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A Noteworthy Dichotomy: Valuation of Intrafamily Notes for Transfer Tax Purposes

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Abstract: *A promissory note which bears interest at the AFR is valued at its stated principal amount on issuance and does not result in a gift. After issuance, the note is valued on a market value basis. If the note is later disposed of by gift or bequest and is valued at a discount, can the IRS argue that the note was not issued for adequate and full consideration under §2036(a)(2) and §2038?*¹

I. INTRODUCTION

Promissory notes are widely used to transfer money or other assets between family members and family entities for many reasons. Loans can provide a child

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¹ All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder, unless otherwise indicated.

or other family member the cash for a down payment on a home or an alternative to bank financing on more favorable terms. In other situations, loans have an income tax motive where a C corporation lends money to a shareholder to avoid dividend treatment or where an S corporation lends money to a shareholder who does not have basis in the S corporation's shares to avoid gain recognition upon a cash distribution. More often, loans are used as seller-provided financing to implement an estate "freeze" designed to permit future appreciation to pass outside of the seller's estate.

On issuance, all notes, including notes used as seller-provided financing, must be valued to determine if a gift has been made, or if the note is an attempt to disguise interest income as taxable capital gain.² After issuance, related party notes again must be valued if they are gifted or forgiven by the lender, or if the lender dies owning a note. What is not well understood is that the methodology for valuing notes on issuance for gift tax purposes is different from the methodology for valuing notes after issuance for gift and estate tax purposes and thus can result in different results for the same note over time. This article will discuss the fundamental valuation principles used to value intrafamily promissory notes at each of these points in time for gift and estate tax purposes, and then apply these principles to a hypothetical loan example to demonstrate that the issuance of a loan providing for adequate stated interest at the applicable federal rate (the "AFR") does not create a gift on issuance even if it is later valued at a discount upon transfer by gift or bequest.

Prior to 1984, a popular estate planning technique was the loan of money to one's children, or a trust for children, without any stated interest. Interest-free loans were not considered to constitute taxable gifts until the Internal Revenue Service (the "IRS") was

² For this article, we will limit our analysis to intrafamily loans of cash used for estate planning purposes that are later disposed of by gift or bequest, or are cancelled by gift or bequest.

successful in *Dickman v. Commissioner*,³ where the Supreme Court held that interest-free demand loans create taxable gifts.⁴ Congress enacted §7872, later in 1984,⁵ to provide rules under which an intrafamily loan that bears interest at less than the AFR results in gift and income tax consequences, and the methodology for calculating those consequences. As a result, §7872 values intrafamily loans for gift tax purposes on issuance using an objective present value methodology. In contrast, after issuance intrafamily loans are valued on a subjective fair market value basis for gift and estate tax purposes.

Our analysis and the questions raised will be addressed in the context of the following hypothetical:

Senior, age 75, creates an irrevocable grantor trust for the benefit of Senior's descendants and funds the trust with a nominal annual exclusion gift of \$15,000. Senior retains no trust powers, either directly or in conjunction with another person, that would expose the trust's assets to estate tax inclusion under §2036(a)(2) or §2038. Senior then loans \$1,000,000 to the trust in exchange for a promissory note paying interest annually at the long-term AFR of 2.21% with all principal due on maturity in 25 years. The loan does not result in a gift under §7872 (see III., below). The trust immediately invests the loan proceeds in a 25-year bond paying interest at 3.21%. The transaction was done for estate planning purposes only and without a business purpose. The trust intends to collect \$32,100 of annual interest on the bond and use \$22,100 to pay the interest on its note obligation. Senior's sole motive was shift \$10,000 of annual income to the trust without the payment of any gift taxes, using the \$1,000,000 bond principal payment on its maturity to pay the trust's \$1,000,000 obligation. The trust uses the \$15,000 seed gift to pay its ongoing administrative costs. Therefore, Senior's only security for the trust's note is the asset the trust purchased with the loan proceeds. Because Senior's life expectancy under the §7520 mortality tables is 11.2 years, there is only a 2.9% chance that Senior will be alive on the note's maturity date.

Can the IRS successfully argue that the note did not constitute adequate and full consideration for the loan under §2036(a) or §2038(a) (see XIV.F., below)? If Senior dies several years after the loan is made and the AFR rate is unchanged, can the loan be valued at a discount in Senior's estate (see

XII below)? Alternatively, if Senior gifts the note to the trust in a later year and the AFR rate is unchanged, can the loan be valued at a discount for gift tax purposes (see XI. and XIV.H., below.)?

II. GIFT TAX VALUATION OF INTRAFAMILY PROMISSORY NOTES UPON ISSUANCE

Under §2512(b), “[w]here property is transferred for less than an adequate and full 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. . . .” Thus, if the value of the assets transferred is equal to the value of the assets received, then no gift has been made. However, specific rules apply to value intrafamily promissory notes upon issuance.

Section 7872 provides an objective mechanism for determining whether a gift has been made in a loan transaction (i.e., a loan of cash), calculated using a mathematical present value formula. If a loan is not a below-market loan,⁶ then no gift has been made under §7872.⁷

While §7872 applies to loans of cash, §7872(f)(8) provides that §7872 does not apply “to any loan to which section 483, 643(i), or 1274 applies.” Nonetheless, the Tax Court held in *Frazer v. Commissioner*⁸ that §7872 “could properly be applicable to some seller financing.” The Tax Court again found in *Estate of True v. Commissioner*⁹ that a deferred payment arrangement (i.e., a seller financed transaction) could be subject to §7872 even where §483 or §1274 applied. Section 7872(f)(2) provides that the AFR, determined under §1274(d), is the test rate of interest for determining forgone interest (i.e., the discount rate) for a below-market loan.¹⁰ Thus, if a demand promissory note issued in an intrafamily sale transaction bears interest at or above the AFR, or for a term loan,¹¹ if the present value of all of the payments due under the loan is equal to or greater than the amount of the

⁶ §7872(e)(1).

⁷ §7872(a)(1).

⁸ 98 T.C. 554 (1992).

⁹ T.C. Memo 2001-167, *aff'd*, 390 F.3d 1210 (10th Cir. 2004) (“In our view, sections 483 and 1274 were enacted to ensure the proper characterization of payments as principal or interest for income tax purposes. By contrast, the key issue for gift tax purposes is the valuation of all payments (both principal and interest).”).

¹⁰ See §7872(e)(2); Prop. Reg. §1.7872-6(c). Regarding demand loans or gift term loans treated as demand loans, see Prop. Reg. §1.7872-13. See Prop. Reg. §25.7872-1, which applies to both demand loans and term loans.

¹¹ §7872(f)(6). See also Prop. Reg. §1.7872-10(a)(2).

³ 465 U.S. 330 (1984).

⁴ *Id.* (“We hold, therefore, that the interest-free demand loans shown by this record resulted in taxable gifts of the reasonable value of the use of the money lent.”).

⁵ Deficit Reduction Act of 1984, Pub. L. No. 98-369.

loan,¹² then the note will not result in a gift if the face value of the promissory note is the sale amount (or financed portion).

Under Prop. Reg. §25.2512-8, “[i]f the buyer [in a sale, exchange or other transfer of property] issues one or more debt instruments as all or a part of the consideration for the property, then the property and the debt instruments shall be valued in accordance with the rules set forth in §1.1012-2.” Prop. Reg. §1.1012-2(b) in turn provides that in a sale or exchange where all or a part of the consideration is a debt instrument issued by the buyer to the seller, the value of a debt instrument that provides for adequate stated interest is the issue price (i.e., the stated principal amount of the loan).¹³ So, a gift tax regulation, referencing an income tax regulation, tells us that an intrafamily promissory note which bears interest at or above the AFR is to be valued at face value in a sale or exchange, meaning that even though the AFR is not a market rate (discussed in V., below), no gift arises under such a note upon its issuance. This conclusion is consistent with §7872 and is supported by private letter rulings.

In PLR 9408018, a shareholder of a closely held corporation desired to terminate her shareholder interest. The corporation proposed to redeem her shares in exchange for two promissory notes. One note required monthly payments of principal and interest based on a twenty-year amortization schedule with a balloon payment at the end of month 145, while the other note required payments of interest monthly with the principal payable at the end of month 145. Each note allowed for prepayment without penalty and bore interest at the greater of 120% of the mid-term AFR on the date the transaction was implemented, or the rate required for each note to have adequate stated interest under §1274(c)(2). The IRS held that neither note would result in a gift subject to gift tax, since having adequate stated interest required the use of at least the long-term AFR (given the length of the term), and that, “for federal gift tax purposes, the fair market value of Note A and Note B will be the principal amount stated in each note.”¹⁴ Further, the IRS discussed how the Tax Court, in *Frazee*,¹⁵ “concluded that the application of section 7872 is not limited to loans of cash. Rather, the term ‘loan’ under section 7872 is broadly interpreted to include any extension

of credit.”¹⁶ Thus, the IRS stated its position that upon issuance a promissory note that bears interest at or above the AFR rate does not result in any gift under §7872 and that §7872 applies to such promissory notes.

In PLR 9535026, the grantor established a trust which created three subtrusts, one for each of three children of the grantor, such child’s spouse, each child’s descendants and their spouses. The grantor transferred assets to each subtrust, and each child also transferred assets to each subtrust which were held in separate subtrusts. Each child then proposed selling stock to that child’s separate subtrust in exchange for a promissory note with interest payments for twenty years and a balloon payment of principal on maturity, secured by the transferred stock and with interest at a rate so that the loan would not be a below-market loan under §7872 (i.e., the long-term AFR). Again noting that, under *Frazee*, §7872 applied to “any extension of credit,” the IRS held that as the stated interest rate will be the rate required by §7872 (i.e., the long-term AFR), “if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax.”¹⁷

In PLR 200147028, the trustees requested a court to reform a generation-skipping transfer (GST) tax-exempt trust to correct a scrivener’s error. The trust, as reformed, permitted the trustees to make loans to the beneficiaries according to the prudent person standard under state law. One of the rulings requested was that the trust would not lose its GST tax-exempt status if the trustee elected to make a loan to a beneficiary, “provided that such loans are adequately secured and subject to a market rate of interest.” In response to this ruling request, the IRS stated that, “[f]or GST tax purposes, as long as loans made to beneficiaries of the trusts are secured and at a market rate of interest, the trusts will not lose their GST tax exempt status.” Given that this ruling, which does not discuss §7872, is “[f]or GST tax purposes,” this would not seem to be contrary authority to the concept, as discussed in this section, that an intrafamily promissory note issued in a sale transaction which bears interest at or above the AFR will not result in a gift and generally will be valued at face value.

¹² §7872(e)(1)(B).

¹³ §1274(c)(1).

¹⁴ PLR 9408018 was “conditioned on both of the following assumptions being met (i) there is no indication that the notes will not be paid according to their terms and (ii) the corporation’s ability to pay the notes is not otherwise in doubt.”

¹⁵ 98 T.C. 554 (1992).

¹⁶ See also Prop. Reg. §1.7872-2(a)(1).

¹⁷ As in PLR 9408018, PLR 9535026 was “conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the [trust’s] ability to pay the notes is not otherwise in doubt.”

III. SECTION 7872 AND THE VALUATION OF INTRAFAMILY PROMISSORY NOTES ON ISSUANCE

To understand the valuation of an intrafamily promissory note on issuance, an understanding of §7872 is required.¹⁸ While §7872 addresses both demand loans and term loans, this article will focus on term loans.

A. Section 7872(a)

Section 7872(a) provides that for any *below-market loan* where (i) this section applies, and (ii) which is a *gift loan* or a *demand loan*, then the *forgone interest* is treated as having been transferred from the lender to the borrower and then retransferred from the borrower back to the lender, as interest. So, to the extent that §7872 applies, it has two consequences, first a deemed gift from the lender to the borrower, then a deemed payment of interest from the borrower to the lender.¹⁹ Both consequences are recognized by the lender. As discussed in the private letter rulings above, if there is no forgone interest, then the loan is not a below-market loan, the value of the note is equal to its stated principal amount and no gift has been made. If the note is not a below-market loan, §7872 treats the stated principal as the value of the note.

1. Below-Market Loans

The first term to define is below-market loan.²⁰ A below-market term loan is any loan where the amount loaned exceeds the present value of all payments due under the loan.²¹ Following the first example in Prop. Reg. §1.7872-14, the formula for determining the present value of a future payment is as follows: $PV = FP / ((1 + (IR / NCPY)) ^ CP)$ where PV is the present value, FP is the future payment whose present value is being determined, IR is the interest rate, NCPY is the number of compounding periods per year, and CP is the compounding period.

Example: Senior loans \$1,000,000 to an irrevocable trust for the benefit of Senior's children. The trust issues a promissory note providing for the payment of 6% annual interest with all principal due at the end of five years. On the date the loan was made, the mid-term AFR also was 6%.

Using the 6% AFR as the discount rate, the present value of the right to receive \$60,000 of interest an-

nually over the five year term is \$56,603.77 + \$53,399.79 + \$50,377.16 + \$47,525.62 + \$44,835.49, totaling \$252,741.83. Similarly, the present value of the right to receive \$1,000,000 in five years is \$747,258.17. Adding the value of the right to receive the five annual interest payments and the value of the right to receive the issue price in five years together totals \$1,000,000. In calculating the present value of a loan that bears interest, the present value of both the principal to be repaid and each installment of interest to be paid must be calculated separately, with the results added together for the total present value.²²

2. Gift Loans

A gift loan is a below-market loan where the forgoing of interest is in the nature of a gift.²³ In the context of an intrafamily loan, it generally will be true that if a loan is made without adequate interest, the shortfall (i.e., the forgone interest) will be considered to be a gift for purposes of Chapter 12 of the Code.²⁴

3. Term Loans

Section 7872(f)(6) provides that a term loan is any loan which is not payable in full upon demand of the lender.²⁵ Under the proposed regulations, however, “[a] loan is treated as a ‘term loan’ if the loan agreement specifies an ascertainable period of time during which the loan is to be outstanding. For purposes of this rule, a period of time is treated as being ascertain-

²² Prop. Reg. §1.7872-3(c) provides that “Section 7872 does not apply to any loan which has sufficient stated interest. A loan has sufficient stated interest if it provides for interest on the outstanding loan balance at a rate no lower than the applicable Federal rate based on a compounding period appropriate for that loan.” This would seem to provide a “safe harbor” for a term loan which bears interest at or above the AFR, without having to do a present value calculation of all the payments due under the loan. The AFR is the minimum interest rate that can be used so that the present value of the note equals the principal amount (i.e., the minimum rate required to avoid a gift). The note can provide an interest rate higher than the AFR. A safe harbor interest rate can be up to 5.0% more than the AFR and still be valued at the issue price. If the stated interest rate is more than 5.0% higher, it will be recharacterized as a high-yield debt obligation (a “HYDO” under §163(i)(1)(B)) and the excessive interest will be treated as disguised principal.

²³ §7872(f)(3). Also, Prop. Reg. §1.7872-4(b)(1) provides that a below-market loan is a gift loan if the forgone interest is in the nature of a gift under Chapter 12. See also Prop. Reg. §1.7872-8(a) for additional rules regarding loans between natural persons.

²⁴ For loans between natural persons, the gift is deemed to occur on the last day of the borrower's taxable year, or final taxable year for a borrower who dies or is liquidated, or on the date of repayment if the loan is repaid during the year. Prop. Reg. §1.7872-6(b). Otherwise, the gift is deemed to occur at the time the loan is made. Prop. Reg. §1.7872-7(a)(1)(i).

²⁵ See also Prop. Reg. §1.7872-10(a)(2).

¹⁸ Under §7872(c)(1)(A), §7872 applies to, among other loans, any below-market loan which is a gift loan (with an exception for certain *de minimis* loans).

¹⁹ See Prop. Reg. §1.7872-1(a).

²⁰ Section 7872(f)(2) provides that the applicable federal rate for demand loans and term loans is the AFR in effect under §1274(d), compounded semiannually.

²¹ §7872(e)(1).

able if the period may be determined actuarially.”²⁶ A loan payable on the death of a person, as life expectancy is actuarially determinable, would be considered to be a term loan.²⁷

4. Forgone Interest

Forgone interest is the excess of “(A) the amount of interest which would have been payable on the loan for the period if interest accrued on the loan at the applicable Federal rate and were payable annually on the day referred to in subsection (a)(2), over (B) any interest payable on the loan properly allocable to such period.”²⁸ Essentially, this is the interest which under the Code should have been charged, with any interest not so charged being the forgone interest.

B. Applying §7872 to a Term Loan

Determine if the amount loaned exceeds the present value of all of the payments due under the loan.²⁹ If the term loan is a below-market loan, and is also a gift loan,³⁰ determine if any of the exceptions under §7872(c)(2) and §7872(d)(1) apply.³¹ If a loan is not a below-market loan, then no gift will be imputed under §7872 and on issuance the loan will have a fair market value equal to the principal amount of the loan.

IV. GIFT TAX VALUATION OF INTRAFAMILY PROMISSORY NOTES AFTER ISSUANCE

If an intrafamily promissory note is gifted (or forgiven) after it has been issued, it must be valued to determine the amount of the gift. Under Reg. §25.2512-4, “[t]he fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value.” After acknowledging that a value below that of the unpaid

principal and accrued interest can be established for a promissory note, the regulation then provides guidance as to how to establish such a lower value. “Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it.” Read in the positive, rather than the negative, **Reg. §25.2512-4 allows a promissory note to be valued below the amount of outstanding principal and accrued interest, i.e., valued at a discount, based on its interest rate, date of maturity, collectibility or “other cause.”** “Factors to be considered when determining the value of a promissory note include the usual rate of interest for commercial notes like the subject note and the length of the maturity of the note.”³²

V. THE APPLICABLE FEDERAL RATE IS NOT A MARKET RATE OF INTEREST

Under §1274(d)(1)(C) and Reg. §1.1274-4(b), the AFR is determined based on the average market yield in the month in question of “outstanding marketable obligations of the United States” with matching remaining periods to maturity. These marketable obligations include Treasury Bills (term of one year or less), Notes (terms of 2 to 10 years) and Bonds (term of 30 years). As obligations backed by the federal government (which can collect taxes to fund repayment), they are very low risk and consequently low yield. Thus, the AFR, which is calculated based on these and other “safe” investments also is a low rate, generally below a “market” rate of interest. “AFR interest *usually* is lower — and often much lower — than returns available with respect to investment opportunities in the marketplace. . . .”³³

That the AFR can be a below-market interest rate is not unknown to Congress. Indeed, the legislative his-

²⁶ *Id.*

²⁷ *Id.*

²⁸ See §7872(e)(2), Prop. Reg. §1.7872-6(c), and, with regard to demand loans or gift term loans treated as demand loans, Prop. Reg. §1.7872-13. See also Prop. Reg. §25.7872-1.

²⁹ §7872(e)(1)(B).

³⁰ See also §7872(d)(2).

³¹ If §7872 applies to the loan (i.e., if the loan is a below-market loan) and none of the exceptions apply, then calculate the forgone interest. For a term loan, under §7872(b)(1) the lender is deemed to have transferred to the borrower, on the date in the year when the loan was made, cash in an amount equal to the difference between the amount loaned and the present value of all payments due under the loan (the forgone interest) under §7872(b)(1) and Prop. Reg. §1.7872-7(a)(1)(ii). Income tax consequences also apply under §7872(a)(1)(B).

³² PLR 8906002, citing *Blackburn v. Commissioner*, 53 T.C. 204 (1953), and *Ballard v. Commissioner*, T.C. Memo 1987-128, *rev'd on another issue*, 854 F.2d 185 (7th Cir. 1988).

³³ Jonathan Blattmachr, Bridget J. Crawford and Elisabeth O. Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, J. of Tax'n (July 2008) (emphasis added). See also Robert P. Schweihs, *The AFR and the Value of Debt*, Gift and Estate Tax Valuation Insights (Summer 2012). But see Jerome M. Hesch, Alan S. Gassman, and Christopher J. Denicolo, *Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, 36 Tax Mgmt. Est., Gifts and Trusts J. 128 (Mar. 10, 2011), in which the authors state that “[s]ince the AFR is based on the prior month’s Treasury Bill rates, it will *always* be less than market rates even in periods of high mar-

tory of the Deficit Reduction Act of 1984 which enacted §7872, states that, “[t]he Congress intended that, in general, in the case of a loan subject to this provision, the amount of the deemed payment from the lender to the borrower is to be determined solely under this provision. Thus, in the case of a below-market loan from a parent to a child, the amount of the gift is to be determined under section 7872, and not under the decision in the Dickman case, supra, *even if the applicable Federal rate is less than a fair market interest rate.*”³⁴

However, under Prop. Reg. §1.7872-3(e)(3), a loan with interest payable at the “prime rate of a major lending institution” is discussed in its Example 4: “The prime rate is not an index which by its terms cannot be less than the lower of the statutory Federal short-term rate or the alternate Federal short-term rate.” As a result, this loan must be tested in each period to determine if it has sufficient stated interest.³⁵ This appears to contemplate that it is at least possible for the AFR to be above the prime rate of interest.

VI. BONA FIDE DEBT

Note that the discussion above assumes that when the promissory note was issued, it was a bona fide debt. In determining whether a bona fide debt exists, courts have considered indicative factors including whether:

- (1) evidence of indebtedness exists, such as a note;
- (2) there is a fixed schedule for repayment;
- (3) any collateral or security is requested;
- (4) a demand for repayment has been made;
- (5) there is a written loan agreement;
- (6) the parties’ records reflect the transaction as a loan;
- (7) any repayments have been made;
- (8) the borrower was solvent at the time the loan was made; and
- (9) any interest was charged.³⁶

ket rates.”

³⁴ Staff of the Jt. Comm. on Tax’n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. (Comm. Print 1984), p. 529 (emphasis added).

³⁵ Prop. Reg. §1.7872-3(e)(3) Ex. 4.

³⁶ *Miller v. Commissioner*, T.C. Memo 1996-3 (factors 1-4, 6, 7, 9); *Dickinson v. Commissioner*, T.C. Memo 2014-136 (factors 1-3, 7, 9); *Alpert v. Commissioner*, T.C. Memo 2014-70, citing *Clark v. Commissioner*, 18 T.C. 780 (1952), *aff’d*, 205 F.2d 353

While the factors provide a basis for determining whether a bona fide debt existed, they are not exclusive and no one factor controls.³⁷ “[T]he ultimate question is whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and whether that intention comports with the economic reality of creating a debtor-creditor relationship.”³⁸

If the IRS could argue that an intrafamily promissory note was not a bona fide debt, then the AFR protections offered by §7872 would not apply.

VII. ESTATE TAX VALUATION

In general, assets includible in a decedent’s gross estate must be valued at their fair market value as of the date of the decedent’s death.³⁹ For promissory notes, however, Reg. §20.2031-4, similar to Reg. §25.2512-4, provides that “[t]he fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless.” As with Reg. §25.2512-4, Reg. §20.2031-4 acknowledges that a value below that of the unpaid principal and accrued interest can be established for a promissory note, and provides guidance as to how to estab-

(2d Cir. 1953) (factors 1, 3, 4, 6, 7, 9); *Suri v. Commissioner*, T.C. Memo 2004-71, *aff’d*, 96 AFTR 2d 2005-6526 (2d Cir. 2005) (factors 1-4, 7-9); *Sundby v. Commissioner*, T.C. Memo 2003-204 (factors 1, 3, 4, 6, 7, 9); *McFadden v. Commissioner*, T.C. Memo 2002-166 (all factors); *Mann Constr. Co. Inc. v. Commissioner*, T.C. Memo 1999-183 (all factors); *Klaue v. Commissioner*, T.C. Memo 1999-151 (all factors); *Barr v. Commissioner*, T.C. Memo 1999-40, citing *Caligiuri v. Commissioner*, 549 F.2d 1155 (8th Cir. 1977) (factors 1-4, 6-9); *Estate of Trompeter v. Commissioner*, T.C. Memo 1998-35, *rev’d on other grounds*, 279 F.3d 767 (9th Cir. 2002), T.C. Memo 2004-27, *aff’d in part and rev’d in part on other grounds without published opinion*, 170 Fed. App’x 484 (9th Cir. 2006) (all factors); *Clanton v. Commissioner*, T.C. Memo 1995-416 (all factors); *Bragg v. Commissioner*, T.C. Memo 1993-479, citing *Hunt v. Commissioner*, T.C. Memo 1989-335 (factors 1, 3, 4, 6, 7, 9); *Crotty v. Commissioner*, T.C. Memo 1990-261 (factors 1, 3, 4, 6, 7); *Rodgers v. Commissioner*, T.C. Memo 1985-220, citing *Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949), *aff’d per curiam*, 192 F.2d 391 (2d Cir. 1951) (factors 1-4, 6, 8, 9); *Goldstein v. Commissioner*, T.C. Memo 1980-273 (all factors).

³⁷ *Barr v. Commissioner*, T.C. Memo 1999-40, citing *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367 (1973).

³⁸ *Schenk v. Commissioner*, T.C. Memo 1996-113, citing *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980); *Litton*, 61 T.C. 367.

³⁹ “The value of every item of property includible in a decedent’s gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent’s death. . . . The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” Reg. §20.2031-1(b).

lish such a lower value. “If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.”⁴⁰ So, the value of a promissory note for estate tax purposes that is below the amount of outstanding principal and accrued interest, i.e., valued at a discount, is determined based on its interest rate, date of maturity, collectibility or “other cause.”

A. TAM 8229001

In TAM 8229001, a decedent sold an interest in a business in exchange for cash and a promissory note to be paid in annual installments with interest at 9%. The TAM presumes the interest to have been at a “fair rate,” as this TAM predates the enactment of §7872 in 1984. Further, the TAM states that the promissory note was “fully secured by property placed in escrow.” Decedent died six months after the sale, at which time interest rates had risen “substantially.” On the estate tax return, the executor valued the promissory note at below face value due to the increase in interest rates.

Discussing Reg. §20.2031-4 and citing Rev. Rul. 67-276, the TAM discusses the factors to be considered (for valuing a mortgage, as that was at issue in the revenue ruling), which include (i) the valuation of the real estate and any collateral, (ii) any arrearage in taxes and interest, (iii) gross and net rentals, (iv) foreclosure proceedings, (v) assignment of rents, (vi) prior liens or encumbrances, (vii) present interest yield, and (viii) bid and ask quotations. “Thus, the guiding principal is that in valuing mortgages and promissory notes all available data and all relevant factors affecting the fair market value must be considered.” In analyzing the loan at issue, the TAM discusses how the present value of the principal and interest payable in the future is equal to the principal obligation (i.e., the amount of unpaid principal) if the interest rate is “equal to the current market rate of interest for such type of obligation. . . . However, if the stated rate of interest on the note is less than the current market rate of interest, the present value of the amounts payable is accordingly less.” This is true even where the note is secured. “Although there is a sentence in Rev. Rul. 67-276 that indicates a mortgage that is amply secured must be valued at face value, the sentence must be read in context with the entire Ruling and not

standing alone. . . . Thus, one factor alone, such as collateral, is insufficient to set a proper value on a note or mortgage.” The TAM concludes by stating that, “[a] promissory note receivable that is fully secured is not necessarily to be valued under section 2031 at face value. The value of the note depends upon an analysis of all available data and all relevant factors affecting the value.”

Shortly thereafter, in PLR 8245007, the IRS again discussed valuing a promissory note below face value where interest rates had risen significantly since the note was issued. “Here, the stated rate of interest on the Company’s promissory note was substantially below the market rate of interest at the time of the decedent’s death. . . . In the absence of other factors indicating a different result, the lower-than-market interest rate would tend to cause the market value of the obligation to fall substantially below the principal amount of the obligation.”

B. Prop. Reg. §20.7872-1

In addition to Reg. §20.2031-4, the IRS also has issued Prop. Reg. §20.7872-1. This proposed estate tax regulation “applies with respect to any term loan *made with donative intent* after June 6, 1984, *regardless of the interest rate under the loan agreement, and regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made.*” (emphasis added). Under the proposed regulation, a gift term loan (defined in Prop. Reg. §1.7872-4(b)) is valued at the lesser of the “unpaid stated principal, plus accrued interest” or the present value of all payments due under the note calculated using the AFR applicable to a loan having a term equal to the remaining term of the loan as of the date of death. Further, “[n]o discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectibility of the loan have changed *significantly* since the time the loan was made.” (emphasis added).

This proposed regulation would impose a stricter valuation standard than Reg. §20.2031-4, as it would apply to a gift term loan even if that loan bore interest at the appropriate AFR in effect when the loan was made and ignores the market-based factors of TAM 8229001, instead valuing the loan at a discount only if the AFR has increased since the loan was made (based on the remaining term) or if the facts have changed “significantly” since the loan was made which renders the loan uncollectible. It also would match the methodology used under §7872 for term loans, making consistent the valuation of such loans both on issuance and for estate tax purposes. Despite being a stricter valuation standard, by requiring revaluation at the then-current AFR, Prop. Reg.

⁴⁰ Reg. §20.2031-4.

§20.7872-1 would appear to mandate an automatic discount to any promissory note where the AFR has increased since the loan was made, and would not value the loan higher than the “unpaid stated principal, plus accrued interest” if the AFR had decreased. However, as discussed above, this proposed regulation conflicts with Reg. §20.2031-4, and thus is inapplicable unless it is ever finalized by the IRS. Indeed, Prop. Reg. §20.7872-1 can be viewed as the IRS’s indirect acceptance that until this proposed regulation is adopted, market rates must be used in valuing a promissory note for estate tax purposes.

VIII. COURT INTERPRETATION OF REG. §20.2031-4

Consider how courts have addressed Reg. §20.2031-4 in cases concerning the estate tax valuation of promissory notes.

A. Estate of Berkman v. Commissioner

In *Estate of Berkman*,⁴¹ Decedent made loans to his daughter and son-in-law on multiple occasions, for which he received five promissory notes. Each note had a 20-year term, 6% annual interest payable monthly, and all principal due on maturity. None of the notes were secured, but interest was paid monthly on each note as required. Decedent, who was 75 when the first note was issued, died two to six years after each note was issued, as the notes were issued over a four-year period. As this case predated *Dickman*⁴² and the enactment of §7872, focus not on the methodology of how the Tax Court calculated the lifetime gifts but rather on the estate tax valuation of the notes under Reg. §20.2031-4.⁴³ While the notes all bore interest at 6%, the prime rate on the date of Decedent’s death was 9.75%. The Tax Court considered the interest rate differential, the lack of security, the solvency of the debtors and the long remaining term to maturity of the notes in determining a value for each of them, which the Tax Court determined to be approximately half or less of the face value of each note (with a greater discount for the notes with the longer remaining terms).

⁴¹ T.C. Memo 1979-46.

⁴² *Dickman v. Commissioner*, 465 U.S. 330 (1984).

⁴³ As this case was decided in 1979, the Tax Court relied on the Internal Revenue Code of 1954, but the language of Reg. §20.2031-4 was unchanged.

B. Smith v. United States

In *Smith v. United States*,⁴⁴ a promissory note was issued to Decedent’s husband by a corporation in 1977 with a principal balance of \$10,312,000, interest at 6%, a 20-year term and annual payments of \$515,600 of principal plus interest accrued on each payment from the date of the note to the date of the payment. Payments were made timely until the death of Decedent’s husband in 1978. A two-thirds interest in the note was bequeathed to Decedent, with the remaining one-third interest passing to a foundation. Payments continued timely until 1981, when the original promissory note was replaced with two promissory notes, one to Decedent for her two-thirds interest and a separate note to the foundation. The “exchange” promissory note Decedent received had a face value of \$5,499,733.33 and a term continuing until 1997. The interest arrangement remained unchanged. The corporation merged with a larger corporation (Champion International Corporation, a Fortune 500 corporation) in 1985, and Champion assumed the obligation of paying the exchange note.

Decedent died in 1988, at which time the outstanding principal balance was approximately \$3,437,733 with interest to be paid over the remaining term. The estate tax return, which valued the note at a substantial discount, was audited and the value of the note was disputed. The court discussed the factors regarding the note, such as how it lacked the significant legal protections applicable to the publicly traded debt of Champion, the lack of a rating (such as a Moody’s or Standard & Poors rating applicable to the publicly traded debt), and the difficulty of obtaining information from Champion (the estate, after a number of communications, received a letter referring to the original note but not the exchange note, and the government was forced to depose Champion’s Financial Officer to obtain information).

The court adopted the estate’s appraiser’s valuation, which considered the lack of marketability, lack of protective covenants, lack of formal acknowledgment of the debt by Champion and various uncertainties as to the status of the note (i.e., the difficulty in obtaining information), unusual payment schedule and lack of divisibility, resulting in a value of the note of less than half of the principal and interest to be paid over time. In adopting the estate’s valuation, the court allowed discounts for traditional market factors such as the market interest rate increase since the note was issued (based on a Champion bond outstanding at the time with interest at an effective rate of 10.09%), marketability issues and the likely subordination of the note to “better documented debt of Champion,” and

⁴⁴ 923 F. Supp. 896 (S.D. Miss. 1996).

also for the unusual characteristics of the note including the uncertainties of the note (such as whether it was indeed a binding obligation of Champion or whether it remained a debt of the original corporation if it remained in existence), despite the note being payable by a Fortune 500 corporation and thus having a low apparent risk of collection.

C. Estate of Hoffman v. Commissioner

The Tax Court revisited the issue of the valuation of an intrafamily promissory note in *Estate of Hoffman v. Commissioner*.⁴⁵ Among the assets in the decedent's estate were two promissory notes, both payable by a family limited partnership, one to Decedent and one to an S corporation of which Decedent was the sole shareholder. Both notes, issued in 1992, were unsecured, bore interest at 7.61% accruing annually and with all accrued interest and principal due on maturity in 2012. The principal for the two notes was \$278,147 and \$173,083.

After discussing Reg. §20.2031-4, the Tax Court considered the parties' appraisals, both of which valued the notes at a discount. While the notes were unsecured, the partnership which issued them had approximately a three-to-one asset-to-liability ratio as of the valuation date, and the partnership was not required to make any payments on the notes until maturity. The IRS's appraiser determined the value of the notes by comparing them to the interest rates of debt securities, corporate bonds, conventional mortgages, one year Treasury securities, bank prime loans and venture capital returns. The IRS's appraiser did not believe that the notes were like bonds in default or highly speculative, as the value of the partnership's assets, if sold, would be sufficient to satisfy all of the partnership's outstanding debts. Assuming that the notes would not be paid until maturity, as provided in their terms, the IRS's appraiser valued the notes using a rate of return which resulted in the notes being valued at a discount from the principal and interest to be paid on maturity. The Tax Court adopted the IRS's appraiser's conclusion of a discount of approximately 87%.

How would the notes in *Hoffman* be treated under §7872? The long-term AFR for January 1992, when the notes were issued, was 7.72% compounded annually, and 7.58% compounded semiannually.⁴⁶ While the facts do not specify the compounding period, they do state the amount of principal and interest due on

⁴⁵ T.C. Memo 2001-109.

⁴⁶ Rev. Rul. 92-1. Also, regardless of whether §1274(d)(2) applies to determine the AFR under §7872, the long-term AFR for each of December 1991 and November 1991 was higher than the rates in January 1992. See Rev. Rul. 91-62, Rev. Rul. 91-57.

maturity. Working backwards, we find that the interest was simple interest (i.e., no interest on interest) calculated annually.⁴⁷ As both loans are term loans, they would be below-market loans if the present value of all payments due under the loans was less than the amount of each loan,⁴⁸ and if the loans were gift loans.⁴⁹ Calculating the present value of all the payments due under the loans, assuming the interest was compounded semiannually, yields the following: for the loan of \$278,147, $\$701,487 / ((1 + (0.0758 / 2)) ^ 40)$, which is \$158,416.04, and for the loan of \$173,063, $\$436,465 / ((1 + (0.0758 / 2)) ^ 40)$, which is \$98,566.41.

Both loans are thus below-market loans, and if they were considered to be gift loans (they were issued in an intrafamily context) they would be subject to §7872. Also, these loans appear to be subject to the OID timing rules, as the interest was both inadequate and deferred. Despite the possible §7872 and OID issues, the IRS did not argue about any past gifts under §7872 or any OID issues, and the Tax Court, in its analysis, focused solely (with regard to the promissory notes, other issues existed in the case) on determining the value of the notes for estate tax inclusion purposes under Reg. §20.2031-4. Said differently, the gift and OID issues which appear to have been applicable to these notes during decedent's lifetime did not affect the valuation of the notes for estate tax purposes.

D. Estate of Harper v. Commissioner

*Estate of Harper v. Commissioner*⁵⁰ considered the value for estate tax purposes of a note from a third party. On Decedent's death, an asset included in Decedent's gross estate was a promissory note for \$450,000 issued in 1991 with interest of 10.75% and a one-year term. As of Decedent's death about four years later, the note had been renewed for additional one-year terms, the interest rate had been reduced to 10% and interest payments were current. The note was secured by a 45% interest in a \$1,000,000 note payable to the payor of the \$450,000 note, and the \$1,000,000 note was in turn secured by a deed of trust in a mobile home park with a value far in excess of the amount of that note.

Unlike the cases discussed above, *Estate of Harper* did not involve a below-market interest rate. Indeed,

⁴⁷ The case states that the amount due on maturity for the notes was \$436,465 and \$701,487 (see n.17, above). $\$173,063 \times 0.0761 \times 20$ [20 years of interest] + \$173,063 [principal] = \$436,465 (rounded); $\$278,147 \times 0.0761 \times 20$ [20 years of interest] + \$278,147 [principal] = \$701,487 (rounded).

⁴⁸ §7872(e)(1)(B).

⁴⁹ §7872(f)(3).

⁵⁰ T.C. Memo 2002-121.

the note on the date of death bore interest at 10%, the case stated that the conventional mortgage rate at approximately this time was 9.13%, and the short-term AFR for January 1995 was 7.19%.⁵¹ The interest rate was therefore not a factor for discounting the note. However, the note's maturity had been extended several times so "there could be no assurance it would be paid in full at the upcoming maturity date without legal action," and there were environmental issues with the mobile home park securing the note collateralizing the note in the estate,⁵² both of which indicated that a discount was applicable to the note. Not fully accepting either expert's reports, the Tax Court adopted the discount range set by the IRS's appraiser but increased the discount in the range to 12%, thus valuing the note at \$396,000.⁵³

E. Other Factors

In valuing a promissory note, future income tax liability on the payments from a promissory note is not a factor applicable to discounting the value of such a note.⁵⁴ However, "risk of nonpayment is a valid consideration in discounting a note."⁵⁵ "In analyzing the fair market value of notes we have considered the ability of the debtor to repay the notes."⁵⁶ Finally, Reg. §20.2031-4 "establishes a presumption of minimum, not maximum, value."⁵⁷

Note also that "the estate tax is a tax imposed 'on the privilege of transferring the property of a decedent at death, measured by the value of the interest transferred or which ceases at death.'"⁵⁸ If a debtor is insolvent, but on the lender's death receives a bequest from the lender that makes the debtor solvent, the value of the debt is determined based on what the lender owned (i.e., a debt from an insolvent debtor), and the debtor's solvency as a result of the bequest is ignored.⁵⁹

⁵¹ Rev. Rul. 95-3.

⁵² "[T]here could be environmental concerns relative to a small section of the mobile home property, which could delay the refinancing and/or sale of the property." T.C. Memo 2002-121.

⁵³ As the note had a one-year term, only a one-year discount was required, with the discount calculated at $\$450,000 \times (1 - 0.12)$. *Id.*

⁵⁴ *Estate of Robinson v. Commissioner*, 69 T.C. 222 (1977).

⁵⁵ *Estate of Friedberg*, T.C. Memo 1992-310, citing *Kronenberg v. Commissioner*, 64 T.C. 428 (1975).

⁵⁶ *Estate of Luton v. Commissioner*, T.C. Memo 1994-539.

⁵⁷ *Levin v. United States*, 373 F.2d 434 (1st Cir. 1967).

⁵⁸ *Estate of Harper v. Commissioner*, 11 T.C. 717 (1948), citing the Supreme Court in *Chase Nat'l Bank v. United States*, 287 U.S. 327 (1929).

⁵⁹ *Id.*

IX. RECENT COMMERCIAL APPRAISALS OF INTRAFAMILY PROMISSORY NOTES

While the Treasury regulations and court decisions are instructive as to how intrafamily promissory notes are to be valued for estate tax purposes, it is helpful to consider how actual appraisals have addressed these issues. Consider two different commercial appraisals from 2018 valuing existing promissory notes issued in 2012, one focused on doing a market-based analysis of a promissory note and another also focused on doing a market-based analysis while following the guidance of the regulations and cases discussed above.⁶⁰

A. Appraisal One

The first appraisal considered the value of a promissory note issued by a grantor trust to the grantor to purchase interests in a limited liability company. The promissory note at issue was issued in December 2012, required payments of interest annually at 0.95% (the mid-term AFR for December 2012),⁶¹ had a nine-year term, and the principal was due on maturity. After discussing the terms of the promissory note and relevant portions of the operating agreement of the LLC, the appraisal discussed how the assets of the LLC, proportionate to the trust's membership interest, would be sufficient if liquidated to repay the amount of the note in full, though the note was not collateralized. In analyzing the value of the note, the appraisal stated that the amount due under the note was to be discounted by a market rate based on publicly traded corporate bond yields adjusted for specific economic factors applicable to the note.

A market interest rate of 3.4% was determined based on the characteristics of the note in comparison with publicly traded corporate bonds. The appraisal then considered various factors regarding the lack of collection rights by the holder of the note. The trust which issued the note owned only a minority interest in the LLC, and thus lacked the power to force the LLC to distribute cash to the trust to make interest or principal payments. The trust had a small amount of cash and an interest in the LLC, and while the LLC had historically made distributions to the trust to fund the annual interest payment, these distributions were not guaranteed as they were not under the control of the trust. These factors resulted in a 50% adjustment to the market interest rate.

⁶⁰ Both appraisals discussed were issued for clients of one author's firm. To preserve confidentiality, identifying information has been omitted.

⁶¹ Rev. Rul. 2012-31.

The discount for lack of marketability is applied to reflect the ability of the holder to convert the note to cash. The appraisal considered the following factors in determining an applicable discount for lack of marketability:

- As the note was issued to allow the trust to purchase a minority interest in an LLC, the trust was not guaranteed a consistent cashflow.
- The trust had a small amount of cash and an interest in the LLC, and while the LLC had historically made distributions to the trust to fund the annual interest payment, the trust lacked the power to compel the LLC to do so in the future.
- The trust's ability to sell its interest in the LLC was limited by certain rights of refusal granted to other members.
- No public market for the interests in this LLC existed.
- The membership interest in the LLC did not provide for redemption rights exercisable by the owner (the trust), so the trust had no ready ability to receive cash in exchange for its membership interest in order to repay the note.
- The remaining term of the note, on the date of the appraisal, was slightly more than three years. Given the lack of liquidity, an investor purchasing this note would require a higher rate of return, and thus the value of the note would decrease.
- The appraisal also considered various restricted stock studies.

After considering these factors, the appraisal concluded that a 20% discount for lack of marketability was applicable. Adjusting the 3.4% market interest rate by 50% for lack of collection rights and 20% for lack of marketability (an increase of 1.7% and 0.70%, respectively) resulted in an adjusted market interest rate of 5.8%. After discounting the payments of interest and principal due under the note to present value at a rate of 5.8%, the resulting discount was 12.85%.

This analysis is generally similar to the methodology used in *Estate of Berkman v. Commissioner*,⁶² in that it is a market-based valuation. While it did a competent job of applying market-based factors to the note at issue to determine its fair market value, it did not discuss Reg. §20.2031-4, or any of the cases or rulings applicable to the valuation of an intrafamily note.

B. Appraisal Two

The second appraisal considered the value of a promissory note issued by an irrevocable gift trust to

the lender's revocable trust. The promissory note at issue was issued in June 2012, required payments of interest annually at 1.07% (the mid-term AFR for June 2012),⁶³ had a nine-year term, and the principal was due on maturity. Though not required by its terms, a portion of the principal had been repaid as of the date of the appraisal. Further, the note was secured by an interest in a closely held LLC.

The report begins by discussing fair market value under Reg. §20.2031-1(b) and §25.2512-1, then discusses Reg. §25.2512-4 regarding the valuation of promissory notes. After determining that the interest rate of the note was a below-market rate given the risk-and-reward characteristics of the note, the appraisal stated that the note would be valued pursuant to Reg. §25.2512-4. The appraisal discussed how the assets of the LLC, proportionate to the borrower trust's membership interest, would be sufficient if liquidated to repay the amount of the note in full, but the borrower trust, owning only a minority interest in the LLC, lacked the power to cause a distribution from the LLC, and as it was possible that the collateral would decline in value over the remaining term, there was no guaranty that the collateral would be sufficient to cover the amount owed.

Three valuation approaches were discussed by the appraisal. The income approach measures value by considering the present value of future payments, with the present value determined by selecting an appropriate discount rate. This approach was (appropriately) selected for the appraisal. The market approach, determining the value of the asset by comparing it to actual transactions for similar assets, and the asset approach, estimating the value of underlying assets net of liabilities or the replacement cost of an asset, were discussed but not selected. In selecting the income approach, the appraisal discussed how, where it is reasonably expected that the borrower will be able to satisfy the obligations of the note, the value of the note is the present value of all of the required payments discounted by a rate which reflects the appropriate level of risk. Various factors were considered in determining the applicable discount rate, as follows:

- The borrower trust's assets exceeded its liabilities, and its historical cashflows were in excess of its debt service. This was not a guaranty of future cash flows, but an indication of the likelihood of the borrower trust being able to make the payments when due.
- There was uncertainty as to whether the borrower trust, which appeared to have sufficient capacity to repay the note, would continue to

⁶² T.C. Memo 1979-46.

⁶³ Rev. Rul. 2012-15.

have such capacity, and thus the risk involved was higher than the risk with high-quality corporate bonds or government-issued securities.

- Corporate bonds with a credit rating of BBB through BBB+ were considered comparable, and the rates of such bonds were considered.

After this analysis, a yield of 3.7% was deemed applicable to the note. Then, the appraisal considered the factors under TAM 8229001, as follows:⁶⁴

- Protective covenants — the note did not include the covenants typically applicable to a bond, such as working capital requirements, debt-to-equity ratios, sinking funds, indebtedness limitations and other factors.
- Default provisions and risk of default — the note provided that the lender had the option to accelerate all payments if the borrower failed to make a payment, which was sufficiently similar to other securities that no adjustment was made for this factor.
- Financial strength of the issuer — the borrower trust's earnings potential and financial strength were compared to, and considered to be weaker than, similar bonds, thus an upward adjustment to the rate was required.
- Value and type of security — as the note was collateralized with interests in the LLC, this was considered sufficiently similar to corporate bonds (which generally do not require collateral due to the issuer's size and financial strength) to be a neutral factor.
- Payment history of the note — as all required payments had been timely made to date, along with prepayments of principal, this was considered to be a neutral factor.
- Size of the note — the appraisal discussed how the size of the note is inversely related to the required discount rate, with larger notes being considered more attractive to investors, so the relatively small size of the note at issue, in comparison to similar bonds, required an upward adjustment to the rate.
- Market for the note — while the comparable bonds are relatively liquid and tradable, the note at issue has no established market. This was considered to be a significantly negative factor requiring a significant upward adjustment in the rate.

In total, the factors considered in this appraisal, following the appraiser's interpretation of TAM

⁶⁴ As both Reg. §25.2512-4 and §20.2031-4 include the same factors, the method of analysis under each is the same.

8229001, required an upward adjustment of 5.5%, resulting in an adjusted market yield (increased from the original 3.7% rate discussed above) of 9.2%. Discounting the cash flows to present value yielded an overall discount of 21.6%.

C. Consider the Differences Between These Two Appraisals

Both calculated the value of the note at issue through an analysis of market factors, and both determined an appropriate discount rate to determine the present value of the note at issue. Appraisal One, however, focused solely on market factors without connecting those factors to the regulations or TAM 8229001. In contrast, Appraisal Two discussed both the regulations and the factors (as interpreted by the appraiser) of the TAM. Ignoring the differences between the discounts determined, the approach taken in Appraisal Two, in an audit by the IRS, would appear to be much easier to defend as it outlined and discussed the applicable guidance, discussed how each factor was considered, and then determined how each factor affected the discount rate. While the IRS could question the conclusions reached and the comparable bonds and securities selected, questioning the methodology of Appraisal Two, which was clear as to how it was applied, would be much more difficult.

Additionally, consider the purpose for these two appraisals. Both were valuing an intrafamily promissory note during the life of the holder, and not in the holder's estate. Each appraisal was used to value the note at issue for gift tax purposes, i.e., the forgiveness of the indebtedness. The ability to gift a promissory note, which does not require the client to have liquid assets readily available, combined with discounts when the interest rate used on the promissory note (typically the then-current AFR) is below current market rates or where other factors requiring a negative valuation adjustment are present, is a very useful technique for estate planners.

X. IF AN INTRAFAMILY PROMISSORY NOTE IS FORGIVEN BY GIFT OR BEQUEST, DOES THE BORROWER HAVE DISCHARGE OF INDEBTEDNESS INCOME?

Under §102(a), “[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance.” A forgiven intrafamily promissory note, absent particularly unusual circumstances, would be considered a gift. If the forgiveness is a gift, then the amount of the forgiveness would not be income to the borrower, though it would constitute a

taxable gift by the lender. Similarly, a debt cancelled by a bequest, in an intrafamily context, would be included in the decedent's gross estate as an asset but would not constitute discharge of indebtedness income to the borrower. "Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules."⁶⁵ Reg. §1.102-1(e) coordinates the non-recognition of gifts as income with grantor trusts, providing that, "Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust. . . ."

What if accrued interest is forgiven, rather than the entire promissory note? Under Prop. Reg. §1.7872-11(a), if "(1) The loan initially would have been subject to section 7872 had it been made without interest; (2) The waiver, cancellation of [sic] forgiveness does not include in substantial part the loan principal; and (3) A principal purpose of the waiver, cancellation, or forgiveness is to confer a benefit on the borrower, such as to pay compensation or make a gift . . ." then the forgiven interest is treated as if it had been paid by the borrower to the lender, and then retransferred by the lender to the borrower (essentially the inverse of the deemed transfers under §7872(a)). Further, "[t]he requisite purpose. . . is presumed in the case of loans between family members. . . ."⁶⁶ This Proposed Regulation, which has been proposed and unfinalized for many years, leaves several questions unanswered, such as whether "in substantial part" refers to a substantial part of the loan principal or whether loan principal constitutes a substantial part of the amount forgiven, what constitutes a "substantial part," and at what point does repeated forgiveness of accrued interest give rise to an argument that the loan is not in fact a bona fide debt.

If a promissory note is gifted or bequeathed, the donee will have a basis in the note equal to the value for gift or estate tax purposes. Subsequently, if the note is paid beyond its basis, or paid in full (i.e., if the note was valued at a discount), the donee will have gain of the amount in excess of the basis, and as there was no "sale or exchange" by donee, it would appear that the gain is ordinary income.⁶⁷ So, a note valued at below face that is ultimately paid beyond such value would benefit from the time value of money and the differ-

⁶⁵ *United States v. Centennial Savings Bank FSB*, 459 U.S. 573 (1991), n.7, citing S. Rep. No. 1035, 96th Cong., 2d Sess., p.8 n.6 (1980). See also Rev. Rul. 84-176.

⁶⁶ Prop. Reg. §1.7872-11(a).

⁶⁷ See *Hudson v. Commissioner*, 20 T.C. 734 (1953), *aff'd sub. nom. Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954). After 1984, §1276 will treat the note as a market discount debt obligation, and the excess received over basis will be treated as interest income.

ence (if any) between the federal (and any applicable state) estate tax and the income tax incurred when payment above the new basis is received.

Special rules apply to the forgiveness of accrued but unpaid interest under a split-dollar loan (split-dollar loans are discussed in more detail in XIV., below). Accrued but unpaid interest that is "subsequently waived, cancelled, or forgiven by the lender" is "treated as if, on that date, the interest had in fact been paid to the lender and retransferred by the lender to the borrower."⁶⁸ The amount deemed transferred is determined under Reg. §1.7872-15(h)(2) or §1.7872-15(h)(3), depending on whether the loan is a term loan or a demand loan. In addition to the amount so determined, a deferral charge also is treated as retransferred by the lender to the borrower.⁶⁹ The deferral charge is calculated based on whether the loan is a term loan or a demand loan, and uses the "average of the quarterly underpayment rates in effect under section 6621(a)(2). . . ."⁷⁰ Additionally, Reg. §1.61-22(b)(6) provides that if a repayment obligation (i.e., principal)⁷¹ is waived, cancelled or forgiven, the "parties must take the amount waived, cancelled, or forgiven into account in accordance with the relationships between the parties" (i.e., as a gift in a typical intrafamily arrangement).

XI. VALUATION SCENARIO ONE (UNCHANGED AFR)

Consider a loan of \$1,000,000, evidenced by a promissory note, from parent to a grantor trust for the benefit of child. The note requires payments of interest annually for nine years with the principal due on maturity and with interest at the then-current mid-term AFR of 3%. One year after the note was issued, when the interest payment is made, the mid-term AFR is again 3%. Assuming there was no pre-agreement to forgive the note after one year,⁷² if the note is forgiven, would the note be valued at a discount for gift tax purposes?

Reg. §25.2512-4 provides that a promissory note can be valued at below face value if there is "satisfactory evidence" that the value is lower. Consider

⁶⁸ Reg. §1.7872-15(h)(1)(i). Also, this includes a payment from the lender to the borrower which is, in substance, a waiver, cancellation, or forgiveness. Reg. §1.7872-15(h)(1)(iii).

⁶⁹ Reg. §1.7872-15(h)(4). See Reg. §1.7872-15(h)(1)(iv) for an exception applicable to certain nonrecourse split-dollar loans.

⁷⁰ Reg. §1.7872-15(h)(4)(i), §1.7872-15(h)(4)(iii).

⁷¹ Reg. §1.7872-15(h)(1)(i) provides that Reg. §1.61-22(b)(6) applies to the waiver, cancellation, or forgiveness of amounts other than interest.

⁷² If there was a pre-agreement to forgive the note, then the note would not be a bona fide debt and would instead be a gift. See Rev. Rul. 77-299.

how this note would compare to a similar commercial debt instrument such as a bond.

- The AFR rate is not a market rate of interest, the note has an eight year term remaining, and no principal is required to be paid until maturity. As the interest rate on the note is below a market rate, the present value of the payments due under the note is accordingly less.
- The grantor trust may have little or no financial history, and if the grantor trust was created for the transaction at issue, the trust might have only made a single payment in its entire history. In contrast, the financial strength of the issuer of a comparable bond is an important consideration.
- The ratio of assets to debt and interest coverage ratios will likely be weaker than those of a comparable bond.
- Intra-family promissory notes typically lack the protective covenants that a comparable bond often would have.
- In comparison with a comparable bond, the size of the note would tend to make it less attractive to an investor, as the cost of monitoring this note versus the cost of monitoring a much larger bond are approximately the same. Also, bonds issued in large denominations are more easily securitized for purchase by investors than small notes.
- There is no established market for trading a privately issued note such as this note, in contrast to the public markets on which a comparable bond would be traded.
- The facts above do not discuss whether the promissory note is secured by collateral. If it is, then this factor may be comparable to a commercially traded debt instrument. If it is not, then an additional upward adjustment to the yield would be required in valuing the note.

These factors indicate a substantial likelihood that, both by the note's characteristics and by its interest rate, satisfactory evidence could show that the note would not have a fair market value equal to its face value and thus would be subject to discounts to reflect these factors, reducing the value of the note.

XII. VALUATION SCENARIO TWO (LONG-TERM NOTE WITH UNCHANGED AFR)

Consider a revised set of facts. Parent loans \$1,000,000 to Child, in exchange for a promissory

note that requires payments of interest annually for 20 years with the principal due on maturity and with interest at the then-current long-term AFR of 4%. One year after the note is made, Parent dies. On Parent's date of death, the long-term AFR is again 4%. How would the note be valued in Parent's estate?

An appraisal of the note might consider factors such as, "(1) Interest rates of various debt securities; (2) corporate bonds of various ratings; (3) interest rates for conventional mortgages, 30-year and 1-year Treasury securities, and bank prime loans; and (4) venture capital returns." These are the factors from *Estate of Hoffman*,⁷³ which valued apparently similar long-term loans at a meaningful discount, except that this scenario requires interest to be paid annually, whereas in *Hoffman* all of the simple interest was payable on maturity (which would tend to reduce the discount under our facts, as interest is paid annually), and our transaction does not involve an apparently below-market loan⁷⁴ as the facts in *Hoffman* indicate. Again, as the AFR is not a market rate, comparing this note to a corporate bond, mortgage rate or prime rate, combined with the other characteristics of this note in comparison to a readily marketable debt instrument would likely indicate that a meaningful discount is applicable to this note which has a 19-year remaining term with all principal due on maturity.

XIII. VALUATION SCENARIO THREE (DECREASING AFR)

Evaluate the following facts. Parent sells an asset valued at \$1,000,000 to Trust (a grantor trust created by Parent) in exchange for a promissory note requiring payment of interest annually at the then-current mid-term AFR of 6% and principal of \$1,000,000 due upon maturity. The note is prepayable at any time without penalty.

The note bears interest at the AFR, and a calculation of the present value of all of the payments due under the note would show that it is not a below-market loan under §7872(b)(1). Under Prop. Reg. §25.2512-8 and Prop. Reg. §1.1012-2(b), the value of the note is its issue price (typically face value assuming adequate stated interest).⁷⁵ Finally, under Reg. §25.2512-4, the value of the note is presumed to be its face value plus accrued interest, unless shown by satisfactory evidence that the value is lower. Having just been issued, without any gift under §7872, the note should be valued at face.

Now assume that on the third anniversary date of the note, all interest has been timely and fully paid but

⁷³ *Estate of Hoffman v. Commissioner*, T.C. Memo 2001-109.

⁷⁴ §7872(e)(1).

⁷⁵ See §1274.

the mid-term AFR has declined to 3%. A new note is issued by Trust requiring payment of interest annually at the now current mid-term AFR of 3% and principal of \$1,000,000 due on maturity in nine years, again prepayable at any time without penalty. As the new note has just been issued with interest at the current mid-term AFR, its value also should be \$1,000,000 following the analysis discussed above. What is the current value of the original note in comparison to the new note?

The original note, under Reg. §25.2512-4, is to be valued at the amount of unpaid principal plus accrued interest unless a lower value applies. As the interest rate on the original note is significantly above the now-current mid-term AFR, the interest rate should not be a factor causing the original note to be subject to a discount relative to the new note. Neither the original nor the new note appear to have protective covenants, both are subject to Trust's financial ability to pay, and both defer payment of principal to maturity. The original note, given its shorter time to maturity and higher interest rate, would appear to be more valuable than the new note, except that **Reg. §25.2512-4 provides for values lower than face but does not provide for higher values**, and thus the original note must have the same value as the new one. If the original note and the new note have the same value, it would seem that Parent and Trust could agree to allow Trust to substitute the new for the old note, and thereby reduce the interest rate which Trust was paying to Parent, without such substitution being considered a taxable gift.⁷⁶

XIV. VALUATION SCENARIO FOUR (NOTE ISSUED IN INTER- GENERATIONAL SPLIT-DOLLAR TRANSACTION)

Having discussed the foundational elements above, consider the following scenario incorporating those elements. Client (G1) is 90 years old and has a large and taxable estate. Among G1's assets are money market accounts holding more than \$15,000,000 of cash earning 2% annually. G1's only child (G2) is 50 years old and also has a large and taxable estate consisting primarily of investments in real estate. G2 is estranged from one of G2's three children (each a G3) and has prepared an estate plan which leaves nothing to that G3 member on G2's death. G1 is concerned that G2 will have insufficient liquidity to pay G2's es-

⁷⁶ For a more detailed discussion of the issue of substituting promissory note, see Jonathan Blattmachr, Bridget J. Crawford and Elisabeth O. Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, J. of Tax'n (July 2008).

tate tax upon G2's death and further is aware that G2 will not leave assets to the estranged member of G3. G1 wants to ensure a meaningful inheritance to all members of G3. G1 therefore creates an irrevocable grantor trust (Trust) for the benefit of G2 and all of G2's descendants. The trustee of Trust is (and is required at all times to be) a person other than G1 who is not "related or subordinate" to G1 as provided in §672(c).

G1 gifts \$1,000,000 to Trust. G1 also loans \$10,000,000 to Trust with interest accruing at 3% (the then-current long-term AFR), compounded annually, but where all interest and principal is payable upon G2's death and where the loan repayment is fully recourse to Trust.⁷⁷ G1 has no further obligation to loan funds to Trust, and the parties intend that the loan will be repaid when due. Trust uses the loan proceeds to purchase a life insurance policy on G2's life (single pay or paid over time), which policy is collateral for the repayment of the loan. The death benefit of this policy likely will be several times the cost. Trust has the right to repay the loan at any time without penalty by paying the principal and all accrued and unpaid interest. If the policy is surrendered to provide for the repayment, any surrender proceeds not needed to repay the loan inure to the benefit of Trust. The parties intend that the agreement be governed under the loan regime (under Reg. §1.7872-15) and not under the economic benefit regime (under Reg. §1.61-22). G1 timely files a federal gift tax return, reports the \$1,000,000 gift and allocates \$1,000,000 of G1's GST exemption to the gift such that Trust has an inclusion ratio of zero.⁷⁸ Four years later, G1 dies at age 94.

Six questions will be discussed below. First, how is the note treated on issuance? Second, would the note be governed under the economic benefit regime or the loan regime? Third, how would the note be valued in G1's estate? Fourth, how would this scenario be impacted by recent cases addressing split-dollar arrangements? Fifth, what additional consequences arise following the death of G1? Sixth, how would the note be valued if it was gifted during G1's lifetime?

A. Treatment of the Note on Issuance

Two regulations govern the treatment of "split-dollar" life insurance arrangements. Reg. §1.61-22 contains the rules applicable to the economic benefit regime, while Reg. §1.7872-15 is applicable to the loan regime. A split-dollar life insurance arrangement

⁷⁷ See *Estate of Berkman v. Commissioner*, T.C. Memo 1979-46, for an example of a 20-year note issued by a person age 75 or older at an interest rate higher than such person was previously earning on the loaned funds.

⁷⁸ See §2642(a).

is any arrangement between an owner and a non-owner of a life insurance policy where either party pays some or all of the premiums, directly or indirectly, including through a loan secured by the life insurance policy, and where at least one of the parties paying premiums is entitled to recover some or all of those premiums from, or secured by, the proceeds of the life insurance policy.⁷⁹ Under Reg. §1.7872-15(b), the loan as described above is treated as a split-dollar loan.⁸⁰ As will be discussed below, the loan is governed under the loan regime (Reg. §1.7872-15) and not the economic benefit regime (Reg. §1.61-22). Further, as the loan is not payable in full upon demand of the lender, it is a split-dollar term loan.⁸¹

What is the term of the loan? Under Reg. §1.7872-15(e)(4)(iii)(D), for a split-dollar term loan described in Reg. §1.7872-15(e)(5)(ii)(A), the projected term of a split-dollar loan payable on the death of an individual (G2) is “the individual’s life expectancy as determined under the appropriate table in §1.72-9 on the day the loan is made.”⁸² Under the table in Reg. §1.72-9, G2’s life expectancy (if G2 was female) is 29.6 years, which is the term of the note for calculation purposes. Further, if G2 survives past life expectancy and the note thus remains outstanding, “the split-dollar loan is treated for purposes of this section as retired and reissued as a split-dollar demand loan at that time for an amount of cash equal to the loan’s adjusted issue price on that date. However, the loan is not retested at that time to determine whether the loan provides for sufficient interest.”⁸³ Reg. §1.7872-15(e)(4)(ii) provides that a split-dollar term loan is “tested on the day the loan is made to determine if the loan provides for sufficient interest,” and “[a] split-dollar term loan provides for sufficient interest if the imputed loan amount equals or exceeds the amount loaned.” Consider the present value of all of the payments due under the note: $\$10,000,000 / ((1 + (0.03 / 1)) ^ 29.6)$ (the principal) plus $\$13,987,326.76 / ((1 + (0.03 / 1)) ^ 29.6)$ (all accrued interest), where the interest is calculated as $\$10,000,000 \times 1.03 ^ 29.6 - \$10,000,000$.

The total present value of all of the payments due under this loan is \$10,000,000. As this is the same as the loan amount, the loan is not a below-market loan

⁷⁹ Reg. §1.61-22(b)(1). Also, “[f]or purposes of this section [Reg. §1.7872-15], the terms split-dollar life insurance arrangement, owner, and non-owner have the same meanings as provided in §1.61-22(b) and (c).” Reg. §1.7872-15(b).

⁸⁰ Reg. §1.7872-15(b)(1) references the definition found in Reg. §1.7872-15(a)(2)(i).

⁸¹ Reg. §1.7872-15(b)(3).

⁸² Reg. §1.7872-15(e)(5)(ii)(C).

⁸³ Reg. §1.7872-15(e)(5)(ii)(D).

to which §7872 applies.⁸⁴ Note that, unlike under §7872 generally,⁸⁵ for purposes of a split-dollar loan it appears that the three-month rule under §1274(d)(2) is inapplicable and the AFR is determined solely under §1274(d)(1).⁸⁶ Reg. §1.7872-15(a)(1) further provides that, “[i]f a split-dollar loan is not a below-market loan, then, except as provided in this section, the loan is governed by the general rules for debt instruments (including the rules for original issue discount (OID) under sections 1271 through 1275 and the regulations thereunder).” However, “[t]he rules of . . . this section apply to a gift split-dollar term loan only for Federal income tax purposes. For purposes of Chapter 12 of the Internal Revenue Code (relating to the gift tax), gift below-market split-dollar term loans are treated as term loans under section 7872 (b) and paragraph (e)(4) of this section. See section 7872 (d)(2).”⁸⁷ So, the split-dollar rules under Reg. §1.7872-15(e) apply for purposes of income tax, and the general rules applicable to a term loan under §7872 apply to determine the gift tax consequences (if any) of the split-dollar loan.

Reg. §1.7872-15(f)(1) addresses the interest provisions of a loan, stating that “[i]f a split-dollar loan provides for stated interest or OID, the loan is subject to this paragraph (f), regardless of whether the split-dollar loan has sufficient interest. Except as otherwise provided in this section, split-dollar loans are subject to the same Internal Revenue Code and regulatory provisions for stated interest and OID as other loans.” Because Trust is a grantor trust, G1 would not have to recognize OID while Trust is a grantor trust,⁸⁸ and thus it appears that Reg. §1.7872-15(f) would not af-

⁸⁴ Reg. §1.7872-15(e)(4)(ii). Also, under Reg. §1.7872-15(e)(5)(iv)(B), “[i]f the loan provides for sufficient interest, then section 7872 does not apply to the loan. . . .”

⁸⁵ Section 7872(f)(2)(A) provides that the AFR for a term loan “shall be the applicable Federal rate in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually.” As §7872 provides that the AFR is determined under §1274(d), and as §1274(d)(2) redefines the AFR as being the lowest three-month rate “[i]n the case of any sale or exchange,” it would appear that the three-month rule would determine the AFR “as of the day on which the loan is made” if the loan is made in the context of a sale or exchange.

⁸⁶ “A split-dollar term loan is tested on the day the loan is made to determine if the loan provides for sufficient interest. A split-dollar term loan provides for sufficient interest if the imputed loan amount equals or exceeds the amount loaned. The imputed loan amount is the present value of all payments due under the loan, determined as of the date the loan is made, using a discount rate equal to the AFR in effect on that date. The AFR used for purposes of the preceding sentence must be appropriate for the loan’s term (short-term, mid-term, or long-term) and for the compounding period used in computing the present value. See section 1274(d)(1).” Reg. §1.7872-15(e)(4)(ii).

⁸⁷ Reg. §1.7872-15(e)(5)(iv)(D).

⁸⁸ §671.

fect the loan during G1's lifetime. Also, a payment ordering rule for split-dollar loans is found in Reg. §1.7872-15(k), which provides that payments made by the borrower to lender are applied first to accrued but unpaid interest (including OID), second to principal, third to amounts paid by lender (the non-owner of the policy) that were not reasonably expected to be repaid by the owner (borrower), and fourth to any other "payment with respect to a split dollar life insurance arrangement. . . ."⁸⁹

Based on the analysis discussed above, and under Prop. Reg. §25.2512-8 and Prop. Reg. §1.1012-2(b), the value of the note should be its face value. Further, under Reg. §25.2512-4, the value of the note again is presumed to be its face value plus accrued interest, unless shown by satisfactory evidence to be lower. Having just been issued, without gift issues under §7872, the note should be valued at face. This fact pattern is in contrast with *Estate of Cahill v. Commissioner*,⁹⁰ which will be discussed in more detail below, where the Tax Court stated that, "according to the estate's valuation theory, the initial transfer of \$10 million in value cannot have been in exchange for property worth that amount; i.e., under the estate's argument, what decedent received was necessarily worth at least 98% less than what he transferred (even without taking into account the amounts used to pay commissions and fees to the insurance company). Consequently, at least according to the estate's valuation theory, the value of what decedent received (allegedly, something close to \$183,700) was not even roughly equal to the \$10 million decedent paid."

B. Economic Benefit vs. Loan Regime

As discussed, Reg. §1.61-22 governs the treatment of a split-dollar loan subject to the economic benefit regime. However, "[e]xcept as provided in paragraph (b)(3)(ii) of this section, paragraphs (d) through (g) of this section do not apply to any split-dollar loan as defined in §1.7872-15(b)(1). Section 1.7872-15 applies to any such loan."⁹¹ Nonetheless, Reg. §1.61-22(b)(3)(ii) further provides that "[p]aragraphs (d) through (g) of this section apply (and §1.7872-15 does not apply) to any split-dollar life insurance arrangement if. . . [t]he arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section)." In para-

graph (c)(1)(ii)(A)(2), the Regulation states that, "[a] donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section." So, for the economic benefit regime to not apply, and thus for the loan regime under Reg. §1.7872-15 to apply, the split-dollar arrangement must provide an economic benefit beyond current life insurance protection to the donee (i.e., Trust).

The requirements of the economic benefit regime and thus the method of causing a split-dollar arrangement to be subject to the loan regime and not the economic benefit regime were discussed in detail in *Estate of Morrissette v. Commissioner*.⁹² *Morrissette* involved the estate's motion for partial summary judgment that the split-dollar arrangements at issue were governed by the economic benefit regime and not the loan regime, which motion the Tax Court granted. It was clear that the parties' intent in *Morrissette* was to create split-dollar agreements governed by the economic benefit regime, as the Tax Court noted, "[e]ach split-dollar life insurance arrangement includes the following recital: 'WHEREAS, the parties intend that this Agreement be taxed under the economic benefit regime of the Split-Dollar Final Regulations, and that the only economic benefit provided to the [Dynasty] Trust[s] under this arrangement is current life insurance protection.' " Nonetheless, the Tax Court discussed the requirements for having a split-dollar agreement governed by the economic benefit regime.

The determination of which regime applies to a split-dollar life insurance arrangement depends on which party owns, or is deemed to own, the life insurance policy subject to the arrangement. Generally, the person named as the owner in the insurance contract is treated as the owner of the contract. . . . As an exception to the general rule, the final regulations include a special ownership rule that provides that if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is current life insurance protection, then the donor will be the deemed owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply. . . . If, on the other hand, the donee receives any additional economic benefit, other than current life insurance protection, then the donee will be considered the owner and the loan regime

⁸⁹ Note that under Reg. §1.7872-15(c), "[t]he borrower may not deduct any qualified stated interest, OID, or imputed interest on a split-dollar loan. See sections 163(h) and 264(a)."

⁹⁰ *Estate of Cahill v. Commissioner*, T.C. Memo 2018-84.

⁹¹ Reg. §1.61-22(b)(3)(i).

⁹² 146 T.C. 171 (2016).

will apply. . . . [I]t follows that where a donor is to receive the greater of the aggregate premiums paid or the CSV [cash surrender value] of the contract, the possibility of the donee receiving an additional economic benefit is foreclosed.⁹³

After discussing the general concepts, the Tax Court summarized the requirements under Reg. §1.61-22.

For a split-dollar life insurance arrangement to be taxed under the economic benefit regime, the owner or deemed owner will be treated as providing an annual benefit to the nonowner in an amount equal to the value of the economic benefits provided under the arrangement, reduced by any consideration the nonowner pays for the benefits. Sec. 1.61-22(d)(1), Income Tax Regs. The value of the economic benefits provided to the nonowner for a taxable year under the arrangement is equal to the sum of (i) the cost of current life insurance protection, (ii) the amount of cash value to which the nonowner has current access during the year, and (iii) any economic benefits not otherwise described that are provided to the nonowner. . . . To determine whether any additional economic benefit was conferred by the [lender's revocable trust] to the Dynasty Trusts, the relevant inquiry is whether the Dynasty Trusts had current access to the cash values of their respective policies under the split-dollar life insurance arrangements or whether any other economic benefit was provided. . . . ***If the Dynasty Trusts have current access to any portion of the policy cash value, then the special ownership rule will not apply, the Dynasty Trusts will be considered the owners of their respective policies under the general ownership rule, and the split-dollar life insurance arrangements will be governed by the loan regime.*** For the Dynasty Trusts to have current access under the final regulations, the Dynasty Trusts must first have a current or future right to any portion of the policy cash value.⁹⁴

Under the facts of this scenario, lender has no specific right to access the policy's cash value. Further, unlike under an economic benefit split-dollar arrangement, there is no requirement that upon termination of the split-dollar agreement during G2's lifetime, G1 would be repaid the entire cash surrender value. Instead, G1 is entitled only to payment of the outstanding loan principal plus accrued and unpaid interest, and any excess cash surrender value would inure to the benefit of Trust. So, if the cash surrender value ex-

ceeded the amount of principal and interest due under the loan and Trust surrendered the policy during G2's lifetime, the excess cash surrender value would inure to the benefit of Trust, giving Trust a right to a portion of the policy cash value and thus, as stated in *Morrisette*, causing the split-dollar arrangement discussed in the scenario above to be governed by the loan regime and not by the economic benefit regime.

C. Valuation of the Note in G1's Estate

Four years after the note is issued, G1 dies at age 94. The note, which has 25.6 years remaining on the term, must be valued for estate tax purposes in G1's estate.⁹⁵ Reg. §1.7872-15(e)(5)(iv)(D) provides that, with regard to a gift split-dollar term loan, the rules stated under that section apply "only for Federal income tax purposes," and specifically excludes their application for purposes of Chapter 12 (gift tax). As these rules apply only for federal income tax purposes, they also appear not to apply for purposes of Chapter 11 (estate tax). Further, Reg. §1.61-22, which also provides rules applicable to split-dollar insurance arrangements, only applies "for purposes of the income tax, the gift tax," and other federal purposes not including estate tax.⁹⁶ "Section 1.61-22(a), Income Tax Regs., lists the purposes for which it applies; the list does not include the estate tax. . . ."⁹⁷

If neither of Reg. §1.7872-15 or Reg. §1.61-22 apply for determining the value of the note for purposes of its inclusion in G1's taxable estate, then Reg. §20.2031-4 would control. A note which has a remaining term of 25.6 years, with no payments due until maturity, where the note would be accelerated if G2 dies before life expectancy or delayed if G2 outlives life expectancy, indicates a meaningfully higher degree of uncertainty (i.e., risk) compared with commercial debt instruments, less marketability (as there is no established market on which the note is traded) and no cashflow for a period which could exceed 25.6 years. Further, as the note bears interest at the long-term AFR in effect when the note was issued, in comparison to other debt instruments, corporate bonds or mortgages, it likely would be at a below-market rate (unless rates had declined meaningfully since the note was issued), which, combined with the remaining term, indicates that an increase in the discount factor would be applicable under Reg. §20.2031-4, further decreasing the value of the note. Combined, these fac-

⁹⁵ Under Reg. §1.7872-15(e)(5)(ii)(C), as the term of the loan is the individual's life expectancy determined "on the day the loan is made," the remaining term would be the initial term reduced by the time elapsed and would not be recalculated at this time.

⁹⁶ Reg. §1.61-22(a)(1).

⁹⁷ *Estate of Cahill v. Commissioner*, T.C. Memo 2018-84.

⁹³ 146 T.C. at 179.

⁹⁴ 146 T.C. at 181 (emphasis added).

tors indicate that (depending on market interest rates on the date of G1's death) the value of the note for estate tax purposes likely would be meaningfully below the amount of outstanding principal and accrued interest.⁹⁸

D. Comparing Cahill to Morrisette

Shortly after the Tax Court's decision in *Estate of Morrisette v. Commissioner*,⁹⁹ the Tax Court addressed another split-dollar case, *Estate of Cahill v. Commissioner*.¹⁰⁰ Like *Morrisette*, *Cahill* involved the estate of a decedent who had entered into a split-dollar arrangement where the estate sought to apply Reg. §1.61-22 to the valuation of decedent's interest. These cases differed significantly, however, in their facts and the Tax Court's ruling. Consider the following differences.

In *Estate of Morrisette*,¹⁰¹ a court appointed conservator created three irrevocable trusts, one for the benefit of each of decedent's children. By an amendment to the decedent's revocable trust (presumably either by the trustees under the terms of the revocable trust or under the conservatorship), the revocable trust was authorized to fund the split-dollar insurance, make loans, enter into the arrangements and, on decedent's death, to "transfer each receivable from the split-dollar life insurance arrangement when paid by each Dynasty Trust back to the Dynasty Trust owing the receivable or directly back to each son." Shortly thereafter, the decedent (presumably by the sons as trustees of the revocable trust, as the conservatorship apparently had expired) entered into the split-dollar arrangements with the three irrevocable trusts. Following the economic benefit regime, if a split-dollar arrangement was terminated during the insured's lifetime, "the Dynasty Trust would not receive anything from the policy." The facts do not indicate the conditions under which a split-dollar agreement could be terminated, but presumably the sons as trustees of the revocable trust and the trustees of the irrevocable trusts could jointly agree to terminate such an agreement. During the next three years, gifts were reported on the economic benefits, and on decedent's death the approximately \$30,000,000 advanced by the decedent's revocable trust was valued at approximately \$7,500,000 (approximately 25% of the amount advanced).

⁹⁸ See *Estate of Hoffman v. Commissioner*, T.C. Memo 2001-109, for the valuation of long-term notes with all payments due on maturity.

⁹⁹ 146 T.C. 171 (2016).

¹⁰⁰ T.C. Memo 2018-84.

¹⁰¹ 146 T.C. 171 (2016).

In *Estate of Cahill*,¹⁰² decedent's son, as attorney-in-fact, created an irrevocable trust for the benefit of himself and his issue. The irrevocable trust purchased three life insurance policies, one on the son's life and two on the son's wife's life (the facts do not indicate if the son's wife also was a beneficiary of the irrevocable trust). The son, as trustee of the decedent's revocable trust, entered into three split-dollar agreements and advanced \$10,000,000 to the irrevocable trust. The funds, however, came from a bank loan obtained by the son on decedent's behalf, with a floating interest rate in excess of the guaranteed rate on the policies, requiring payment of interest only for five years with a balloon payment of principal on maturity. The split-dollar agreements provided that they could be terminated during the insured's lifetime by agreement of the trustees of the revocable trust and the irrevocable trust. A small gift was reported in the first year of the split-dollar agreement, and decedent died about a year after the agreement was executed. On decedent's death, the \$10,000,000 advanced by the decedent's revocable trust was valued at \$183,700 (less than 2% of the amount advanced).

Estate of Cahill v. Commissioner is clearly a "bad facts" case. While both *Morrisette* and *Cahill* involved an elderly and incompetent person, via a fiduciary, advancing millions of dollars to fund life insurance, *Morrisette* had (i) a court appointed conservator, (ii) a clear business purpose for the insurance, and (iii) an estate tax value which was, while significantly discounted, a meaningful portion of the amount advanced. In contrast, *Estate of Cahill* involved (i) the son on both sides of the transaction (as trustee of the revocable trust, as grantor (as attorney-in-fact) of the irrevocable trust and as the borrower (either as trustee or as attorney-in-fact) of the loan from the bank, (ii) a funding source which could not have been intended to extend for the life expectancies of the son and his wife,¹⁰³ and (iii) an estate tax value which was virtually de minimis. In *Estate of Morrisette*, the Tax Court held that Reg. §1.61-22 applied, and in *Estate of Cahill* it did not (or at least the estate's motion for partial summary judgment on the applicability of Reg. §1.61-22 was denied).

A key difference between the *Morrisette* and *Cahill* cases and the scenario discussed above, is that both cases were either governed by, or argued to be governed by, the economic benefit regime, while the scenario above is governed under the loan regime and thus has different facts. Indeed, the Tax Court in *Cahill* discussed a promissory note in comparison to a split-dollar agreement, stating that,

¹⁰² T.C. Memo 2018-84.

¹⁰³ "[I]f decedent was acting as a prudent business person, why did he fund a long-term obligation with a short-term loan?" *Estate of Cahill v. Commissioner*, T.C. Memo 2018-84.

[a] note is generally a bargained-for agreement between two parties in which one party lends a sum of money and the other party agrees to repay that sum with interest over a period of time. . . . But the term of a bona fide promissory note is a bargained-for part of the economic deal between the parties to the note; the debtor compensates for the term by paying interest to the lender. Nothing in the facts presently before us suggests that [the irrevocable trust] ever paid anything to compensate decedent for the indeterminate term of these arrangements, which are therefore entirely unlike bona fide notes.¹⁰⁴

This implies that a bona fide debt evidenced by a promissory note would be respected (either generally or for purposes of §2703(a)) where the split-dollar agreements in *Cahill* were not. Further, the Tax Court stated that the “[t]rust did not bargain for these split-dollar agreements (it provided nothing to fund these arrangements), nor did [trust] agree to repay with interest the money provided by decedent.”¹⁰⁵ In contrast, under the scenario above Trust specifically agreed to repay with interest the loan from G1. Indeed, under the facts stated above the promissory note issued to G1 had a present value on issuance equal to the amount of the loan and would continue to accrue interest if G2 outlived life expectancy, in contrast to *Cahill* where “the value of what decedent received (allegedly, something close to \$183,700) was not even roughly equal to the \$10 million decedent paid.”¹⁰⁶ Note also that, while the Tax Court stated that the term of the arrangement in *Cahill* was “indeterminate,” a loan for the life of a person is an actuarially determinable term and this type of loan is specifically addressed in Prop. Reg. §1.7872-10(a)(2) as being a term loan.

E. Section 2703

Section 2703(a) applies to value property without regard to “any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property. . . .” If the note payable to G1 had a value below the amount of the loan, then the note would be a below-market loan under §7872(e)(1). However, as discussed above, on issuance the promissory note payable to G1 had a present value equal to the amount loaned and was not a below-market loan. In contrast, the Tax Court in *Cahill* stated that, “[t]he estate claims that decedent paid

\$10 million to the insurance companies for the benefit of [the irrevocable trust] and in return received certain rights, namely, the termination rights (which the estate claims are worthless) and decedent’s death benefit rights (which, according to the estate’s valuation theory, are worth less than 2% of the cash surrender value).” The apparent disconnect in value between what the decedent transferred and received in *Cahill*, without a corresponding gift having been reported, appears to have been a meaningful part of the basis on which the Tax Court found that §2703(a) applied.

Under §2703(a)(1), the promissory note should not constitute an “option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right)” because the fair market value of the promissory note when it was issued was equal to the amount of the loan, as discussed above, and thus no property was acquired at less than its fair market value. A loan also should not constitute a “restriction on the right to sell or use such property” under §2703(a)(2), as the note itself can freely be sold (assuming a buyer could be found), and while it does prevent a lender from “using” the loaned proceeds until the loan is repaid, that is an inherent concept in all loans. As the fair market value of the promissory note on issuance was equal to the amount of the loan, there is no valuation discount caused by a contract restriction to disregard. Additionally, under the scenario above, Trust has the unilateral right to “terminate” the loan by prepaying all outstanding principal and accrued interest. Consider whether this might also avoid the application of §2703(a).¹⁰⁷

F. Section 2036(a) and §2038(a)

The Tax Court in *Estate of Cahill v. Commissioner* also relied on its ruling in an earlier case, *Estate of Powell v. Commissioner*.¹⁰⁸ *Powell* is another “bad facts” case with meaningful similarities to *Cahill*. Briefly, in *Powell*, decedent’s son, acting on decedent’s behalf, created a general partnership nine days before decedent’s death, with the son as the general partner. Two days later, the son had decedent’s revocable trust transfer about \$10,000,000 of assets to the partnership in exchange for a 99% limited partner interest. The son then purported to transfer that limited partner interest to a charitable lead annuity trust, valued at a 25% discount, and then on decedent’s death included only the value of the remainder in the CLAT on decedent’s estate tax return. The Tax Court in *Ca-*

¹⁰⁴ T.C. Memo 2018-84.

¹⁰⁵ T.C. Memo 2018-84.

¹⁰⁶ T.C. Memo 2018-84.

¹⁰⁷ See Steve R. Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, Bessemer Trust (Feb. 2019), p. 90.

¹⁰⁸ *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

hill, in discussing §2036(a)(2), quoted its opinion in *Powell*, that “[D]ecedent’s ability to dissolve *** [her limited partnership] with the cooperation of her sons constituted a ‘right *** in conjunction with *** [others], to designate the persons who shall possess or enjoy the property [she transferred to the partnership] or the income therefrom’, within the meaning of section 2036(a)(2).”¹⁰⁹

Note the similarities between *Powell* and *Cahill*. Both involved an elderly and incompetent person whose son acted on her or his behalf. Both involved the significant transfer of assets in a transaction where the son acted on both sides of the transaction. Further, both involved the value of the transferred assets being greatly discounted (under different theories) within three years of the date of the decedent’s death. Indeed, the *Powell* court discussed §2035, which was appropriate given that the transaction was implemented one week before the date of decedent’s death.¹¹⁰ In contrast, under the facts of the scenario discussed above, G1 died four years after the implementation of the transaction, which should eliminate the §2035 argument. Further, G1 was acting directly, rather than through a fiduciary, and G1 was not on both sides of the transaction, as the trustee of Trust is a person who is not the grantor nor anyone related or subordinate to the grantor.

Consider the argument which the Tax Court found applicable in *Cahill*. Under §2036(a)(2) and §2038(a)(1), the Tax Court denied summary judgment (i.e., that Reg. §1.61-22 applied, and §2036 and §2038 did not apply) finding that decedent, in conjunction with another person (i.e., the trustee of the irrevocable trust) had the right to terminate a split-dollar agreement. This follows the Tax Court’s decision in *Powell*.¹¹¹ As commentators have noted,¹¹² any transaction involving two people could allow one of them, in conjunction with the other, to alter the terms of the transaction. Indeed, taken to its logical extreme, an outright gift of cash would be covered by §2036(a)(2) as the donor, in conjunction with the donee, could redirect the gifted cash. The scope of §2036(a)(2) and §2038(a)(1) must be more limited. Note that *Estate of Morrisette* did not discuss §2036 or §2038, so a direct comparison between *Morrisette* and *Cahill* on this issue cannot be made.

The Tax Court in *Cahill* noted that “[w]here (as here) the only benefit to the donee is current life insurance protection, the economic benefit regime

clearly treats decedent as the owner of the cash surrender value. See, e.g., sec. 1.61-22(b)(3)(i), (ii)(B), (c)(1)(ii)(A)(2), (d)(2), (4)(ii), Income Tax Regs. . . . Consistency between the regulations and the estate tax Code sections would therefore demand that the cash surrender value remaining as of decedent’s date of death be valued as part of, or included in, decedent’s gross estate.”¹¹³ This is due to the special rule in Reg. §1.61-22(b)(3)(ii)(B) where the donor (i.e., lender) is treated as the owner of the life insurance contract under Reg. §1.61-22(c)(1)(ii)(A)(1). However, under the scenario discussed above, the special rule under Reg. §1.61-22(b)(3)(ii)(B) does not apply, thus the economic benefit regime does not apply and the loan regime applies. So, if the rule that would cause G1 to be treated as the owner of the cash surrender value does not apply, then the cash surrender value should be treated as owned by the owner, i.e., Trust. In this case, §2036(a) and §2038(a) should not apply.

If a court was considering the scenario discussed above, and nonetheless believed that §2036(a) or §2038(a) did apply under the “in conjunction with” position in *Powell*,¹¹⁴ the exception for a “bona fide sale for an adequate and full consideration in money or money’s worth” under §2036(a) and §2038(a) should cover this transaction. “Whether a transfer was a bona fide sale is a question of business purpose; i.e., did decedent have a legitimate and significant nontax reason, established by the record, for transferring the \$10 million?”¹¹⁵ The Tax Court in *Cahill* questioned whether the transfers in that case were actually intended to provide liquidity decades in the future, why the interest rate on the loan used to fund the purchase was higher than the guaranteed return on the policies, and why a long-term arrangement was funded with a short-term loan. Under the scenario discussed above, G1, in addition to seeking to provide liquidity for G2’s estate, wanted to provide a meaningful inheritance to all members of G3, one of whom would receive nothing under G2’s estate plan. Further, G1 took cash earning 2% and loaned it to Trust under the note which accrues interest at 3% compounded annually and due on maturity, and did not need to borrow the cash in order to lend it.

“Whether a transfer was for adequate and full consideration is a question of value; i.e., did what decedent transferred roughly equal the value of what he received in return?”¹¹⁶ Under the scenario discussed above, G1 transferred \$10,000,000 of cash to Trust. Trust then transferred to G1, in the form of the prom-

¹⁰⁹ T.C. Memo 2018-84.

¹¹⁰ 148 T.C. 392 (2017).

¹¹¹ 148 T.C. 392 (1997).

¹¹² See Steve R. Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, Bessemer Trust (Feb. 2019), p. 90.

¹¹³ T.C. Memo 2018-84.

¹¹⁴ 148 T.C. 392 (2017).

¹¹⁵ *Cahill*, T.C. Memo 2018-84.

¹¹⁶ *Id.*

issory note, its promise to pay the amount loaned plus interest at 3% compounded annually, which, on issuance, had a total present value, as determined under §7872, of \$10,000,000. The scenario discussed above should therefore satisfy both parts of the exception under §2036(a) and §2038(a).

Consider also the Supreme Court cases of *Commissioner v. Wemyss*¹¹⁷ and *Merrill v. Fahs*.¹¹⁸ *Wemyss* considered the gift tax on a transfer of property between a couple just before their marriage.¹¹⁹ In considering whether the transfer was for “less than an adequate and full consideration in money or money’s worth . . .” the Court stated, “[i]f we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct. . . . The section taxing as gifts transfers that are not made for “adequate and full [money] consideration” aims to reach those transfers which are withdrawn from the donor’s estate.”¹²⁰ In *Merrill*, which involved a transfer between spouses and the gift tax attributable thereto (remember that the unlimited marital deduction did not exist until 1981¹²¹), the Court considered whether “adequate and full consideration” in the estate tax should have the same meaning in the gift tax, and stated “[w]e believe that there is every reason for giving the same words in the gift tax the same reading. . . to interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation. Here strong reasons urge identical construction.”¹²² Further, “[t]he gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together.”¹²³

Under §2512(b), “[w]here property is transferred for less than an adequate and full 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. . . .” Reg. §25.2511-2(a) provides that the gift tax “is measured by the value of the property passing from the donor. . . .” Similarly, the Tax Court in *Steinberg v. Commissioner* discussed *Commissioner v. Wemyss*

and the “estate depletion theory,” stating that, “whether a donor receives consideration is measured by the extent to which the donor’s estate is replenished by the consideration.”¹²⁴ All of these are focused on whether there was a difference in value, for gift tax purposes, between what the donor transferred and what the donor received, with the difference, if any, being the amount of the gift. Congress, in enacting §7872, provided a determinable method for valuing the amount of a gift in an intrafamily loan.¹²⁵ The loan of \$10,000,000 from G1 to Trust, as discussed above, is not a below-market loan, and thus no gift was made when the loan was made in exchange for the promissory note. If an intrafamily loan does not result in a gift under §7872, then what was transferred and what was received should have the same value for gift tax purposes, the donor’s estate should be fully replenished and what was received by the donor should constitute “adequate and full consideration in money or money’s worth” for gift tax purposes because if such consideration was “less than an adequate or full consideration in money or money’s worth” there would have been a gift.¹²⁶ This is further supported by Reg. §25.2512-4, which provides that “[t]he fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest,” which in this case is the \$10,000,000 of unpaid principal on the note.

If the gift tax and the estate tax must be construed together, as the Supreme Court stated in *Merrill v. Fahs*, and if for gift tax purposes the consideration received (i.e., the note) constitutes “adequate and full consideration in money or money’s worth,” then it also should constitute the same for estate tax purposes. Additionally, note that “adequate and full consideration” under §2512(b) is measured “at the date of the gift” under §2512(a) and is not a continuing obligation lasting until the donor’s death. If the consideration received by the donor later declines in value or is valued differently under Reg. §20.2031-4, that should not affect whether there was “adequate and full consideration” at the date when the transfer was made.

¹²⁴ *Steinberg v. Commissioner*, 141 T.C. 258 (2013).

¹²⁵ “The Commissioner’s primary position in *Frazer* was that the value of the intrafamily note for gift tax purposes should be its ‘present value’ under section 7872 (i.e., a value determined by reference to the applicable Federal rate), rather than its fair market value under general tax principles (i.e., a value determined by reference to market interest rates). Although we found this position to be ‘anomalous’ because it was contrary to the traditional fair market value approach, *Frazer v. Commissioner*, supra at 590, we nevertheless accepted the Commissioner’s treatment. . . .” *Estate of True v. Commissioner*, T.C. Memo 2001-167, *aff’d*, 390 F.3d 1210 (10th Cir. 2004).

¹²⁶ §2512(b).

¹¹⁷ 324 U.S. 303 (1945).

¹¹⁸ 324 U.S. 308 (1945).

¹¹⁹ *Wemyss*, 324 U.S. 303 (1945).

¹²⁰ 324 U.S. 303 (1943).

¹²¹ Economic Recovery Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

¹²² 324 U.S. 308 (1945).

¹²³ *Id.*, citing *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939); *Estate of Cahill v. Commissioner*, T.C. Memo 2018-84.

While a detailed discussion of §2036, §2038, and §2703 is beyond the scope of this article, the facts of the scenario discussed above indicate that §2036(a) and §2038(a) should not apply, or if either does, the bona fide sale exception should apply. The split-dollar rules apply for purposes of income tax (and Reg. §1.61-22 also applies for purposes of gift tax), but not for purposes of estate tax. If the inclusion arguments made in *Estate of Cahill v. Commissioner* can be addressed, then the note should be valued for estate tax purposes under the applicable rules for promissory notes as discussed above.

G. Treatment of the Note After G1's Death

Following G1's death, Trust will cease to be a grantor trust. Once that happens, the OID rules will apply. If G2, as G1's only child, inherits the note under G1's estate plan, as the OID rules then would be applicable, *G2 would recognize OID income annually on the note, regardless of G2's regular method of accounting, even though no payments are required to be paid on the note during G2's lifetime.*¹²⁷ In essence, this gives G2 phantom income for life on the note (as the note is payable on G2's death), though Trust is not permitted to deduct the interest on a split-dollar loan.¹²⁸

As an alternative, if G1's estate plan bequeaths the note to Trust, then, as Trust would be both the payor and payee, the note would end. The estate tax would apply as discussed to the value of the note in G1's estate but the note would not be includible (and thus would not require valuation) in G2's estate. This also would eliminate the OID issues on the note.

H. What if the Note Was Gifted During G1's Life?

As a variant of the facts discussed in this scenario, consider the following. G1 is 86 when G1 makes the loan to Trust, but all other facts remain the same (though G2's life expectancy at age 46 would be longer, so the term of the note would be longer). When G1 is 90, G1 elects to gift the note to Trust. G1 dies at age 94 as discussed above. How would the gift of the note be valued? As discussed in XI., above, the note would be valued by comparing it to similar commercial debt instruments. Given the terms of the note and depending on interest rates on the date of the gift,

¹²⁷ Reg. §1.1272-1(a)(1). For more detail on the OID rules, see Michael S. Strauss, *Applying the OID Rules to an Intra-Family Promissory Note*, by J. of Tax'n (Sept. 2016).

¹²⁸ Reg. §1.7872-15(c).

this would seem likely to result in the note being valued at less than the amount of unpaid principal plus accrued interest. As a gift made during lifetime, this also would appear to not be subject to §2036 and §2038, which address estates, and would not be subject to §2035 as the gift occurred four years before the date of G1's death.

Although *Estate of Morrisette v. Commissioner* and *Estate of Cahill v. Commissioner* have cast considerable doubt on the valuation of split-dollar arrangements under the economic benefit regime, a loan issued to fund a life insurance policy, with proper process and appropriate facts, should be a viable method of funding such insurance, and on the lender's death such a promissory note would appear to be subject to the typical rules for valuation of intrafamily promissory notes as discussed above.

XV. CONCLUSION

Section 7872 provides that if on issuance a note is not a below-market loan, *then the issuance of the note does not create a gift for gift tax purposes*. It necessarily follows that the note must have been issued for full and adequate consideration, for if the note was not issued for full and adequate consideration, then there would have been a gift on issuance; yet §7872 tells us that there was no such gift. Valuing the note at a discount if it is later transferred by gift or bequest should not allow the value of the note at its issuance to be disregarded provided that the note was a bona fide debt. It therefore follows that if an irrevocable trust is obligated on a note constituting a bona fide debt which was valued on issuance at face value under §7872 and below face value in a decedent's gross estate, the IRS should not be able to successfully claim that the note was not issued for adequate and full consideration so as to cause the trust's assets to be included in the note holder's gross estate.

In comparison to commercial debt instruments (such as bonds), a typical intrafamily promissory note bearing interest at the AFR (as of the date it was issued) often will present valuation opportunities for both gift and estate tax purposes due to the difference between the method of valuing a note on issuance for gift tax purposes and the method of valuing a note after issuance for either gift or estate tax purposes. While the IRS may challenge the comparable instruments selected and any discounts applied, an appraisal of a bona fide debt evidenced by a promissory note with below-market interest, after it has been issued and following the regulations, TAM 8229001 and applicable cases, should allow for a supportable discount from face value under the types of circumstances discussed above.