry over after death to the recipient of the property) generated a great deal of confusion for taxpayers and their advisors. The first carryover basis regime was part of the Tax Reform Act of 1976 and was retroactively repealed in 1980. The second was part of the Economic Growth and Tax Relief Reconciliation Act of 2001 but effective for one year only (and

transfer for loss purposes, then the donee recognizes no gain and no loss on the sale of the property to the other party. See Reg. §§ 1.1001-1(c), Ex. 4; 1.1015-4(b), Ex. (4). For a discussion of the complex basis rules that apply to lifetime transfers, see Douglas A. Kahn & Jeffrey H. Kahn, "Gifts, Gifts and Gifts"—The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income, 78 NOTRE DAME L. REV. 441, 450–52 (2003) (reviewing income tax basis rules for property acquired by lifetime gift).

References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (Code), unless otherwise indicated.

2 I.R.C. § 1014(a). Section 1014(a)'s step-up in basis does not apply, however, to property which constitutes a right to receive an item of income in respect of a decedent under section 691. I.R.C. § 1014(c). See F. Ladson Boyle & Jonathan G. Blattmachr, IRD and Charities: The Separate Share Regulations and the Economic Effect Requirement, 52 REAL PROP. TR. & EST. L.J. 369, 371 (2018) (discussing section 1014(c)).

3 I.R.C. § 2032(a)(1). If the property is disposed of before the alternate valuation date, its basis for tax purposes generally will be the value on such disposition date. See I.R.C. § 2032(a)(1) (property included in the gross estate that is "distributed, sold, exchanged, or otherwise disposed of" before the sixth month after the decedent's death is valued for estate tax purposes as of the date of such distribution, sale, or exchange).

4 Of course, this rule could result in a step-down in the basis of the property received if the value on the estate valuation date is lower than the basis in the hands of the decedent at death. See I.R.C. § 1014.


essentially only by election)\(^8\) when the estate tax was temporarily repealed (again, essentially by election) in 2010.\(^9\)

Basis matters to the person who acquires property through a donative transfer, whether during the donor’s lifetime or at the donor’s death. Gratuitous transfers may be accomplished by a deed of gift or be governed by the provisions of a will. Gratuitous transfers also may happen by operation of law, such as in the case of a surviving joint tenant or the named beneficiary of an account with a payable-on-death designation. Transfers under wills usually are wholly gratuitous. For example, a testator may leave $10,000 in cash to a favorite niece or her stamp collection worth $10,000 to a friend. These are “gifts” in the colloquial sense of word. From an income tax perspective, the $10,000 of cash and the stamp collection are “free money” to the testator’s niece and friend because gifts, bequests, and inheritances are excluded from a recipient’s gross income under section 102.\(^10\) From a planning perspective, cash bequests do not present any particular challenges because the niece is not required to compute an income tax basis in the $10,000 cash. But if the friend who receives the stamp collection then wants to dispose of it during his lifetime, the friend will need to determine the tax basis of the collection in order to properly report the tax consequences of the sale.\(^11\)

Part II of this Article describes a common context for a bargain sale: a senior-generation member of a wealthy family wishes to make a transfer to a younger-generation family member, and the family has a unified charitable outlook. These transfers may occur during lifetime or at death. Part III compares the combined income and wealth transfer tax consequences of a lifetime bargain sale of appreciated assets to a charitable beneficiary and a noncharitable beneficiary. There is some ambiguity in the regulations under section 1015 as to how the transferee’s basis should be calculated when the transferor paid gift tax on the transfer. We believe that, in most cases, the correct interpretation is for the transferee’s basis to be increased by the entire amount of the gift tax paid. Part IV compares the combined income and wealth transfer tax consequences of a pair of transactions: a lifetime versus death-time bargain

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\(^10\) Property may be included in a taxpayer’s gross estate for federal estate tax purposes even though not passing at death (such as when the taxpayer transferred property during his lifetime but retained the right to the income from it). See I.R.C. § 2036(a)(1). As a general rule, such property also will receive a step-up or step-down in basis to its estate tax value in the hands of the recipient.

\(^11\) I.R.C. §§ 1001(a) (determination of gain); 1001(b) (amount realized); 1011(a) (adjusted basis); 1012 (cost basis); 1014 (basis of property acquired from a decedent).
sale to a noncharitable beneficiary followed by a gift to a charitable beneficiar. Depending on the will’s direction regarding the payment of taxes, the lifetime transfers may (somewhat surprisingly) result in less overall tax liability for the family. Part V argues for a single basis allocation rule for all part-sale/part-gift transactions, regardless of the identity of the recipient. Unitary rules would be clearer and easier for taxpayers to follow.

II. Overview of Bargain Sales

A. Bargain Sales During Lifetime

Gifts by one family member to another are common. Most people are familiar with relatively low-value birthday gifts or holiday gifts, or even annual exclusion gifts of up to $15,000 (in 2020) under section 2503. But people may be less familiar with transfers during life (or at death) that have characteristics of both a gift and a sale. Technically speaking, for gift tax purposes, when property is transferred “for less than full and adequate consideration in money or money’s worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.” For example, a transferor may wish to confer some gratuitous benefit on a family member or other individual, but also may desire to receive some direct financial benefit from the transfer during lifetime or at death. This type of transfer is known as a bargain sale (or a part-sale/part-gift transaction). As described in Part III, there are clear rules that apply to these types of transfers when they occur during the transferor’s lifetime.

B. Bargain Sales at Death

Despite the fact that transfers at death typically take the form of wholly gratuitous transfers, it is not unusual for a testator to authorize the sale of property from her estate. The reasons for this vary. For planning purposes, the testator may direct the sale of property in order to convert the costs associated with the sale of a personal residence, for example, into a deductible expense of the estate under section 2053. In multi-generational wealthy families, a senior-generation family member also might choose to leave her entire estate to charity because her descendants do not “need” the money. For sentimental or other reasons, however, the testator may want some assets to pass to her family members or friends, but in the most tax-effective way. Such a testator, having no available exemptions or credits that could reduce or eliminate the estate tax, might consider including in her will a direction to

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13 I.R.C. § 2512(b).
14 I.R.C. § 2053(a)(2) (administration expenses).
15 See I.R.C. § 2010 (unified credit against the estate tax).
sell property to a named beneficiary or group of beneficiaries, either for fair market value or at a discount. Inserting such a direction in a will makes sense if the testator’s beneficiaries are wealthy and can “afford” to buy the property. It also makes sense when a family is unified in its general charitable outlook. A testator may give to her descendants, for example, the right to purchase certain property of sentimental or practical value from the estate, with the proceeds then payable to a charity that the testator and her family have supported for many years. The net effect is that the family members can still obtain property without any associated wealth transfer tax cost. The family members have paid fair market value for the property and the estate—now in liquid form—passes to charity.

III. Bargain Sales and Basis Allocation

A. Comparing the Tax Consequences of a Lifetime Bargain Sale to an Individual with a Lifetime Bargain Sale to a Charity

The current bargain sale basis rules were established in 1939 with the Bureau of Tax Appeals decision in Fincke v. Commissioner. The Supreme Court affirmed this approach over thirty years later in Diedrich v. Commissioner. These rules were subsequently adopted in regulations.

1. Tax Consequences for the Transferor

A bargain sale to an individual is treated as a single transaction for purposes of determining the transferor’s gain. The regulations provide that a transferor recognizes gain on a bargain sale to an individual only to the extent that the transferor’s amount realized exceeds the transferor’s adjusted basis in the property. In contrast, in the case of a bargain sale to a charity, the transferor’s basis is apportioned between the “gift” portion and the “sale” portion in the same ratio that the amount realized bears to the fair market value of the entire property.

Consider, for example, a hypothetical taxpayer, Tom. Tom owns a parcel of real property known as Blackacre that he purchased six months ago as an

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18 Reg. §§ 1.1001-1(e), 1.1015-5.

19 Reg. § 1.1001-1(e).

20 I.R.C. § 1011(b); Reg. § 1.1011-2(a). The allocation of the entire basis to the sale in the case of a part sale/part gift to an individual has been subject to some academic criticism. See Freeland, Maxfield & Sawyer, supra note 16, at 421–22; Marjorie E. Kornhauser, The Constitutional Meaning of Income and the Income Taxation of Gifts, 25 CONN. L. REV. 1, 17 n.68 (1992).
investment for $10 million. Tom is not a real estate dealer. Assume, however unrealistically, that Tom never took any depreciation deductions with respect to Blackacre (perhaps, because it is vacant land). Tom wants to make a lifetime gift of Blackacre in part to his adult daughter Edwina, but also wants to make a large charitable gift in the same year to the American Cancer Society, an organization that Tom has long supported and that Edwina is also pleased to support. Tom decides that he will sell Blackacre at a discount to Edwina and make a significant contribution of the net proceeds of the sale (after taxes) to the American Cancer Society.

Assume that within a year of his original purchase for $10 million, Blackacre is worth $60 million due to unexpected (and unrealistic) events. Tom sells Blackacre to Edwina for $40 million. The income tax consequences of the transaction to Tom and Edwina are relatively straightforward. The amount by which Tom’s amount realized ($40 million) exceeds his adjusted basis ($10 million) is his gain. In other words, Tom has a short-term capital gain of $30 million. Assuming that Tom is taxed on this gain of $30 million at the highest marginal rate of 37% (as short-term capital gains are taxed at the same rates as ordinary income), he has an income tax liability of $11.1 million.

But Tom has also made a partial gift to Edwina. Because the fair market value of Blackacre ($60 million) exceeds the consideration Tom received ($40 million), Tom made a taxable gift of $20 million. Assuming no available exemptions and a gift tax rate of 40%, Tom owes $8 million in gift taxes as a result of the gift portion of the bargain sale to Edwina. Edwina has no income under section 102(a).

Assume that there is no limit on Tom’s charitable contributions under section 170(b) and no obstacle to netting any charitable tax deduction against the gain from the sale of Blackacre. If Tom makes a cash gift to the American Cancer Society of at least $30 million, he can net this deduction against his $30 million gain from the sale of Blackacre. Of course, he still must pay $8

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21 The unrealistic facts are used to simplify the tax calculation.
22 I.R.C. §§ 1001, 1011, 1012, 1016; Reg. § 1.1001-1(e).
23 Reg. § 1.1001-1(e) (providing that a transferor recognizes gain on a bargain sale to an individual only to the extent that the transferor’s amount realized exceeds the transferor’s adjusted basis in the property); but see I.R.C. § 1011(b) (providing that, in the case of a bargain sale to a charitable organization, the basis is apportioned between the “gift” and the “sale” portions of the transfer for purposes of determining the transferor’s gain); Reg. § 1.1011-2(b) (same).
25 See I.R.C. § 2512(b).
26 If Tom makes a larger contribution to the American Cancer Society, he can further reduce his overall income tax liability for the year. If he cannot “use” all of his charitable deduction, Tom can carry forward his excess charitable contributions for the next five years. See I.R.C. § 170(b)(1)(B).

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million in gift tax to the government. Assuming that Tom makes a gift of $30 million to the American Cancer Society from the $40 million he receives from Edwina, he can pay his gift tax liability of $8 million and retain $2 million in his pocket.

If, in the preceding example, Tom had sold the property to the American Cancer Society, rather than to Edwina, for $40 million, Tom would have been deemed to have sold property with a basis equal to $6.67 million (rounded) (two-thirds of his $10 million basis in the property) and to have given property with a basis equal to $3.33 million (rounded) (one-third of his $10 million basis in the property). Thus, he would have a short-term capital gain of $33.33 million ($40 million - $6.67 million). Absent an available exclusion or exemption, Tom would pay tax on the $33.33 million gain in the bargain sale to the charity, but, in contrast to the part sale/part gift with Edwina, he would pay no gift tax on the $20 million ($60 million - $40 million) transfer to the charity under section 2522. With respect to any charitable contribution deduction available to Tom, however, because the part-sale/part-gift transaction involves a gift of appreciated property to the charity that, if sold, would have generated short-term capital gain, Tom’s deduction is limited to his basis in the portion of the property gifted, $3.33 million. His $33.33 million of short-term capital gain on the sale portion of the transfer will be reduced by the $3.33 million deduction, for a net gain of $30 million. At a tax rate of 37%, his net gain on the sale of the property results in an income tax liability of $11.1 million. From the $40 million that he received from the American Cancer Society, Tom pays the $11.1 million tax liability and retains $28.9 million in his pocket.

Table 1 summarizes the overall income tax consequences of a lifetime bargain sale to an individual versus one to a charity based on the prior hypothetical. It illustrates the simple point that a bargain sale to a charity generates greater income tax liability than a bargain sale to an individual, holding all facts constant.

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Table 1: Income and Gift Tax Consequences of a Lifetime Bargain Sale to Charitable vs. Noncharitable Transferee

<table>
<thead>
<tr>
<th></th>
<th>Bargain Sale to Edwina</th>
<th>Bargain Sale to Charity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tom’s basis allocated to the sale</td>
<td>$10.00 million</td>
<td>$6.67 million</td>
</tr>
<tr>
<td>Tom’s gain</td>
<td>$30.00 million</td>
<td>$33.33 million</td>
</tr>
<tr>
<td>Fair market value of Tom’s gift</td>
<td>$20.00 million</td>
<td>$20.00 million</td>
</tr>
<tr>
<td>Deduction due to Tom’s gift to charity</td>
<td>$30.00 million</td>
<td>$3.33 million</td>
</tr>
<tr>
<td>Net taxable gain</td>
<td>$0</td>
<td>$30.00 million</td>
</tr>
<tr>
<td>Capital gains tax owed on sale (37%)</td>
<td>$0</td>
<td>$11.10 million</td>
</tr>
<tr>
<td>Net income tax owed</td>
<td>$0</td>
<td>$11.10 million</td>
</tr>
<tr>
<td>Gift tax owed on account of gift</td>
<td>$8.00 million</td>
<td>$0</td>
</tr>
<tr>
<td>Total tax collected by government</td>
<td>$8.00 million</td>
<td>$11.10 million</td>
</tr>
</tbody>
</table>

Because of the basis apportionment rules, Tom is forced to recognize more gain in the bargain sale to the charity.29 This result makes sense because the charity is a tax-exempt organization.30 In most cases, the charity will not owe any income tax on a subsequent sale of the property. Tom recognizes comparatively less gain in the bargain sale to Edwina, but as an individual taxpayer, Edwina likely will realize taxable gain on a subsequent sale of the property. In other words, the government will have “another bite at the apple,” or another chance to tax the gain on the subsequent sale of Blackacre by Edwina, but not by the charity. In this particular case, the government’s combined income and gift tax revenue from the bargain sale to Edwina is less than the tax revenue generated by Tom’s deemed pro rata sale to the charity. Any corresponding income tax deduction as a result of his charitable gift is limited to his pro rata basis in the gifted property.

Since at least 1977, if not before, the Treasury Department itself has criticized the application of the different basis rules for bargain sales to an individual and bargain sales to a charity, suggesting the pro rata allocation of basis in both scenarios as the “logical” choice.31 The Joint Committee on Taxation also recommended pro rata allocation of basis in both types of transactions.32

29 See I.R.C. § 1001(b); Reg. §§ 1.1001-1(e), 1.1011-2(b).
30 See I.R.C. § 501(c).
31 G.C.M. 36642 (Mar. 23, 1976) (“The logical treatment is to allocate part of the basis to the gift portion, and part of the basis to the sale portion.”).
32 STAFF OF THE JOINT COMM. ON TAX’N, JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 59–61 (Jan. 27, 2005).
Scholarly commentators, too, have criticized the failure to apportion the transferor’s basis in the case of a part sale/part gift to an individual. The authors are not aware, however, of any recent or pending challenge to the different tax treatment for the two types of transactions.

2. Tax Consequences for the Transferee

To fully understand the income tax consequences of the bargain sale, one must also consider the basis of the acquired property in the hands of the transferee. Generally speaking, modified carryover basis rules apply in the context of bargain sales to individuals. Under the Code and regulations, the transferee’s basis is the greater of the amount paid or the transferor’s basis, plus an increase in basis for any gift tax paid. Using the facts of the previous hypothetical, because the amount Edwina paid is greater than Tom’s basis, Edwina’s basis is $40 million plus some amount attributable to the gift tax paid. Section 1015(d) provides for an adjustment in the transferee’s basis by “the amount of gift tax paid with respect to such gift.” When Tom received $40 million from Edwina for the property worth $60 million, his $20 million gift generated a gift tax of $8 million. At first glance, one might think that Edwina’s basis is $48 million ($40 million + $8 million gift tax). The analysis does not, however, end there.

Section 1015 provides that, with respect to gifts made after December 31, 1976, the increase in basis for gift tax paid is “an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as—(i) the net appreciation in value of the gift, bears to (ii) the amount of the gift.” Net appreciation is defined as “the amount by which the fair market value of the gift exceeds the donor’s adjusted basis immediately before the gift.”

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These rules were considered for revision in 1999 but the regulations were not changed. Dept. of the Treasury, General Explanations of the Administration’s Revenue Proposals 164 (Feb. 1999), https://home.treasury.gov/system/files/131/General-Explanations-FY2000.pdf [https://perma.cc/N6H8-PAPZ]. See generally Robert E. Madden & Lisa H.R. Hayes, Other Tax Developments, 26 Est. Plan. 185 (1999) (describing the proposal to require basis allocation for bargain sales to individuals in a manner consistent with the allocation for bargain sales to charities under section 1011).

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34 I.R.C. § 1015(d); Reg. § 1.1015-4(a).


In the case of outright gifts (as opposed to bargain sales), the adjustment to basis for gift tax paid is relatively straightforward. For example, instead of the bargain sale to Edwina, assume that Tom had made an outright gift of Blackacre to his son Jerry, with Blackacre having a basis of $10 million and a fair market value of $60 million. The “net appreciation in the gift” would be $50 million: the amount by which $60 million exceeds $10 million. The ratio of net appreciation in the value of the gift ($50 million) to the value of the gift ($60 million), would be five-sixths (5/6), or 83.33%. At a gift tax rate of 40%, the tax on a $60 million gift would be $24 million. Under section 1015, Jerry’s basis would be Tom’s basis ($10 million) increased by $20 million (83.33% x $24 million), for a total basis of $30 million.

In the case of bargain sales, there is an ambiguity about how to calculate the adjustment to basis for gift tax paid. In the case of the part-sale/part-gift transaction between Tom and Edwina, Tom recognizes gain only to the extent that the amount realized ($40 million) exceeds the transferor’s basis ($10 million).\(^{37}\) Even though Tom is technically selling only part of the property (Edwina is paying $40 million), he must “use” his entire basis ($10 million) in determining his gain.\(^{38}\) Thus, it would seem that Tom’s basis in the property gifted to Edwina should be zero. If so, then the “net appreciation in the gift” is $20 million: the amount by which the value of the gifted property ($20 million) exceeds his basis in the gift portion ($0).\(^{39}\) Under the regulations, Edwina’s basis would then be the greater of the amount she paid ($40 million) or Tom’s basis ($10 million), plus any increase in basis authorized by section 1015 for that portion of the gift tax paid ($8 million) that equals the ratio of the net appreciation in the gifted property ($20 million) to the value of the gift ($20 million).\(^{40}\) In other words, Edwina’s basis would be $48 million. To be clear, this is a practical argument proceeding from the fact that the transferor’s basis has been “used” mathematically in the determination of the transferor’s gain.\(^{41}\)

It is possible, however, that the Service could take a different approach to determining the transferee’s basis adjustment for the gift tax paid under section 1015.\(^{42}\) The Service could argue that even though the pro rata allocation of basis is not required for purposes of determining the transferor’s gain as part of a bargain sale to an individual, a pro rata allocation of basis is required for purposes of determining the increase in the donee’s basis. In other words, the Service could argue that the “net appreciation in the gift” is $16.67 mil-

\(^{37}\) Reg. § 1.1001-1(e).
\(^{38}\) See I.R.C. § 1015(d).
\(^{39}\) I.R.C. § 1015(d)(6)(B) (defining net appreciation).
\(^{40}\) Reg. § 1.1015-4(a).
\(^{41}\) I.R.C. § 1011(b).
\(^{42}\) I.R.C. § 1015(d).
lion: the amount by which the value of the gifted property ($20 million) exceeds the transferor's proportional basis in the gift portion (one-third of $10 million, or $3.33 million). Under this approach, Edwina’s basis would be the greater of the amount she paid ($40 million) or Tom’s basis ($10 million), plus an increase in basis authorized by section 1015 for that portion of the gift tax paid ($8 million) that equals the ratio of the net appreciation in the gifted property ($16.67 million) to the value of the gift ($20 million).

In that case, the increase under section 1015 in Edwina’s basis for the gift tax paid by Tom would be $6.67 million (83.33% of $8 million). That is the amount which bears the same ratio (83.33%) to the amount of tax so paid ($8 million) as the net appreciation in value of the gift ($16.67 million) bears to the amount of the gift ($20 million). Edwina’s basis in Blackacre would be $46.67 million. This would be consistent with the Service’s approach to charitable bargain sales, but there is no statutory authority for the Service to take this position with respect to noncharitable bargain sales. We do not believe that proportional allocation is the correct result because it is inconsistent with requiring Tom to allocate all of his basis to the sale portion for purposes of calculating his gain.

Of course, Treasury regulations are only the Treasury’s interpretation of the meaning of the statute. While regulations are entitled to deference, they are subject to review by the courts.

Practically speaking, whether Edwina has a basis of $48 million or $46.67 million matters tremendously from Edwina’s perspective. After the bargain sale with Tom, if she were to immediately sell Blackacre to a third party for its fair market value of $60 million, Edwina would recognize a short-term capital gain of $12 million (under the correct approach) or $13.33 million (under the approach the Service might take). Assuming a tax rate of 37%, Edwina would owe $4.44 million in income tax and net $55.56 million from the sale to the third party (under the correct approach) or she would owe $4.93 million and net $55.07 million (under the approach the Service might take).

Looking with a bird’s eye perspective at the lifetime transactions taken together, Tom receives $40 million from Edwina for property in which he has a basis of $10 million, and he owes the government $11.1 million in income taxes. If, separate and apart from the bargain sale to Edwina, Tom also contributes $30 million to a charity in the same year, and assuming no caps on his charitable contributions under section 170, then he can reduce his total

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44 Reg. § 1.1015-4(a).
46 See Reg. § 1.1001-1(e).
48 I.R.C. § 1001(a).
49 See supra note 24.
Basis and Bargain Sales to Individuals

On their face, the statutes and regulations that apply to lifetime bargain sales may not appear to apply to bargain sales made by an estate after a decedent's death. Nevertheless, under section 641(b), the taxable income of an estate or trust is computed, in general, in the same manner as that of an individual. For this reason, the rules for lifetime bargain sales should be the same as the rules for death-time bargain sales, with one exception. Instead of determining the transferee's basis by reference to the greater of the amount paid by the transferee or the transferor's basis, with an adjustment under section 1015(d) for a certain portion of the gift tax paid, the transferee's basis should be the fair market value of the property as of the transferor-decedent's date of death (or as of the alternate valuation date). This is because the assets in the estate receive a stepped-up basis under section 1014. Consequently, just as a taxpayer who intends to make a wholly gratuitous transfer of low-basis property is well-advised to wait to make the transfer at death, if possible, in order to allow the beneficiary to take the property with a stepped-up basis, a taxpayer who intends to make a bargain sale of low-basis property during lifetime will be well-advised, in general, to wait to do so at death, for the same reason.

1. Estate Tax Consequences of Bargain Sales

Consider again Taxpayer Tom, except now he is Testator Tom. These new hypothetical facts contemplate a bargain sale of Blackacre to Edwina pursuant to the terms of Tom's will. Assume that Tom took no action with respect to Blackacre during his lifetime and that his will directs that Edwina has the right to purchase Blackacre from Tom's estate for two-thirds of the property's fair market value at the time of Tom's death. Blackacre, which Tom purchased for $10 million, is worth $60 million at the time of Tom's death. Except for Edwina's right to purchase Blackacre, the rest of Tom's estate will pass to the American Cancer Society. The estate tax consequences will depend in large part on the tax clause of the will. For simplicity, assume that there are no assets in Tom's estate other than Blackacre, he has no debts, and his estate incurs no administration expenses.

a. Payment of Taxes Out of Charitable Portion of the Estate. Assume that the will directs that any estate taxes due will be paid from the portion of Tom's estate passing to the charity (setting the stage for an interrelated estate

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50 I.R.C. §§ 1015, 1014. Note that the change in basis does not apply to any right to income in respect of a decedent. See I.R.C. § 1014(c).

51 See I.R.C. § 1014.
tax computation). The direction by Tom to his executors to make a bargain sale of Blackacre to Edwina for $40 million means that Tom is deemed to make a (taxable) death-time transfer of $20 million to Edwina. Assuming no available applicable exemptions or credits and an estate tax rate of 40%, Tom’s estate appears at first glance to owe $8 million in estate tax, the same as in the case of a lifetime bargain sale, but in actuality the estate tax will be significantly higher.

The estate tax is “tax inclusive,” meaning that the funds that ultimately are used to pay the estate tax are included in the decedent’s gross estate under section 2031. In other words, the estate tax comes out of the “pot” of assets that is subject to estate taxation. Consider also the fact that because Tom’s will directs that the portion of the estate passing to charity bear the tax on the portion of the estate passing to Edwina, the value of the charitable deduction is less than $40 million (the amount of cash that Edwina paid) and the amount of the estate tax will increase from $8 million (the estate tax on a $20 million gift) to $13.33 million. This calculation assumes that Blackacre is the only asset in Tom’s estate, that Tom’s estate receives $40 million from Edwina, and that the bargain sale to Edwina creates a gift to her of $20 million. The charitable portion of his estate decreases by the amount of tax due on account of the transfer to Edwina.

In this scenario, Tom’s estate receives $40 million in the bargain sale to Edwina. The estate owes $13.33 million in estate tax. There is $26.67 million

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52 If a charity pays the estate tax, so that the amount passing to the charity otherwise is reduced by the amount of the tax, then the decrease in the amount passing to the charity decreases the charitable deduction. Reg. § 20.2055-3(a)(2). See also Internal Revenue Serv., Instructions for Form 706, United States Estate and Generation-Skipping Transfer Tax Return 39 (rev. Aug. 2019), https://www.irs.gov/pub/irs-pdf/i706.pdf ("If under the terms of the will . . . the federal estate tax . . . is payable in whole or in part out of any bequest, legacy, or devise that would otherwise be allowed as a charitable deduction, the amount you may deduct is the amount of the bequest, legacy, or devise reduced by the total amount of taxes.").

53 I.R.C. §§ 1014(a), 2031 (definition of gross estate).

54 See supra note 52 (discussion of interrelated estate tax computation); see also Jonathan G. Blattmachr et al., Untangling Installment Payments of Estate Tax Under Section 6166, 36 Est. Plan. 3, 15 n.43 (July, 2009) ("An interrelated calculation is one where the variables are dependent upon and affect each other; as one variable changes, it affects a second which affects the first, which then again affects the second and so on.").

55 The total estate tax is calculated as follows, where T stands for estate tax:

\[ T = 0.40 \times (T + 20m) \]
\[ T = 0.40T + 8m \]
\[ 0.60T = 8m \]
\[ T = 13.33m \]
left over that will pass to the American Cancer Society. The results are shown in Table 2 below.

**Table 2: Wealth Transfer Tax Consequences of Death-Time Bargain Sale; Taxes Paid Out of Charitable Portion**

<table>
<thead>
<tr>
<th></th>
<th>Death-Time Bargain Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Gain on bargain sale</td>
</tr>
<tr>
<td>B</td>
<td>Amount transferred by estate to charity</td>
</tr>
<tr>
<td>C</td>
<td>Income tax owed by estate</td>
</tr>
<tr>
<td>D</td>
<td>Wealth transfer tax owed by estate</td>
</tr>
<tr>
<td>E</td>
<td>Net tax owed by estate (Line C plus Line D)</td>
</tr>
<tr>
<td>F</td>
<td>Edwina’s gain on sale to third party</td>
</tr>
<tr>
<td>G</td>
<td>Income tax owed by Edwina</td>
</tr>
<tr>
<td>H</td>
<td>Total tax revenue to government (Lines E plus Line G)</td>
</tr>
<tr>
<td>I</td>
<td>Net assets in Edwina’s hands</td>
</tr>
</tbody>
</table>

b. **Payment of Taxes Out of the Noncharitable Portion of the Estate.** Assume now that the will directs that any estate taxes due on account of the bequest to Edwina must be paid from the portion of Tom’s estate passing to Edwina. Recall that Blackacre is worth $60 million. The will directs that she has the right to purchase it for $40 million. Thus, Tom is deemed to make a $20 million gift to Edwina. Assuming no available applicable exemptions or credits and an estate tax rate of 40%, Tom’s estate owes $8 million in estate tax. That tax must be paid out of portion of the estate passing to Edwina (Blackacre). If Edwina herself is unable (or chooses not) to pay the tax in order to take Blackacre in kind, the executors will sell Blackacre to pay the tax. Edwina would be entitled to the net proceeds of sale ($60 million) minus the estate tax owned ($8 million), or $52 million. The $40 million paid by Edwina to the estate passes to charity, giving rise to a $40 million estate tax charitable deduction. The results are shown in Table 3 below.

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56 I.R.C. § 2055 (estate tax charitable deduction); see supra note 52 (discussion of interrelated estate tax computation).

57 I.R.C. § 2055 (estate tax charitable deduction).
Table 3: Wealth Transfer Tax Consequences of Death-Time Bargain Sale; Taxes Paid Out of Noncharitable Portion

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Death-Time Bargain Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Gain on bargain sale</td>
<td>$ 0</td>
</tr>
<tr>
<td>B</td>
<td>Amount transferred by estate to charity</td>
<td>$ 40 million</td>
</tr>
<tr>
<td>C</td>
<td>Income tax owed by estate</td>
<td>$ 0</td>
</tr>
<tr>
<td>D</td>
<td>Wealth transfer tax owed by estate</td>
<td>$ 8 million</td>
</tr>
<tr>
<td>E</td>
<td>Net tax owed by estate (Line C plus Line D)</td>
<td>$ 8 million</td>
</tr>
<tr>
<td>F</td>
<td>Estate's gain on sale to third party</td>
<td>$ 0</td>
</tr>
<tr>
<td>G</td>
<td>Income tax owed by Edwina</td>
<td>$ 0</td>
</tr>
<tr>
<td>H</td>
<td>Total tax revenue to government (Lines E plus Line G)</td>
<td>$ 8 million</td>
</tr>
<tr>
<td>I</td>
<td>Net assets in Edwina's hands</td>
<td>$ 52 million</td>
</tr>
</tbody>
</table>

2. Basis of the Property in the Hands of the Transferee

But what of Edwina's basis? Regulation section 1.1015-4 provides that in the case of a part sale/part gift, the transferee's unadjusted basis is the greater of (1) the amount paid by the transferee for the property or (2) the transferor's adjusted basis of the property at the time of the transfer plus the amount of any increase in basis under section 1015(d) "for any gift tax paid." As previously described, the transferor's basis is not allocated in a noncharitable bargain sale between the sale portion and the gift portion. And in any event, section 1014 provides that the basis of property acquired from a decedent or "to whom the property passed from a decedent" is the property's fair market value as of the date of the decedent's death (or the alternate valuation date).

Under these facts, Edwina acquires Blackacre in a bargain sale from Tom's estate. Depending on the tax clause of Tom's will, the charitable bequest may or may not bear the associated estate tax liability.

If any estate taxes due are paid from the portion of Tom's estate passing to the charity, then the government collects $13.33 in estate tax. If Edwina immediately sells the property to a third-party purchaser for its fair market value of $60 million, she has no gain and no loss. The government's combined revenue on the bargain sale by the estate to Edwina and Edwina's subsequent sale is $13.33 million. In contrast, if estate taxes are paid from the portion of Tom's estate passing to Edwina, the government collects $8 million in tax. If Edwina were to sell Blackacre for its fair market value of $60 million, she

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58 Reg. § 1.1015-4(a)(1), (2).
59 See supra notes 19–20 and accompanying text.
60 I.R.C. § 1014(a).

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again would have no gain and no loss. If taxes are the family’s primary concern, it is “cheaper” to have the taxes paid from the portion of the estate passing to Edwina.

C. Overall Tax Consequences of Lifetime Bargain Sales Compared to Death-Time Bargain Sales

Compared to the lifetime bargain sale, the part sale/part gift by the estate may be more tax-effective from the family’s perspective, as long as the taxes are paid out of the noncharitable portion of the estate. Table 4 provides a summary of the economic consequences of the two transactions.

Table 4: Income and Wealth Transfer Tax Consequences of a Lifetime and Death-Time Bargain Sale

<table>
<thead>
<tr>
<th></th>
<th>Lifetime Bargain Sale (from Table 1)</th>
<th>Death-Time Bargain Sale (from Table 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Tom/Tom’s estate gain on bargain sale</td>
<td>$30.00 million</td>
<td>$0</td>
</tr>
<tr>
<td>B Amount transferred by Tom to charity</td>
<td>$30.00 million</td>
<td>$40.00 million</td>
</tr>
<tr>
<td>C Income tax owed by Tom/Tom’s estate</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>D Wealth transfer tax owed by Tom/Tom’s estate</td>
<td>$8.00 million</td>
<td>$8.00 million</td>
</tr>
<tr>
<td>E Net tax owed by Tom/Tom’s estate (Line C plus Line D)</td>
<td>$8.00 million</td>
<td>$8.00 million</td>
</tr>
<tr>
<td>F Edwina’s gain on sale to third party</td>
<td>$12.00 million</td>
<td>$0</td>
</tr>
<tr>
<td>G Income tax owed by Edwina</td>
<td>$4.44 million</td>
<td>$0</td>
</tr>
<tr>
<td>H Total tax revenue to government (Lines E plus Line G)</td>
<td>$12.44 million*</td>
<td>$8.00 million</td>
</tr>
</tbody>
</table>

*Note that this figure does not include any subsequent estate tax that may be owed by Tom’s estate if he were to die without consuming the $2 million he retained after the lifetime bargain sale to Edwina. If he were to transfer that amount entirely to charity at death, it should not result in any estate tax liability. See I.R.C. §§ 2031, 2055.

1. The Charity’s Position

Consider which scenario leads to more money passing to the charity. If, during the year of the lifetime bargain sale to Edwina, Tom gives to the charity only as much as he needs in order to eliminate his gain on the sale of Blackacre, the charity will receive $30 million. Tom might spend, give away or otherwise use the remaining $2 million (after payment of the $8 million gift tax) for any purpose Tom wishes. But if Tom were to die in the same year
that he makes the lifetime bargain sale to Edwina, without having consumed any of the funds he retained, and he leaves his entire estate to charity, then the charity would end up with an additional $2 million, for a total of $32 million. In either case, the charity receives more from a bargain sale made during Tom’s lifetime than at his death.

If Blackacre were the only asset in his estate and Tom directs a sale to Edwina for $40 million with the taxes paid out of the charitable portion of the estate, the American Cancer Society would receive $26.67 million after paying the estate tax attributable to the gift to Edwina.

2. The Family’s and Government’s Positions

Looking at the tax consequences of Edwina’s acquisition and subsequent sale of the property, the transactions together may yield more overall tax in the death-time bargain sale scenario than in the case of a lifetime bargain sale. In the lifetime bargain sale, Edwina acquires a basis of $48 million in the property, and her subsequent sale for $60 million triggers gain of $12 million, presumably taxed at a 37% rate, for an income tax liability of $4.44 million. Because Tom paid a gift tax of $8 million, the family’s total tax liability is $12.44 million. In contrast, in the case of a bargain sale at Tom’s death, Edwina acquires a basis of $60 million in the property, and her subsequent sale results in no gain to her and no income tax liability. The estate pays $13.33 million in estate taxes, if attributable to the charitable bequest, and that is the total tax revenue from the two death-time transfers.

IV. Planning Considerations

A. Simple Estate Planning

Calculating the tax consequences of a bargain sale during lifetime or at death is relatively straightforward, except for the lack of clarity under section 1015 concerning the calculation of the increase in the transferee’s basis attributable to the gift tax paid.6 In a lifetime bargain sale to an individual, the transferor’s entire basis in the property is taken into account for purposes of calculating gain under section 1011(a) and Regulation section 1.1001-1(e). Thus, the transferor “uses” all of his basis in determining gain, and when calculating the increase in the donee’s basis on account of the gift tax paid, it is appropriate to increase the basis by the entire amount of the gift tax paid.

Once the lifetime transferee’s basis is determined, one can readily compare the tax consequences of the bargain sale during lifetime and at death. If all factors are held constant, the death-time bargain sale (such as in Table 3) results in more overall financial benefit for the family, but less tax revenue for the government, as long as the tax clause in the will directs the payment of

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6 See supra text accompanying notes 37–47.
estate tax from the noncharitable portion of the estate. A charity might benefit more from a lifetime bargain sale followed by a cash gift, but such a result depends on a variety of (possibly) unrealistic assumptions, such as Tom having enough money to make a charitable transfer of $30 million. To be sure, life is never as simple as a hypothetical. One cannot predict whether any transferor’s charitable interests remain constant, what her consumption patterns may be, or the future time of death (unless death is imminent). Health emergencies, a reversal of business fortunes, or divorce have changed many people’s financial portfolios.

Bargain sales, especially to family members, may only make financial sense when the intended beneficiary has sufficient funds to purchase the intended asset or assets and when the family’s charitable interests are generally aligned across generations. For a family of more modest means, if the senior-generation family member wants to make certain that her beneficiaries will receive property either during lifetime or at death, an outright gift or bequest (which may or may not trigger a wealth transfer tax, depending on the availability of exemptions and credits) will be more practical. Also, if a senior-generation family member has a testamentary charitable beneficiary that the intended family beneficiary does not support for whatever reason, even if the intended family beneficiary has the financial means to purchase the particular property, the family member may choose to forgo the estate property with sentimental or practical value. This might give the beneficiary a fragile sense that she has not actively supported an organization that is subjectively undesirable for whatever reason, but the failure to exercise the option to purchase means the property will pass to the charity anyway.

B. Complex Estate Planning

This brief Article has addressed the scenario involving a testator who wishes to confer some postmortem benefit on a family member, but also wishes to leave the remainder of his estate to charity. There are a myriad of other situations in which bargain sales might be appropriate.

Lifetime part-sale/part-gift transactions are effective ways for a taxpayer to transfer an appreciating asset out of her estate, shifting the future asset appreciation to a younger-generation family member, with the transferor receiving some financial benefit at the time of the transfer. If that asset is income-producing, a bargain sale may be a way for the taxpayer to effectively shift some income to a family member who is in a lower income tax bracket as well. If the asset is highly depreciable, a bargain sale may be a way for the taxpayer to effectively shift the deduction to a family member in whose hands the deduction is “worth” more (if the transferee is in a higher tax bracket). A taxpayer who no longer has substantial income may wish to convert a non-income-producing asset into a more liquid form.

Death-time part-sale/part-gift transactions may be helpful beyond the specific scenario contemplated in this Article, in which the testator intends to
benefit primarily the charity but wishes his family members to be able to obtain property of sentimental or practical value (and the family members have sufficient assets to buy that property). In any estate, including one with mostly (or entirely) noncharitable beneficiaries, a bargain sale increases estate liquidity, minimizing the likelihood that the executor may be forced to sell valuable property to satisfy pecuniary legacies or pay tax liabilities. But an executor who intends the estate to qualify for the extended time to pay any estate tax under section 6166, for example, will want to take care that any bargain sale does not have the effect of removing from the estate property of the type (or the amount) that would make the otherwise eligible estate ineligible for this treatment. With careful planning, the bargain sale can achieve the desired tax results.

V. Policy Considerations

Basis is fundamental to all of tax law, but it is generally underappreciated as a stand-alone "asset" for estate planning purposes. Given the increases in the wealth transfer tax exemption, income tax basis should not be ignored. It presents many opportunities for tax planning (and savings), especially in the context of donative transfers. Query whether there is any policy reason for treating transactions differently, depending on the identity of the donee-purchaser (e.g., an individual or a charity). The most obvious rationale is that because charities are, for the most part, tax-exempt organizations, the regulations are written in a way that forces greater gain recognition, if any, on the initial transfer by the donor-seller to the donee-purchaser. Otherwise, when the charity later sells the same property, regardless of whether the fair market

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62 See, e.g., I.R.C. § 6166(g). See generally HOWARD M. ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS DURING LIFE: ANALYSIS WITH FORMS § 2.05 (5th ed. 2019); Blattmachr et al., supra note 54 (exploring the complexities of an election under section 6166).

63 In 2017, prior to the enactment of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 [hereinafter the TCJA], the amount that any individual could transfer tax-free, cumulatively during lifetime and at death, was $5.49 million. This amount was to be adjusted for inflation every year by reference to the Consumer Price Index. I.R.C. § 1(f)(3) (2014). The TCJA increased the basic exclusion amount to $10 million. TCJA, § 11061(a), 131 Stat. at 2091 (codified at section 2010(c)(3)). The TCJA also changed the determination of the inflation adjustments with reference to the Bureau of Labor Statistics' Chained Consumer Price Index for All Urban Consumers. Id., § 11002(b), 131 Stat. at 2059; see U.S. BUREAU OF LABOR STATISTICS, CHAINED CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS (C-CPI-U), U.S. BUREAU OF LABOR STATISTICS, https://www.bls.gov/cpi/additional-resources/chained-cpi.htm [https://perma.cc/WS58-MMTX]. In 2020, the estate and gift tax exemption is $11.58 million per individual. See Rev. Proc. 2019-44, 2019-47 I.R.B. 1093 (announcing a variety of indexed limitations, including the basic exclusion under section 2010). For a discussion of the importance of basis in estate planning, see Jonathan G. Blattmachr & Madeline J. Rivlin, Searching for Basis in Estate Planning: Less Tax for Heirs, 41 EST. PLAN. 3 (Aug., 2014).
value of the property has increased, decreased, or remained the same, the government will collect the same amount of revenue: none. In contrast, in the case of a part sale/part gift to an individual, the same economic imperative to tax the initial transaction does not exist. Regardless of the price at which the property is sold by the donee-purchaser, the donee is subject to income tax, and all of the gain (or loss) on the transaction will be captured by the tax system, albeit at a later point in time than if the rules for bargain sales to a charity applied. Nevertheless, the individual donee-purchaser may be in a lower income tax bracket than the donor-seller, so there may be some revenue loss to the government.

In short, the government “loses” by continuing to maintain two sets of rules for bargain sales, based on the identity of the purchaser. A single rule for all such transactions would be more logical, likely increase government revenue (albeit modestly), and eliminate the need for individual donee-purchasers to track the carryover basis of the donor-seller. It should be possible for the Treasury to implement such a rule by revising the regulations.

VI. Conclusion

The bargain sale transaction exists because the human impulse to give is often tempered by a desire to reap some financial reward. There is no reason, though, to have two sets of rules based on whether the transferee is an individual or a charitable organization. Adopting unitary rules is clearer and serves the purposes of tax administration. In the meantime, income tax basis remains a ripe area for estate planning.