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When is Money from Family Considered a Loan Versus a Gift?

Changes to the Estate & Gift Tax Laws Still Pending

planning matters

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when is money from family considered a loan versus a gift?

by James K. Estabrook, Esq. & Lauren M. Mulcahy, Esq.

It is very common for parents to provide funds to their children over their lifetime, but are these transfers gifts or loans? A recent ruling in the Tax Court, *Estate of Bolles v. Commissioner, T.C. Memo. 2020-71, 119 T.C.M. (CCH) 1502 (June 1, 2020)*, highlights the importance in estate planning of differentiating between loans and gifts.

Mary Bolles was a loving mother of five children whom she tried to treat equally. Her practice was to keep a record of her advances to and the occasional repayments from each child. Based on her intent and the advice of tax counsel, she treated the advances as loans. She forgave the "debt" account of each child every year to the extent of the annual gift tax exclusion amount. According to the Tax Court, her practice would have been noncontroversial had she not advanced substantial funds to one son, Peter.

When Peter ran into financial difficulties with his architectural business, Mary supported him and between 1985 and 2007 she transferred $1,063,333 to Peter or for his benefit.

In 1989 Mary established the Mary Piper Bolles Revocable Trust, which excluded Peter from any distribution of her estate upon her death. Mary later amended the trust—Peter was no longer entirely excluded but his distribution was tied to a formula to account for loans made to him by Mary. In 1995 Peter signed an acknowledgment that he had received loans from Mary and would not be able to repay her.

When Mary died in 2010, the IRS assessed her estate with a deficiency of $1.15 million in estate taxes, taking the position that the entire $1,063,333 transferred to Peter was a loan and included in her taxable estate. The IRS argued that the loan had accrued interest in the amount of $1.165 million and that a total of $2.23 million should be added to the value of Mary's estate. The estate argued that the $1,063,333 in transfers were prior taxable gifts, and therefore while those gifts would be added to the tax base there should be no accrued interest added to the value of the estate.

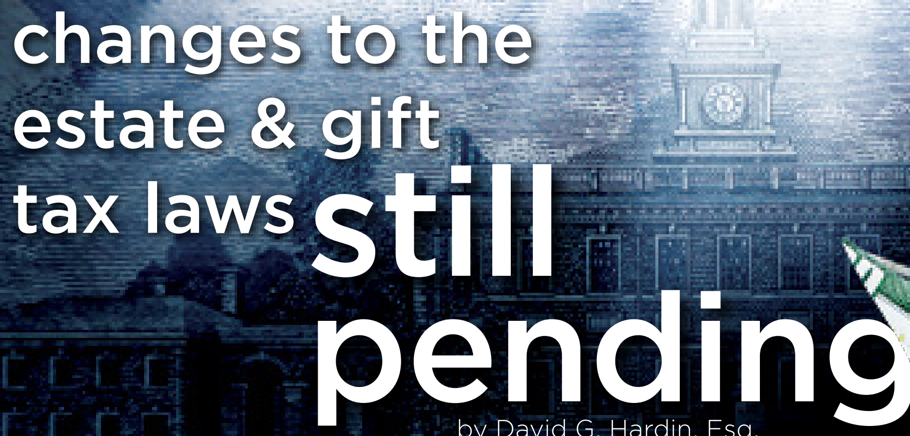
Traditionally courts consider the following factors in determining whether an advance is a gift or a loan:

- whether there was a promissory note or other evidence of indebtedness
- whether interest was charged
- whether there was security or collateral
- whether there was a fixed maturity date
- whether a demand for repayment was made
- whether actual repayment was made
- whether the transferee had the ability to repay
- whether records maintained by the transferor and/or the transferee reflect the transaction as a loan
- the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.[1]

In Mary's case, the Tax Court found that through 1989 the advances to Peter constituted loans, but from 1990 on, the advances would be considered gifts. While Mary had always recorded the advances to Peter and kept track of interest, there were no loan agreements, collateral, nor requests for repayment. The Court noted that Mary initially had an expectation of repayment, but eventually it became clear to her that Peter's business would not be successful and that he would not have the means to repay her. The Court noted that the "reasonable possibility of repayment is an objective measure of Mary's intent." The evidence of Mary's intent was key to the characterization of the advances as gifts. Mary appeared to have accepted that the advances to Peter from 1990 forward would not be repaid. The Court noted that in the case of an intra-family loan, an actual expectation of repayment and an intent to enforce the debt are critical to sustaining the characterization of the transaction as a loan.

The lesson here is that while family loans can be great estate planning tools, the recordkeeping, actions, and intent of the parties are vital in determining whether an advance will be considered a loan or a gift in the eyes of the IRS, with serious financial consequences both during life and at death if the distinction is not clearly made.

1. Miller v. Commissioner, T.C. Memo 1996-3, aff'd, 113 F.3d 1241 (9th Cir. 1997).



changes to the estate & gift tax laws still pending

by David G. Hardin, Esq.

It has been our hope that estate and gift tax reform would be settled by the time this article goes to print. Unfortunately, this is not the case. Revenue issues involving the debt ceiling and stop-gap spending are circulating in Congress at the same time as legislative priorities, like infrastructure, are being hashed out, and procedural steps, like filibuster and reconciliation, are being threatened. Tax reform is but one issue in the mix, and its ultimate resolution is influenced by, and dependent upon, the resolution of a number of the others which are still unresolved. This article will provide a summary of the most recent available information.

1. Perhaps the most significant proposal on the table is the reduction of the lifetime estate and gift tax exemption, often referred to as the "unified credit," from its current $11,700,000 per person to $6,020,000 per person in 2022 as estimated by the staff on the Joint Committee on Taxation. The lifetime exemption was increased from $5.5-million to $11-million (with adjustments for inflation) as part of the 2017 Tax Act. The increased exemption amount is due to sunset by its own terms on December 31, 2025, but the current proposal would accelerate that timetable. Individuals looking to make maximum use of the higher lifetime exemption currently available will want to consider making gifts before any reduction becomes effective. Under the proposed bill, the provision would apply to decedents dying and gifts made after December 31, 2021.

2. The current proposals would eliminate the use of discounts for transfer tax purposes when valuing passive, nonbusiness assets. Discounts are generally based on concepts of minority interest and lack of control, and can reduce the value of an asset for gift or estate tax purposes by as much as 50% or more. The proposal would not affect the valuation of assets that are used in the conduct of a trade or business, which could continue to be valued at a discount. Discounts have been useful in leveraging lifetime estate and gift tax exemptions. The new rule, if adopted, would be effective as of the date of enactment.

3. Another tax planning concept, the grantor trust, also faces dramatic change as grantor trusts would be included in the grantor's taxable estate. Under current law, a grantor trust is treated as a completed gift for transfer tax purposes such that it is not treated as part of the grantor's estate on death, notwithstanding that the grantor is treated as the ongoing owner of the trust assets for income tax purposes. The effect of the grantor trust rules is to require certain income tax payments to be made by the grantor, thereby avoiding depletion of the trust by the tax payments. The payment of income taxes from a source outside of the trust can be a substantial benefit to the trust. Under the current proposal, payment of income tax on a grantor trust will continue to be assessed to the grantor, but the trust itself will be included in the estate of the grantor upon death! The grantor trust changes are currently slated to apply to trusts created on or after the date of enactment, and to contributions made after the date of enactment to grantor trusts established before the date of enactment. Existing grantor trusts that are funded with additional assets after the date of enactment may involve adverse consequences.

4. In addition to the proposed changes to trust and estate law summarized above, there are other tax law changes being proposed, including increases in the top individual income tax rates, higher capital gain tax rates for individuals at higher income levels, and larger tax bills for estates and trusts. The proposals also include larger required minimum distributions from retirement accounts with large aggregate balances.

Although it may not appear so, all of the news regarding proposed tax law changes is not dire. A number of the earlier proposals that have not worked their way into the current tax bill include elimination of the step-up in basis on assets at death and imposition of capital gain tax on all estate assets at death, both of which would have a significant impact on many individuals. Similarly, an earlier proposal to reduce the lifetime gift tax exemption to $1-million has not been included in the bill currently on the table.

While the current tax proposals show some movement toward the tax reform that might be anticipated, a word of caution is required. Nothing is set in stone, and it is impossible to predict the form any final legislation might take. Nevertheless, it is prudent to consider the potential changes that may be coming, and position oneself to take advantage of opportunities that may only be available for a limited period of time.

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