BESSEMER TRUST

Estate of Bolles v. Commissioner, T.C. Memo. 2020-71

July 2020

Treatment of Advances to Son as Legitimate Loans vs. Gifts

Steve R. Akers

Senior Fiduciary Counsel
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
akers@bessemer.com
www.bessemer.com

Table of Contents

Synopsis 1
Basic Facts 1
Court Analysis 1
Planning Observations 2

Copyright © 2020. Bessemer Trust Company, N.A.

All rights reserved.

July 24, 2020

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Synopsis

The Tax Court addressed whether advances from a mother to her children (and particularly, over $1 million of advances to a struggling son) were legitimate loans or were gifts. Although the mother documented the advances, there were no loan agreements, security, or attempts to force repayment. She forgave the "gift tax exemption amount" of the debts each year. Large amounts were advanced to a struggling son ($1,063,333 over 23 years), and at some point, the mother realized that the son would never be able to repay the advances; on October 27, 1989**,** she prepared her revocable trust to exclude that son from any distribution of her estate at her death. The court treated advances through 1989 as loans, but treated subsequent advances as gifts. *Estate of Bolles v. Commissioner*, T.C. Memo. 2020-71 (June 1, 2020, Judge Goeke).

Basic Facts

A mother generally wanted to treat her five children equally. She made advances to her children, keeping records of the advances and "occasional repayments for each child," but there were no notes, no collateral, and no attempts to force repayment. She treated the advances as loans, but she "forgave the 'debt' account of each child every year on the basis of the gift tax exemption amount." The court observed that "[h]er practice would have been noncontroversial but for the substantial funds she advanced to Peter."

Peter was the oldest of the children. He took over his father's architecture practice. He experienced success in attracting clients but had financial difficulties largely because his expectations exceeded realistic results. A family trust became liable for $600,000 of his bank loans. Because of his financial difficulties, the mother advanced substantial funds ($1,063,333) to Peter from 1985 through 2007.

The mother prepared a revocable trust dated October 27, 1989 that "specifically excluded Peter from any distributions of her estate upon her death." She subsequently amended the revocable trust to permit Peter to share in her estate but only after accounting for "loans" made to him plus accrued interest. Peter signed an acknowledgement that $771,628 plus accrued interest using the AFR for short-term debt determined at the end of each calendar year, would be subtracted from Peter's share of the estate at the mother's death.

Presumably, the mother forgave some of the advanced amounts to Peter under her annual gift plan, and Peter apparently made some repayments on the loans through 1988, but the IRS asserted that the entire $1,063,333 amount, plus $1,165,778 of accrued interest, was an asset of the mother's gross estate or that $1,063,333 was an adjusted taxable gift to be included in computing her estate tax liability.

Court Analysis

Both parties pointed to *Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd*, 113 F.3d 1241 (9th Cir. 1997) for the traditional factors used to decide whether an advance is a loan or a gift:

> Those factors are explained as follows: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) actual repayment was made, (7) the transferee had the ability to repay, (8) records maintained by the transferor and/or the transferee reflect the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.
>
> These factors are not exclusive. See, e.g., Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992), aff'd, 3 F.3d 591 (2d Cir. 1993). In the case of a family loan, it is a longstanding principle that an actual expectation of repayment and an intent to enforce the debt are critical to sustaining the tax characterization of the transaction as a loan. Estate of Van Anda v. Commissioner, 12 T.C. 1158, 1162 (1949), aff'd per curiam, 192 F.2d 391 (2d Cir. 1951).

The court observed that the mother had recorded the advances and kept track of interest, but there were no loan agreements, collateral, or attempts to force repayment. A critical factor to the court was "that the reasonable possibility of repayment is an objective measure of [the mother's] intent." Peter's creative ability as an architect and ability to attract clients likely convinced the mother that he would be successful and "she was slow to lose that expectation." But she must have realized he would be unable to repay her loans by October 27, 1989, when her revocable trust blocked Peter from receiving additional assets from her at her death.

The court concluded that advances to Peter were loans through 1989 but after that were gifts. Also, the court "considered whether she forgave any of the prior loans in 1989, but [found] that she did not forgive the loans but rather accepted they could not be repaid on the basis of Peter's financial distress."

Planning Observations

a. **Significance Generally.** The IRS may treat the transfer as a gift, despite the fact that a note was given in return for the transfer, if the loan is not bona fide or (at least according to the IRS) if there appears to be an intention that the loan would never be repaid. (If the IRS were to be successful in that argument, the note should not be treated as an asset in the lender's estate.)

   A similar issue arises with sales to grantor trust transactions in return for notes. The IRS has made the argument in some audits that the "economic realities" do not support a part sale and that a gift occurred equal to the full amount transferred unreduced by the promissory note received in return. Another possible argument is that the seller has made a transfer and retained an equity interest in the actual transferred property (thus triggering § 2036) rather than just receiving a debt instrument.

b. **Gift Presumption.** A transfer of property in an intra-family situation will be presumed to be a gift unless the transferor can prove the receipt of "an adequate and full consideration in money or money's worth." Treas. Reg. §§25.2512-8; 25.2511-1(g)(1)("The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions ..."). *See Harwood v. Commissioner*, 82 T.C. 239, 258 (1984), *aff'd,* 786 F,2d 1174 (9th Cir. 1986), *cert. den.*, 479 U.S. 1007 (1986).

c. **Treatment as Bona Fide Loan.** In the context of a transfer in return for a promissory note, the gift presumption can be overcome by an affirmative showing of a bona fide loan with a "real expectation of repayment and an intention to enforce the collection of indebtedness." *Estate of Van Anda v. Commissioner*, 12 T.C. 1158, 1162 (1949).

   The bona fide loan issue has been addressed in various income tax cases, including cases involving bad debt deductions, and whether transfers constituted gross income even though they were made in return for promissory notes. *E.g.*, *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo. 2005-104 (no basis was established for assumption of debt that was not a bona fide indebtedness); *Todd v. Commissioner*, T.C. Memo. 2011-123, *aff'd*, 110 AFTR 2d ¶ 2012-5205 (5th Cir. 2012)(unpublished decision) (appellate decision emphasized post hoc note execution and that the loan was never repaid as supporting that the note was merely a formalized attempt to achieve a desired tax result despite a lack of substance).

   The *Bolles* court cited *Miller v. Commissioner*, which is often cited regarding whether transfers are treated as bona fide loans. It involved transfers made to a son in return for a non-interest-bearing unsecured demand note, and the *Miller* court analyzed in detail the nine factors that it listed. *Miller* cited a number of cases in which those same factors have been noted to determine the existence of a bona fide loan in various contexts, and those nine factors have been listed in various subsequent cases.

   A recent case addressing advances from a family limited partnership analyzed eleven factors that were important in determining whether the transfers were gifts or loans. *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40. *See also Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115 (detailed analysis of eleven bona fide loan factors as applied to transfers from an FLP).

d. **Other Transfer Tax Related Contexts in Which Loan Issue May Arise.**

   (1) **Sale-Leaseback and Whether §2036 Applies.** In *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2d Cir. 1993), a sale of property to the decedent's son for a note secured by a mortgage, with a retained use of the property under a lease, triggered inclusion under §2036. The court held that the sale-leaseback was not a bona fide sale where the decedent continued to live in the house and the purported annual rent payments were very close to the amount of the annual interest payments the son owed to the decedent on the note. The court observed that the rent payments effectively just cancelled the son's mortgage payments. The son never occupied the house or tried to sell it during

the decedent's lifetime. The son never made any principal payments on the mortgage (the decedent forgave $20,000 per year, and forgave the remaining indebtedness at her death under her will). The court concluded that the alleged sale was not supported by adequate consideration even though the mortgage note was fully secured; the note was a "façade" and not a "bona fide instrument of indebtedness" because of the implied agreement (which the court characterized as an "understanding") that the son would not be asked to make payments.

(2) **Estate Inclusion Under §§ 2033, 2035 and 2038 For Property Transferred Under Note That Is Not Respected.** In *Estate of Musgrove v. United States*, 33 Fed. Cl. 657 (1995), the decedent transferred $251,540 to his son less than a month before his death (at a time that he had a serious illness) in exchange for an interest-free, unsecured demand note, which by its terms was canceled upon the decedent's death. The court determined that the property transferred was included in the decedent's estate under any of §§2033, 2035, or 2038. The court reasoned that the promissory note did not constitute fair consideration where there was an implied agreement that the grantor would not make a demand on the obligation and the notes were not intended to be enforced.

(3) **Advances from FLP Treated as Distributions Supporting Inclusion of FLP Assets Under § 2036 Even Though Notes Were Given For the Advances.** Assets of an FLP created by the decedent were included in the estate under §2036 in *Rosen v. Commissioner*, T.C. Memo. 2006-115 Part of the court's reasoning was that advances to the decedent from the partnership evidenced "retained enjoyment" of the assets transferred to the FLP even though the decedent gave an unsecured demand note for the advances. The purported "loans" to the decedent were instead treated by the court as distributions from the FLP to the decedent. There was an extended discussion of actions required to establish bona fide loans.

In *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, an FLP distributed $2 million to the decedent, purportedly as a loan, though no documentation of the loan existed. The decedent used those funds for various personal purposes, which the court pointed to as retained enjoyment for inclusion purposes under §2036(a)(1). In addition, the FLP transferred $500,000 to each of the decedent's four children in return for five-year notes bearing interest at a rate of 3.6% (the mid-term AFR for that month was 3.83%). The notes had no amortization schedule, no payments were made, and no efforts were made to collect on the notes. Even though the children signed notes and the debt was not proportionate to the children's ownership in the FLP (both of which weighed in favor of a bona fide debt), the court found it was "more likely than not" that these were gifts based on a variety of other factors (analyzing each of the eleven factors addressed in *Rosen v. Commissioner*). The transfers were treated as gifts from the decedent (who owned a 95% limited partner interest at the time of the transfers).

(4) **Valid Debt for § 2053 Deduction.** The nine factors listed above from the *Miller* case were mentioned in *Estate of Holland v. Commissioner*, T.C. Memo. 1997-302, to support the finding that the decedent's estate did not owe bona fide indebtedness that could be deducted under §2053, which allows a deduction for any indebtedness, but only "to the extent that [it was] contracted bona fide and for an adequate and full consideration in money or money's worth." A variety of cases have mentioned one or more of these factors in analyzing the deductibility of a debt as a claim under §2053(a)(3), *e.g.*, *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40 (loan from FLP to decedent not a legitimate loan), or of post-death interest paid on a loan as an administrative expense under §2053(a)(2), *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255.

One of the requirements for being able to deduct a debt as a claim or interest on a loan as an administrative expense under §2053 is that the debt is bona fide in nature and not essentially donative in character. A variety of factors apply in determining the bona fides of an obligation to certain family members or related entities for purposes of the debt deduction under §2053. Treas. Reg. § 20.2053-1(b)(2)(ii)-(iii).

e. **Upfront Gift If Intend to Forgive Loan?** In *Bolles*, the mother made advances and, according to the opinion, "forgave the 'debt' account of each child every year on the basis of the gift tax exemption amount." The court said that "practice would have been noncontroversial but for the substantial funds" the mother advanced to Peter. While the court may have thought that plan was

"noncontroversial," the IRS has taken the position that advances made with the intention of forgiving the purported "loans" are treated as upfront gifts, but cases have not always agreed with that position.

(1) **IRS Position.** Revenue Ruling 77-299 announced the IRS position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan. The IRS relied on the reasoning of *Deal v. Commissioner,* 29 T.C. 730 (1958), for its conclusion in Rev. Rul. 77-299. However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness. Rev. Rul. 81-264, 1081-2 C.B. 186. The IRS has subsequently reiterated its position. *See e.g.,* Field Service Advice 1999-837 (donor makes gift of full amount of loan initially if donor intends to forgive the loan as part of a prearranged plan); Letter Rul. 200603002.

(2) **Case Law.** The Tax Court reached a contrary result in several cases that were decided before the issuance of Rev. Rul. 77-299 (and the IRS non-acquiesced to those cases in Rev. Rul. 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance. The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable. *See Haygood v. Commissioner*, 42 T.C. 936 (1964). (gift that occurred at the time of the initial transfer was reduced by the full face amount of the secured notes even though the taxpayer had no intention of enforcing payment of the notes and the taxpayer in fact forgave $3,000 per year on the notes from each of the transferees); *Estate of Kelley v. Commissioner*, 63 T.C. 321 (1974) (no upfront gift even though parents extinguished notes without payment as they became due).

The court in *Estate of Maxwell v. Commissioner*, 3 F.3d 591 (2d Cir. 1993), distinguished *Haygood* and *Kelley* in a §2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. Other cases have criticized the approach taken in *Haygood* and *Kelley* (though in a different context), observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth. *E.g., Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997); *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 664 (1995); *Estate of Lockett v. Commissioner*, T.C. Memo. 2012-123.

(3) **Which is the Best Reasoned Approach?** One commentator gives various reasons in concluding that taxpayer position is the more reasoned position on this issue.

> The IRS has not done well with this approach, and there are reasons for this. Even if the lender actually intends to gradually forgive the entire loan, (1) he is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. Therefore, if the loan is documented and administered properly, this technique should work, even if there is a periodic forgiveness plan, since the intent to make a gift in the future is not the same as making a gift in the present. However, if the conduct of the parties negates the existence of an actual bona fide debtor-creditor relationship at all, the entire loan may be recharacterized as a gift at the time the loan was made or the property lent may be included in the lender's estate, depending on whether the lender or the borrower is considered to "really" own the property.
>
> …
>
> If the borrower is insolvent (or otherwise clearly will not be able to pay the debt) when the loan is made, the lender may be treated as making a gift at the outset.

KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.05[2][a](Warren Gorham & Lamont 1997). Other commentators agree that the Tax Court analysis in *Haygood* and *Kelley* is the preferable approach. *E.g.*, HOWARD M. ZARITSKY & RONALD D. AUCUTT, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, §12.03 (2d ed. 1997).

(4) **Planning Pointers.** While the cases go both ways on this issue, taxpayers can clearly expect the IRS to take the position that a loan is not bona fide and will not be recognized as an offset to the amount of the gift at the time of the initial transfer if the lender intends to forgive the note payments

as they become due. Where the donor intends to forgive the note payments, it is especially important to structure the loan transaction to satisfy as many of the elements as possible in distinguishing debt from equity. In particular, there should be written loan documents, preferably the notes will be secured, and the borrower should have the ability to repay the notes. If palatable, do not forgive all payments, but have the borrowers make some of the annual payments.