

In the

ORIGINAL

Supreme Court of the United States

VICTOR P. DIEDRICH ET UX.,)	
)	
Petitioners)	
)	
v.)	NO. 80-2204
)	
COMMISSIONER OF INTERNAL REVENUE)	

Washington, D. C.

February 24, 1982

Pages 1 thru 45

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Washington, D. C.
Wednesday, February 24, 1982

The above-entitled matter came on for oral
argument before the Supreme Court of the United States
at 11:10 o'clock a.m.

APPEARANCES:

NORMAN E. BEAL, ESQ., Kansas City, Missouri; on behalf
of the Petitioners.
STUART A. SMITH, ESQ., Office of the Solicitor General,
Department of Justice, Washington, D. C.; on behalf of
the Respondent.

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P R O C E E D I N G S

CHIEF JUSTICE BURGER: We will hear arguments next in Diedrich against the Commissioner of Internal Revenue.

Mr. Beal, I think you may proceed whenever you are ready.

ORAL ARGUMENT OF NORMAN E. BEAL, ESQ.,
ON BEHALF OF THE PETITIONERS

MR. BEAL: Mr. Chief Justice, and may it please the Court, this is an income tax case involving a commonly used estate planning device called a net gift. The issue presented is whether or not the donor of a gift made subject to the condition that the donee pay the resulting gift taxes realizes taxable gain to the extent the gift taxes paid by the donee exceed the donor's adjusted basis in the property transferred.

For the purposes of our brief and in this argument, I will define a net gift as a transfer by gift of property subject to a condition that the donee make payment of the resulting gift taxes. The term net gift does not refer to any other conveyance of property subject to an indebtedness or an obligation. The sole obligation assumed by the donee is the discharge of the gift taxes.

There are two cases before the Court at the

1 present time, both here on a writ of certiorari to the
2 Eighth Circuit Court of Appeals. Both cases had been
3 decided by the United States Tax Court favorably to the
4 taxpayer. The Eighth Circuit reversed both taxpayer --
5 both decisions in favor of the taxpayer, and found for
6 the government.

7 I was personally responsible for the Grant
8 case. There are no material factual variances between
9 the two cases, and I will state the facts with reference
10 to that particular case.

11 In 1970 and 1971, Frances G. Grant made
12 separate gifts of BMA Corporation securities to her son,
13 subject to the condition that he pay the resulting gift
14 taxes. The first gift was made in December of 1970, the
15 second in January of 1971. The total value of the
16 property covered by the two transactions was
17 approximately \$1 million, and the total gift taxes
18 involved on the transfers was \$232,000. That payment
19 was made by Mrs. Grant's son in April, 1971.

20 The securities that were transferred in Mrs.
21 Grant's hands had a basis of approximately \$9,000 for
22 federal income tax purposes. Upon audit of Mrs. Grant's
23 return, the Commissioner of Internal Revenue asserted
24 that the transfers, the net gift transfers that she had
25 made resulted in a taxable gain in that they constituted

1 a part sale and part gift transfer, that she was
2 entitled to capital gain treatment on the transaction,
3 and that her gain was the difference between the gift
4 taxes paid of \$232,000 and her basis of \$9,000, or
5 approximately a \$223,000 capital gain.

6 Her taxable income was increased by \$110,000,
7 and an additional \$70,000 or so of income taxes were
8 assessed against her.

9 QUESTION: Suppose at the time of the gift,
10 Mr. Beal, the father said, here's this gift I am going
11 to give you, and with gifts of that size he is likely to
12 have very good legal counsel, and he says to his son,
13 our lawyers tell us the gift tax on this is going to be
14 \$232,000 or whatever, and in addition to the gift, here
15 is a check for \$232,000 to pay the gift tax when it
16 comes due. What about that?

17 MR. BEAL: In that instance, Your Honor, there
18 would be a gift of \$232,000 of corporate securities, and
19 there would be an additional gift -- I'm sorry. There
20 would be a gift of corporate securities of whatever
21 value, and there would be an additional gift of the
22 \$232,000. The using --

23 QUESTION: What is the legal difference
24 between the hypothetical and the case before us?

25 MR. BEAL: Well, in -- I don't believe there

1 is any difference. The using of the \$232,000 in cash by
2 the donee to pay off the gift taxes wouldn't, I don't
3 think, even under the Commissioner's theory, result in
4 any income tax consequences to the donor. It is only in
5 the instance where adequate cash to pay off the gift
6 taxes is not transferred that the government asserts
7 that there has been an income tax consequence incurred
8 on the gift.

9 If we had \$1 million of cash paid over subject
10 to that same condition, without question, there would be
11 no assertion of an income tax consequence, and in our
12 view, it is not because there is no gain to the taxpayer
13 upon the transfer of the money, but it is simply because
14 it was not a taxable transaction from an income tax
15 standpoint to start with.

16 Preliminarily, I would like to point out that
17 the Tax Court in both cases specifically found that the
18 aggregate of the property in Mrs. Grant's case, the
19 \$90,000, was conveyed to her son by gift. That factual
20 finding is included in the record. The case did go on a
21 motion. The finding was made by the court in ruling
22 upon the motion.

23 The government's contention is that the intent
24 of Mrs. Grant to make or not make a gift is completely
25 beside the point, and that in effect a rule of law must

1 be imposed that when the gift taxes are discharged by
2 the donee without regard to the other circumstances, an
3 income tax may be payable.

4 The net gift transfer as it relates to income
5 tax consequences came up in the court of appeals for the
6 first time in 1969, in a decision by the Sixth Circuit,
7 Turner versus Commissioner. In that particular case,
8 gifts had been made on a net basis into trusts, and also
9 outright to an individual, and the Commissioner conceded
10 that the transfers to the trusts were not part sale
11 transactions, but asserted that the gifts to the
12 individuals were part sales and partly in gift, and
13 attempted to assess an income tax on the payment of the
14 gift taxes by the individual. The Sixth Circuit found
15 for the taxpayer in that particular case.

16 The next decision from the courts of appeals
17 was Estate of Davis versus Commissioner, decided by the
18 Fifth Circuit in 1974. Again, the Commissioner's theory
19 was part gift, part sale, and again it was rejected by
20 the Tax Court, and the Tax Court's decision was affirmed
21 on a procurium by the Fifth Circuit.

22 The next decision in the courts of appeals was
23 rendered by the Fourth Circuit in 1978, in Hirst v.
24 Commissioner. A three-judge panel of the court
25 initially decided the issue in favor of the government.

1 A motion for rehearing was filed, granted, and in a four
2 to three decision the Fourth Circuit again determined
3 that there was no net gift -- there was no income tax
4 consequence to the donor of a net gift. The decision in
5 that case was written for the majority by Chief Judge
6 Hainesworth.

7 The Diedrich decision, which is the case
8 before us, is the first instance in which a court has
9 found that the net gift transfer results in an income
10 tax consequence -- results in a taxable gain upon the
11 payment of the gift taxes.

12 There has been a subsequent ruling made by the
13 Sixth Circuit in Owen v. Commissioner. In that
14 instance, a three-judge panel found for the taxpayer on
15 the basis of the Turner decision by the Sixth Circuit
16 earlier. A motion for rehearing in that case was
17 granted, and the opinion has been vacated, and that case
18 along with several others are being held in abeyance by
19 the Sixth Circuit pending a decision in this case.

20 QUESTION: Mr. Beal, would you agree with the
21 Solicitor General that for some 25 years the
22 Commissioner has consistently said that such a
23 transaction is subject to income tax --

24 MR. BEAL: No, I do not. In 1953, Estate of
25 Staley was tried, I believe in the Fifth Circuit, and in

1 that particular case, property had been transferred into
2 a trust with a reservation by the donor of sufficient
3 income to pay the gift taxes. The Commissioner asserted
4 that he had retained an income interest in the trust
5 that was taxable to him under the trust provisions of
6 the Internal Revenue Code as ordinary income. The
7 taxpayer, on the other hand, said, I did not retain an
8 income interest in that trust, I made a sale in part of
9 the property into the trust, exactly the theory that is
10 now the basis of the claim in this case. And the
11 government opposed that theory, and it was decided that
12 the part gift, part sale rationale did not apply.

13 In 1957, the --

14 QUESTION: What case was that?

15 MR. BEAL: That was Estate of Davis.

16 QUESTION: Davis, yes.

17 MR. BEAL: No, I am sorry, Estate of Staley.

18 QUESTION: Staley. Staley.

19 MR. BEAL: And I don't have the cite. I can
20 give it to you --

21 QUESTION: No, that's all right. What is the
22 next one you were going to talk about?

23 MR. BEAL: The next one that I am going to
24 refer to is a revenue ruling by the Commissioner which
25 is cited in the amicus brief, Revenue Ruling 57-564, and

1 in that instance, the Commissioner himself responded to
2 the following request. Advice has been requested with
3 respect to the federal income tax consequences to a
4 donor pursuant to a trust instrument requiring the donee
5 to pay the federal gift tax on a gift of such stock. He
6 was replying to a request for an opinion on the federal
7 income tax consequences.

8 Again the Commissioner ruled that there was a
9 retention under these circumstances of an income
10 interest which was taxable, and there is no suggestion
11 whatsoever that there is another tax consequence, that
12 there is perhaps also or in lieu of the reservation of
13 an interest a capital gain consequence.

14 In the Turner case itself, the Commissioner
15 made the part gift, part sale argument, and insofar as
16 we can tell, I was able to check, there was no petition
17 for cert filed requesting a review of that decision.

18 QUESTION: Let me ask you about my
19 understanding of the present situation. If the donee
20 pays the gift tax, the amount that the donee pays for
21 the tax is added onto the basis of the property in the
22 hands of the donee. Is that correct?

23 MR. BEAL: That is correct.

24 QUESTION: And to that extent no capital gains
25 tax or other income tax would ever be levied on that

1 incremental add-on to the basis.

2 MR. BEAL: That is correct.

3 QUESTION: Okay. What is the consequence if
4 the donor pays the gift tax? Is that same amount added
5 to the donee's basis when the donee gets it?

6 MR. BEAL: Yes, it is. The stepup in basis
7 for the amount of gift taxes paid occurs in both
8 instances.

9 QUESTION: Yes.

10 QUESTION: But Mr. Beal, the stepup occurs,
11 but isn't it true that in your case -- what is the
12 basis? I will ask you. What do you understand the
13 basis in the donee's hands of the -- in this case?

14 MR. BEAL: In our case, the basis of the stock
15 in the donee's hands would be the donor's basis
16 increased by the amount of the gift taxes.

17 QUESTION: So in other words it would be
18 \$9,000 plus \$232,000.

19 MR. BEAL: That's correct.

20 QUESTION: Under the government's view, as I
21 understand it, it is 232 plus another 232. Is that
22 right?

23 MR. BEAL: That's correct.

24 QUESTION: So there's a difference between you
25 as to -- between the two of you as to what the proper

1 basis is in the donee's hands.

2 MR. BEAL: Right, and that is because the
3 government wants to --

4 QUESTION: Because they treat that as a sale
5 to the extent of 232.

6 MR. BEAL: Exactly.

7 QUESTION: And then -- but you agree that
8 under their view, you get both the 232 as purchase price
9 plus the 232 in the form of gift tax.

10 MR. BEAL: Yes, Your Honor, I do.

11 QUESTION: I understand.

12 QUESTION: Counsel, be sure to stay as near to
13 the microphones as you can.

14 MR. BEAL: I am sorry.

15 I want to at this point -- I had better make
16 another point before I slip by it. I have been accusing
17 the government of the part gift, part sale rationale,
18 and in all fairness, the government no longer makes that
19 contention. The government no longer asserts that the
20 essence of the transaction is a sale in part of the
21 securities but claims that the payment of the gift
22 taxes, that particular aspect of the transaction is the
23 taxable event for federal income tax purposes.

24 We have a potential, it seems to me, of three
25 points in time at which we could find there to be a

1 taxable event: when the agreement is made, when the
2 condition is imposed and the donee says, I agree to
3 that; when the property itself is conveyed subject to
4 the obligation to pay the gift taxes; or at the time of
5 payment of the gift taxes, and it is this latter point
6 in time that the government now asserts results in a
7 gift tax -- or an income tax consequence, based upon the
8 decision of this Court in Old Colony, in Old Colony
9 Trust Company versus Commissioner in 1929, in which the
10 payment of an individual's income tax by his employer
11 was found to be additional compensation.

12 QUESTION: And straight income.

13 MR. BEAL: Yes. Ordinary income to him, just
14 as though his salary had been paid -- in fact, his
15 salary was partly paid in the form of money paid over to
16 the Treasury.

17 QUESTION: Why shouldn't that have been the
18 result here, under the government's theory?

19 MR. BEAL: Because in that -- in the Old
20 Colony case, there is a taxable transaction for income
21 tax purposes. And the decision in that -- in that case
22 only is that the manner in which the compensation is
23 paid is immaterial. In this particular instance, we
24 submit that there has not been --

25 QUESTION: I know you submit, but how about

1 the -- on the government's theory that paying off
2 somebody's obligation results in income. That is
3 their --

4 MR. BEAL: I -- I --

5 QUESTION: Why shouldn't it be ordinary income?

6 MR. BEAL: The government's theory that it is
7 not ordinary income is that it is a gain from dealing in
8 property, and therefore subject to the favorable
9 treatment of capital gains --

10 QUESTION: Well, then, what if it were cash?

11 MR. BEAL: Oh, if it were cash, the government
12 would let us go free, without --

13 QUESTION: Why? Why would that -- if they
14 rely on Old Colony?

15 MR. BEAL: The statement --

16 QUESTION: You would think it wouldn't be a
17 dealing in property, it would be a dealing in money.

18 MR. BEAL: The statement in --

19 QUESTION: And it should be ordinary income.

20 MR. BEAL: The statement --

21 QUESTION: Under the government's theory. I
22 understand your theory, but --

23 MR. BEAL: Mr. Smith would have the answer to
24 that.

25 QUESTION: Well, I will have to ask Mr. -- I

1 will ask Mr. Smith. He is very good at explaining it.

2 MR. BEAL: In his brief, he only states that
3 it is tantamount to giving the tax money to the taxpayer
4 and having him tender it, which is tantamount to the
5 same transaction we are dealing with. I would like to --

6 QUESTION: Mr. Walter, normally when a person
7 is said to realize a taxable gain, when someone else
8 pays off his debt or discharges his liabilities, now,
9 how does this differ from that?

10 MR. BEAL: Okay.

11 QUESTION: Except that you have the Turner
12 case and its progeny. However, this Court has never
13 ruled on that.

14 MR. BEAL: The discharge of indebtedness in
15 connection with a transfer of property really is based
16 upon Crane versus Commissioner, in which a sale of
17 property was made subject to a non-recourse mortgage,
18 and the taxpayer received some boot. The Supreme Court
19 held in that case that the mortgage which was on the
20 property at the time she acquired it was not deducted in
21 determining her basis in the property.

22 Under federal estate tax law, she had a fair
23 market value basis. The mortgage that it was subject to
24 was not deducted, so she had a basis of \$260,000
25 roughly. When she conveyed that property to another

1 person in a sale transaction, the government asserted
2 and the court found that the basis -- I'm sorry, that
3 the non-recourse indebtedness was a part of what she
4 received.

5 The difference between the cases is this.
6 Number One, there has been in the mortgage encumbrance
7 case, the pre-existing indebtedness case, a realization
8 by the taxpayer of a portion of the value of the
9 property which the taxpayer is free to use or do with as
10 he or she pleases. In the net gift case, there never is
11 a pre-existing obligation, and there never is an
12 instance in which the taxpayer has a right to receive
13 any cash to do with as the taxpayer pleases.

14 When you encumber property, you in effect
15 withdraw a portion of the value of that property, and
16 the cash that you get in that manner can be used for
17 whatever purpose you choose. That in our opinion is the
18 difference between the Crane type transaction and the
19 net gift involved here.

20 QUESTION: If the donee were to pay the amount
21 of the gift tax plus \$100, how should that \$100
22 additional amount be treated for tax purposes?

23 MR. BEAL: That would clearly be a taxable
24 amount to the party. That has -- the receipt of that
25 consideration would represent a conversion of that asset

1 into cash, at least to that extent.

2 QUESTION: Taxable at capital gains rates,
3 presumably?

4 MR. BEAL: Yes, it would be.

5 QUESTION: Could you tell me why would a donor
6 structure his gift this way rather than himself making a
7 net gift? Say he is thinking of depleting his estate by
8 the amount of \$1 million, and he says the gift tax on
9 this is going to be \$200,000, so I will give the donee
10 \$800,000 and pay the tax. Now, why does he not do it
11 that way rather than give the donee \$1 million and ask
12 him to pay the tax?

13 MR. BEAL: Two reasons.

14 QUESTION: Yes.

15 MR. BEAL: The first reason, and the one that
16 applies in the Grant case, is that the donor does not
17 have sufficient cash to pay the gift taxes herself, and
18 she did not want to make a sale. The family as a unit --

19 QUESTION: Why didn't she want to make a sale?

20 MR. BEAL: Because the --

21 QUESTION: Because it would precipitate some
22 capital gains tax?

23 MR. BEAL: Well, that is not true in the Grant
24 case. It was because control of BMA Corporation was
25 held, effective control of it was held by the Grant

1 family, and they were not about to let any of that stock
2 out of their hands --

3 QUESTION: I see. I see.

4 MR. BEAL: -- if possible not to.

5 QUESTION: So the donee would maybe have the
6 cash.

7 MR. BEAL: And he could arrange for the cash
8 himself, and he could arrange to service the debt. The
9 first case involved a farm which the parties didn't --
10 three pieces of land that they didn't want to sell.

11 QUESTION: So he can raise the money on the
12 farm.

13 MR. BEAL: Right, and she was not in a
14 position to service the debt.

15 QUESTION: So what is the other reason?

16 MR. BEAL: The second reason is that if a sale
17 of the property is going to take place in any event, and
18 the donee, the recipient is in a lower --

19 QUESTION: Tax bracket.

20 MR. BEAL: -- tax bracket, the sale of that
21 property in his hands results in a lesser tax.

22 QUESTION: Yes.

23 MR. BEAL: The overall income tax consequences
24 is lower.

25 QUESTION: The basis remains -- there is no

1 basis difference. It is just a -- it's a bracket
2 difference.

3 MR. BEAL: Exactly right, and the problem that
4 I have just -- that you point out is true of an ordinary
5 gift.

6 QUESTION: Yes.

7 MR. BEAL: If the donor has enough cash to pay
8 the tax and gives the stock to a donee who immediately
9 sells it, with the exception of trusts, which are under
10 a certain -- a separate rule, they get the advantage of
11 the lower tax bracket.

12 QUESTION: Well, isn't there a new statute
13 that limits the bracket advantage?

14 MR. BEAL: For trusts. For transfers into
15 trusts and sales which are made within two years after
16 the transfer has been made, they in effect tax those as
17 though the sale had been made by the donor.

18 QUESTION: But not in a situation like this.

19 MR. BEAL: No, not in an outright -- not in a
20 net gift to an individual.

21 QUESTION: Yes.

22 MR. BEAL: Or an ordinary gift to an
23 individual, a bracket advantage would not be picked up.
24 That is -- we assert there is Congressional recognition
25 of only a limited necessity of adjusting on the bracket

1 advantage.

2 I would like to give two examples, very
3 quickly, on how this would operate in practice. Let's
4 assume that we have two taxpayers, A and B, each with \$1
5 million in corporate securities which they want to
6 transfer to their sons, who are running the businesses,
7 as was the case in Grant; that Taxpayer A has a \$300,000
8 basis in the property, and Taxpayer B has a \$100,000
9 basis in the property; and that the taxes, the gift
10 taxes imposed in each instance are \$200,000.

11 Under the government's theory of taxation in
12 this case, Taxpayer A, who has a \$100,000 basis in that
13 property, realizes a \$100,000 capital gain, the
14 difference between the \$200,000 gift taxes paid by the
15 donee and her \$100,000 basis in the stock.

16 Taxpayer B, who has a \$300,000 basis, realizes
17 a \$100,000 capital loss as a result of that transaction,
18 which may or may not be recognizable through her return,
19 but nevertheless it is a realized loss.

20 We submit that there is no policy of the
21 Internal Revenue Code or the gift tax laws that dictates
22 that that result should occur with two taxpayers who
23 have exactly the same motivation for entering into the
24 transaction.

25 QUESTION: But the premise of your

1 hypothetical is that the tax law is always a logical
2 structure --

3 (General laughter.)

4 QUESTION: -- and that is hardly the case. It
5 is an arbitrary one, of necessity, isn't it?

6 MR. BEAL: Yes, it is.

7 QUESTION: And produces some very odd results
8 sometimes.

9 MR. BEAL: It can in instances, yes, very
10 definitely so, as Mrs. Grant found out in this instance,
11 when the Commissioner of Internal Revenue said, you owe
12 an income tax for having made a gift to your son. It
13 does -- the interpretation of it does result in strange
14 -- The next point I want to go to is the nature of the
15 gift tax, and why --

16 QUESTION: Suppose -- Before you go on, let me
17 try a hypothetical. I am not sure where this may be
18 relevant. Suppose in giving the gift to the son, said,
19 now, you pay the -- you pay the gift tax, but I can give
20 you reasonable assurance that next year, or very soon I
21 will reimburse you for whatever you paid with another
22 gift.

23 MR. BEAL: Well, under our view of the tax --

24 QUESTION: I don't mean that IRS knew about
25 this conversation, but suppose that was actually what he

1 did.

2 MR. BEAL: In that particular instance, the
3 government would tax us on the donee's payment of the
4 gift taxes, and would tax us again when he was
5 reimbursed --

6 QUESTION: As income?

7 MR. BEAL: No, in the second instance there
8 would be another gift tax imposed.

9 QUESTION: It would be a gift tax, yes. A
10 gift tax. And then you would have the same thing in a
11 diminishing pattern, wouldn't you?

12 MR. BEAL: Exactly. That's correct.

13 QUESTION: Under the pattern in this case
14 where the donee pays, on what amount does he pay a gift
15 tax on? The net?

16 MR. BEAL: The gift --

17 QUESTION: The net?

18 MR. BEAL: That's correct. The gift tax is
19 imposed upon the net amount. It is exactly as though
20 she had given only the extent of the difference between
21 the two.

22 I want to reserve the balance of my time.

23 CHIEF JUSTICE BURGER: Very well.

24 Mr. Smith.

25 ORAL ARGUMENT OF STUART A. SMITH, ESQ.,

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ON BEHALF OF THE RESPONDENT

MR. SMITH: Mr. Chief Justice, and may it please the Court, the question presented in this case involves, as Mr. Beal has pointed out, the income tax consequences to the donor of a gift of low basis property on the condition that the donee pay the resulting gift tax. In our view of the matter, the question implicates a fundamental principle of tax law deriving from both the statute and this Court's decisions.

Let me refer the Court, if I may, to Section 1001 of the Code, which is set forth at Page 5a of the appendix to our brief. Subsection (a) defines the computation of gain or loss as, "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis," et cetera, and Section -- Subsection (b) of that section says, "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property other than money received."

Now, this is very fancy statutory language for the very obvious proposition that if you buy something for a dollar and you sell it for \$1,000, your \$1,000 is your amount realized under Subsection (b) and your basis

1 is a dollar, and therefore your gain under Subsection
2 (a) is \$999.

3 Now, this case, in our view, is really nothing
4 more than that transaction dressed up in lawyers'
5 language. Here the taxpayers in both cases had property
6 which -- for which they paid a very small amount. It
7 was family corporation stock. In one case the basis was
8 just a dollar a share, and in the other case it was also
9 a very small amount.

10 They decided to give the stock to objects of
11 their bounty, children, what have you, and as the Court
12 knows from the recent opinion yesterday, there is a gift
13 tax that complements the estate tax. So there is a gift
14 tax due, and the Code is very precise that the
15 obligation to pay the gift tax is on the donor.

16 Section 2502(d), which is set forth at Page 8a
17 of our appendix, says very explicitly, "The tax imposed
18 by Section 2501" -- that's the gift tax -- "shall be
19 paid by the donor." So the donors in this case, in
20 these cases, the taxpayers, had a gift tax obligation.
21 Now, how is it -- how is it arranged? It was arranged
22 that the transfer would be made on the condition that
23 the donees would pay the resulting gift taxes.

24 Now, in our view, this payment of the gift tax
25 by the donees is an amount realized just as if the -- in

1 economic terms, the donors sold the property to the
2 donees for the amount of the gift taxes, because indeed
3 it -- these transfers were made on the condition -- that
4 is very important here, that they were made on the
5 condition that the donees pay the gift taxes, and in
6 fact, really explains Justice White's query as to why
7 these -- why this amount is tied in with sale or
8 exchange. It is tied in with sale or exchange
9 principally because it is really an inextricable part of
10 the transaction. I am going to give you this property,
11 and you are going to pay a sum of money that I owe X.
12 In this particular case, X happens to be the Internal
13 Revenue Service, but it could well be the grocer --

14 QUESTION: That isn't the question I asked, is
15 it?

16 MR. SMITH: I thought --

17 QUESTION: I understand your theory for saying
18 that there is a capital gain in this case, but what
19 about when there is money?

20 MR. SMITH: Well --

21 QUESTION: When there is money, and he says to
22 the donee, please pay the tax, and he does, and
23 theoretically I thought your argument was that when he
24 does that, he is paying off an obligation of the donor.

25 MR. SMITH: Well, indeed --

1 QUESTION: And is he? Is he?

2 MR. SMITH: He is.

3 QUESTION: And do you say there is an income
4 consequence then?

5 MR. SMITH: He is, but the view of the
6 transaction -- these transactions that has been
7 developed by the Commissioner over the year -- over the
8 years, and indeed it is for a very long time -- We take
9 issue with Mr. Beal's protestation that this is some new
10 development. This is really an old development. But
11 the view is that the consideration for the transfer was
12 the payment of the gift tax.

13 Now, indeed, if I were to say, if the
14 transaction would be A just gives the money, gives the
15 stock to B, and then later on there is this gift tax,
16 and no one knew about it at the time, and then A -- and
17 then A says, gee, I don't have the money to pay this,
18 and B says, well, I am going to --

19 QUESTION: I know, but --

20 MR. SMITH: -- I am going to pay it --

21 QUESTION: -- the donor, the donor -- As you
22 say, let's remember this very important condition.

23 MR. SMITH: Um-hm.

24 QUESTION: The donor gives some money.

25 MR. SMITH: Um-hm.

1 QUESTION: And he says, on condition, however,
2 that you pay the gift tax that is due on this gift.

3 MR. SMITH: Oh, I see. Well, that's -- that's
4 a variation on the transaction.

5 QUESTION: Well, then, but Mr. Beal says that
6 you would -- you would not say that the donor had any
7 income tax on that.

8 MR. SMITH: Well, if the donor -- if the donor
9 just gives the donee money to pay --

10 QUESTION: He gives him \$1 million on
11 condition that the donee pays the gift tax. That is
12 what he does. Just like in this case.

13 MR. SMITH: Well, of course, then -- then you
14 don't have -- well, I think we advert to that in --

15 QUESTION: Well, is there -- does the
16 government there, then say that the donor realizes no
17 income?

18 MR. SMITH: No, there would be no -- there
19 would be no income if the donee -- if the donee -- if
20 the donor, excuse me, gives the donee a sum of money and
21 says, here, you pay the gift tax out of it. Well, of
22 course, that is really equivalent to the donor paying
23 his gift taxes. It is really just a kind of a
24 circuitous way of -- if you give someone \$1 million and
25 say, there will be gift taxes --

1 QUESTION: And you think that -- you think
2 that is quite distinguishable from this case?

3 MR. SMITH: Oh, absolutely, because here you
4 have a situation where you have appreciated property --

5 QUESTION: Well, the Tax Court certainly
6 doesn't think so.

7 QUESTION: Isn't that the key to it, that the
8 basis in the cash is not a very small amount?

9 MR. SMITH: Well, there is --

10 QUESTION: The basis in cash.

11 MR. SMITH: The basis in cash is just --

12 QUESTION: Just the amount of the cash.

13 MR. SMITH: -- is just the amount of the
14 cash. The way we view this transaction, and I think it
15 is quite appropriate in statutory terms, is that A
16 decides to give appreciated stock to B on the condition
17 that B pay his gift taxes. He could have said, B,
18 please pay my grocer, and B then dutifully says, well,
19 how much is it, and it is \$200,000, and that's an amount
20 realized on the transfer, and that has to be netted out
21 against the donor's basis in the property, and that is
22 in one case \$51,000, and the amount realized is the
23 amount of the gift taxes. That is just like a purchase
24 price, essentially.

25 QUESTION: You mean, exactly as if he said, I

1 will sell you the \$1 million worth of stock for \$232,000?

2 MR. SMITH: Exactly. Exactly. It is part,
3 you know -- there are a lot of slogans that have --

4 QUESTION: But that is --

5 MR. SMITH: Exactly.

6 QUESTION: You say the transactions are no
7 different.

8 MR. SMITH: The transactions are no different,
9 and indeed in economic terms it is exactly what it is.
10 I have this stock, and I am going to give it to you if
11 you -- for \$200,000, but please, don't give it to me
12 because the Commissioner of Internal Revenue is waiting
13 here in the wings, and I would like you to give it to
14 him. Now, the teaching of Old Colony is really a
15 helpful --

16 QUESTION: But not very relevant to this
17 theory.

18 MR. SMITH: Well, it -- well, it is -- it is
19 relevant.

20 QUESTION: Well, if it were, you would -- you
21 would -- in the cash transaction, you would have income
22 tax consequences.

23 MR. SMITH: Well, that's -- that's true, but
24 the point is, the way I would view that cash
25 transaction, it's as if the donor pays the tax. In

1 fact, if I may refer the Court to Footnote 21 of our
2 brief at Page 30, where we discuss the Krause case, in
3 which the Tax Court stated there that if the donor had
4 transferred cash in the amount of the gift tax, the use
5 of the cash for the discharge of the gift tax liability
6 would have not generated any taxable income. This is
7 true enough. But the donor's transfer of tax is
8 tantamount to his paying the gift tax himself. That is
9 the view. I think it is a sound view of the
10 transaction. This is not that transaction. Now --

11 QUESTION: Mr. Smith, do you concede, though,
12 that the intent of the donors in these cases was to make
13 a gift, not a sale?

14 MR. SMITH: Yes, I am sure that the intent of
15 the donors here was to make a gift, but in our view,
16 that intent is irrelevant. The economic objective,
17 economic consequences of the transaction have to be
18 viewed objectively. One commentator has put it really
19 quite succinctly in a way that the court of appeals has
20 quoted. He has said, "Terming the transaction a net
21 gift does not alter the fact that despite the
22 transferor's intention, he is actually transferring the
23 entire property and receiving something in return. His
24 intent that the transferee receive only a portion of the
25 value of the property cannot eliminate that essential

1 fact of economic life."

2 In our view, subjective intent is simply not
3 relevant here, and I think that -- you know, that kind
4 of argument is well known to this Court's jurisprudence.
5 As long ago as 22 years ago, really, in Commissioner
6 versus Duberstein, a celebrated tax case, the Court
7 said, it scarcely needs adding that the parties'
8 expectations or hopes as to the tax treatment of their
9 conduct in themselves have nothing to do with the
10 matter, and in our view --

11 QUESTION: But that is not the same question
12 as the parties' intent in engaging in the transaction
13 without respect to tax consequences. I mean, one can
14 have an intent to make a gift --

15 MR. SMITH: Oh, sure, sure, sure.

16 QUESTION: -- quite apart from one's
17 expectations --

18 MR. SMITH: But I think that in this
19 particular case, to say that, well, gee, all I wanted to
20 do was to give a gift, and I didn't think that I was
21 going to have to have income tax consequences, I didn't
22 think of this as an income taxable transaction, I think
23 that that is a level of unsophistication that really
24 just doesn't wash with respect to -- I mean, I don't
25 think that has any relevance in determining what the

1 income tax consequences are of the transaction.

2 I suspect that Mrs. Crane in the Crane case
3 had no idea when she stepped away from her house for a
4 very small amount of cash and had the buyer assume a
5 mortgage, and she really didn't have very much, that she
6 in fact wound up having really a large taxable gain.
7 It's the same sort of thing.

8 I mean, one can only think of a case that this
9 Court had several years ago, Commissioner versus Gordon,
10 which involved a very complicated spinoff transaction,
11 in which the court of appeals had analyzed it in much
12 those terms. Well, gee, you know, they just had pieces
13 of paper in one corporation, and then they had them in
14 another, and nothing really very much happened, and this
15 Court very sharply said that these are statutory
16 questions that have to be -- these transactions have to
17 be measured against statutory language.

18 And here, in our view, the concept of amount
19 realized, and here, you have a transaction in which
20 there is a transfer of property with a low basis for an
21 amount realized which is as real as anything. Paying
22 the donor's gift taxes in this -- in these cases is a --
23 confers a very real and substantial benefit that is part
24 of the consideration on the transfer.

25 QUESTION: Mr. Smith, why do you think the Tax

1 Court has been so persistently wrong over the years?

2 MR. SMITH: Well, this -- this is --

3 QUESTION: Whereas in yesterday's case you
4 felt it had been persistently right over the years.

5 (General laughter.)

6 MR. SMITH: Sometimes they are right, and
7 sometimes they are wrong. But -- Like all of us, I
8 suppose.

9 QUESTION: Yes, like the Commissioner.

10 MR. SMITH: Like all of us.

11 QUESTION: Perhaps the answer is that the
12 Commissioner's duty is to collect taxes, wherever he can
13 get them.

14 MR. SMITH: Well, that -- that is -- that is
15 true, but I think there -- there are explanations as to
16 why the -- why the Tax Court has gone astray here. If
17 you examine the Turner case, I think one of the things
18 that plagued the decision in that case was the
19 Commissioner's quite unwise conception that the
20 transfers to the trust in those cases didn't produce
21 gain, but that the transfers to the individual donees
22 did, and that involved quite a wrong theory that somehow
23 the trustees didn't have personal liability.

24 So, the Tax Court could naturally say at that
25 juncture, well, these transactions seem the same to us,

1 and if the trust -- if the transfers to the trust aren't
2 taxable, why should the transfers to the individuals be
3 taxable? Not an unsound reaction, quite frankly. So
4 the Commissioner lost these cases, and then they were
5 appealed, and I think the court of appeals really didn't
6 consider the cases in any detail, so now you have Turner
7 as a precedent.

8 QUESTION: Mr. Smith, has the Commissioner's
9 view been -- just been a case by case situation, or is
10 it -- is it reflected in any regulation or revenue
11 ruling?

12 MR. SMITH: It has been reflected in a long
13 string of rulings which we cite, since 1957, in our
14 brief, and it is also reflected in Section 1001-1(e) of
15 the regulations which we cite, which talk about
16 transfers of property and part sale and part gift. The
17 transferor has a gain to the extent that the amount
18 realized by him exceeds his adjusted basis in the
19 property, and that's exactly -- I mean, there are a lot
20 of slogans that come --

21 QUESTION: Of course, that regulation really
22 begs the question. The question is whether it is part
23 sale and part gift.

24 MR. SMITH: Well, that -- but I would submit
25 to you that it really is here, because --

1 QUESTION: Well, I understand. Your -- but
2 that is what the case is all about.

3 MR. SMITH: I would almost -- and the taxpayer
4 almost concedes that by saying, well, we only wanted to
5 give this certain amount. I mean, they have this very
6 convoluted retained interest theory, which really -- I
7 mean, Mr. Beal in his brief at one point says, well, you
8 know, the donor really held back some of the property,
9 that is what it is tantamount to, to pay the gift tax,
10 or the donee was paying it on behalf of the donor, but --

11 QUESTION: Actually, the -- and the -- I guess
12 you both agree, don't you, that in computing the tax you
13 measure the difference between the amount of the tax and
14 the value of the gift?

15 MR. SMITH: Right.

16 QUESTION: That is just --

17 MR. SMITH: In computing the gift tax. That's
18 right.

19 QUESTION: In computing the gift tax.

20 MR. SMITH: Right. Yes, there is a -- there
21 is a ruling which we agree is sound that has an
22 algebraic formula for the computation.

23 QUESTION: That raised this question with me.
24 You alluded to the possibility that the donor might give
25 the property to a member of the family, and they just

1 not think about the problem of paying the gift tax.

2 MR. SMITH: Um-hm.

3 QUESTION: In that situation, the gift tax
4 would have been larger, wouldn't it, if they just --

5 MR. SMITH: That's right.

6 QUESTION: And then supposing later on they
7 say, oh, my gosh, we didn't think about this, we don't
8 want Mother to pay the tax, and then the donee paid the
9 tax. What would happen in your view?

10 MR. SMITH: Well, I suppose on those kinds of
11 facts one could possibly raise an inference that there
12 was a gift back, but that is not this case, and it is
13 not the -- it is not the normal --

14 QUESTION: Then the payment of the tax might
15 be --

16 MR. SMITH: I mean, I think -- I think --

17 QUESTION: -- subject to gift tax rather than
18 income tax.

19 MR. SMITH: Right. I think careful counsel
20 would want to ensure that a donee, you know, if a donor
21 wanted to shed his liability to pay the gift tax and to
22 have it -- to have it assured that it would be paid, I
23 think careful counsel would make that a condition of the
24 sale -- I mean, of the transfer. And once that is made
25 a condition of the transfer, it seems to us that it

1 really is amount realized for the transfer, just as --

2 QUESTION: I understand. But your view would
3 be, if it is was not a condition of the sale, or the
4 transfer --

5 MR. SMITH: If it were not a condition of the
6 sale, it would be -- it might be --

7 QUESTION: -- then, if anything, the payment
8 of the tax by the donee would be subject to gift tax.

9 MR. SMITH: It might be a different case. In
10 fact, that was one -- that was really one of the strands
11 in the Hirst opinion in the Fourth Circuit. It was one
12 of the things that Judge Hainesworth said, that he
13 thought it was a gift back, but it really isn't. I
14 mean --

15 QUESTION: So your -- your --

16 MR. SMITH: -- whatever -- whatever that might
17 have been, and I take issue, because the record there
18 doesn't reflect any such, you know, any foundation for
19 such a speculation, here, with the conditions really
20 embedded in the agreement of the transfer, there really
21 is no basis for making -- for making such a --

22 QUESTION: So you are saying that the
23 Commissioner has put a reasonable construction on the
24 sale and exchange provision of the Code.

25 MR. SMITH: Yes.

1 QUESTION: And of his own regulations issued
2 under it.

3 MR. SMITH: Yes. I think that is perfectly
4 appropriate. This is a 25-year-old position. It is not
5 -- it hasn't been dreamed up yesterday, and it seems to
6 me absolutely sound, and I think the Commissioner's
7 persistence in this area is due to the fact that the Tax
8 Court has misconstrued this, and indeed, if -- if -- if
9 courts could step away and have the luxury of writing on
10 a clean slate, lower courts, I suspect the Tax Court
11 might have already changed its mind, and really, it is
12 that clean slate that this Court has an opportunity --

13 QUESTION: How do you respond to your opposing
14 counsel, Mr. Beal's explanation as to how the
15 Commissioner has not taken a consistent position for 25
16 years?

17 MR. SMITH: Well, Mr. Beal has -- Mr. Beal has
18 referred to another line of cases that we don't think
19 are -- is germane. He has referred to a line of cases
20 in which you have transfers to trust in which the donor
21 has the income of the trust, you know, paid to him to
22 pay the gift taxes. We have won some of those cases and
23 lost some of those cases on the basis of whether the
24 trust -- you know, the details of that kind of trust
25 obligation.

1 But those cases, really, were decided under
2 the so-called grantor trust provisions of the Internal
3 Revenue Code, Sections 671 through 677, which deal with
4 situations under what conditions a grantor of a trust
5 can be charged with income taxes on the income of the
6 trust, and of course in those instances where we have
7 won those cases, the grantor has -- or the donor has
8 been charged with ordinary income, because in effect it
9 is -- he is deemed to be the owner of the trust's income.

10 But those cases don't have -- those cases
11 don't signal any inconsistency. In fact, they simply
12 reflect the Commissioner's responding to the particular
13 kind of transaction.

14 Let me, if I may, you know, refer -- we quote
15 it in our brief in a footnote, but it is almost -- it is
16 almost worth setting it forth in just a few brief
17 sentences. In the Hirst case, which was the last major
18 pronouncement of the Tax Court in this matter, Judge
19 Raum wrote the opinion for the Tax Court, in which he
20 felt bound -- of course, the Tax Court, unless they are
21 going to overrule one of their old decisions, is bound
22 by them, and he felt bound by Turner and that progeny,
23 but he said at the end that if he were going to write on
24 a clean slate, they might really come out the other way
25 because of the torturous, myriad details of the

1 decisions in this area.

2 And he said, and I think with a good deal of
3 candor and sound analysis, "We recognize that there is
4 much force to the government's position. The gift tax
5 itself is imposed only upon the net gift, that is, upon
6 the gross amount of the property transferred minus the
7 gift tax paid by the donee. In substance, a portion of
8 the transferred property equal in value to the amount of
9 the gift tax is not treated as having been part of the
10 gift, but surely that portion did not vanish into thin
11 air, and a strong argument can be advanced for the
12 conclusion that it was exchanged for the donee's payment
13 of the gift tax on the net gift, a transaction that may
14 result in the realization of gain or loss depending upon
15 the donor's basis in the property."

16 We are making that strong argument here, and
17 this Court has the unique and weighty responsibility to
18 write on the clean slate that Judge Raum wishfully
19 opined that he had. And we urge that the court of
20 appeals in these cases reached the sound result and
21 should be affirmed.

22 QUESTION: If the property had depreciated in
23 value, and the donee agreed to pay some minor benefit to
24 the donor at the time of the transfer, would you let the
25 donor take a loss?

1 MR. SMITH: Whether the donor could take a
2 loss or not really depends upon other Code provisions.
3 While a loss might be realized in such a situation, not
4 every loss is deductible for income tax purposes. If I
5 may refer the Court to Section 165(c)(1) of the Code,
6 (c)1, 2, 3, which lists a number of losses, kinds of
7 losses that are not deductible. For example, if you
8 were to sell your personal residence at a loss, it would
9 not be a deductible loss. Indeed, there --

10 QUESTION: But, Mr. Smith, under your
11 regulation there is no loss, is there? Don't you
12 expressly --

13 MR. SMITH: Under the regulation, there is --
14 the regulation flatly says that there is no loss, but
15 without going into that, I can simply say that in this
16 particular case there would be no loss, in these
17 particular cases, and in the typical net gift
18 transaction there would be no loss, because Section 267
19 of the Code provides for a number of situations of
20 intra-family transfers in which there is no loss. If
21 you sell -- if a father sells property to a son, or any
22 collateral relative like that, listed in that Code
23 section, those losses are disallowed by statute.

24 So, there may be a loss for computational
25 purposes, but there may not be a loss which is permitted

1 to be recognized for income tax purposes.

2 Thank you.

3 CHIEF JUSTICE BURGER: Do you have anything
4 further, Mr. Beal? You have about four minutes. You
5 may complete before we rise.

6 ORAL ARGUMENT OF NORMAN E. BEAL, ESQ.

7 ON BEHALF OF THE PETITIONERS - REBUTTAL

8 MR. BEAL: Thank you very much.

9 Mr. Chief Justice, and may it please the
10 Court, I would like to hit a couple of things real fast.
11 The government is asking for a per se rule that any time
12 consideration is paid by a donee in connection with a
13 gift, the donor recognizes taxable gain to the extent
14 that consideration exceeds his adjusted basis in the
15 property.

16 Section 2512(d) of the gift tax code provides
17 that whenever property is transferred for less than an
18 adequate and full consideration in money or money's
19 worth, then the amount by which the value of the
20 property exceeded the value of the consideration shall
21 be deemed a gift. The Commissioner is asking in this
22 case that the corollary to 2512(d) be judicially adopted.

23 Congress saw fit and saw a necessity to adopt
24 a specific provision making a part -- making a sale in
25 part a gift in an instance where there was less than

1 full consideration. Congress did not see any necessity
2 to impose a similar income tax requirement in the
3 situation where a gift does involve some payment of
4 consideration by the donee.

5 If the -- if there was a necessity to adopt
6 2512(d) in the first instance, then there has to have
7 been a necessity, or it seems to us there is a necessity
8 for there to be a corollary code, corollary provision in
9 the Income Tax Code, and there is none.

10 Point Number Two. There is no tax abuse
11 involved in these transactions. The only thing that is
12 involved is a carryover basis which is a necessary part
13 of any gift transaction, and the -- and a potential for
14 deferral of capital gains or deferral of gain in the
15 hands of the donee, which is another integral part of a
16 gift transactions. Those aspects of an ordinary gift
17 are the only instances in which there is "any tax gain"
18 off of these transactions.

19 The third thing I want to hit is the nature of
20 the gift tax itself. The government, relying upon a
21 provision of the gift tax code, states that it is a
22 personal obligation of the donee. The estate tax code
23 and the gift tax codes are in pari materia. The
24 provisions -- the interpretations of one apply to the
25 other. The gift tax -- the estate tax code imposes the

1 estate tax on the executor in language that is
2 substantially identical to the language in the gift tax
3 code, yet I don't think even the government would
4 contend that in an instance where most of the property
5 transfers through joint tenancies or through trust
6 estates outside the probate estate, that we would impose
7 an income tax consequence on the executor because the
8 recipient of the property in the joint tenancy situation
9 or as a recipient from a trust made payment of that
10 federal estate tax.

11 That is exactly -- that is the corollary,
12 though, to the argument that the gift tax is the
13 obligation of the donor. The gift tax is a tax on the
14 transfer. It is an opportunity for the government to
15 take a portion of wealth that is moving from one
16 generation to another, and the importance of one party
17 paying it as opposed to another party doesn't have any
18 -- doesn't have anything to do with the underlying
19 policies for the gift tax and estate tax laws.

20 QUESTION: That might be a very good argument
21 to address to the Congress, the theory that you have
22 just advanced.

23 MR. BEAL: Well, it seems to me that that
24 theory is exemplified by the Congressional enactment of
25 two provisions imposing a tax on a particular person for

1 payment purposes, and yet in the one instance, when it
2 is really the corresponding tax, it is not in any
3 economic sense a tax of the executor. It's a tax on
4 that property that's going down by -- by a death
5 transfer, the movement of property from one generation
6 to another.

7 Thank you very much.

8 CHIEF JUSTICE BURGER: Thank you, gentlemen.
9 The case is submitted.

10 (Whereupon, at 12:02 o'clock p.m., the case in
11 the above-entitled matter was submitted.)

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CERTIFICATION

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VICTOR P. DIEDRICH ET UX v. COMMISSIONER OF INTERNAL REVENUE NO.80-2204

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BY Sharon Anne Connelly

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