

# Valuation of Intrafamily Notes for Gift and Estate Tax Purposes

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*In estimating the value of a promissory note that a family or family limited partnership issued, there are no safe harbor guidelines provided by the Internal Revenue Service (the “Service”) with regard to appropriate market interest rates, discounts, or methodologies, except for Revenue Ruling 67-276. Revenue Ruling 67-276 states that “the existence of an over-the-counter market for such securities and the quotations and opinions of value provided by brokers and real estate appraisers will not be accepted as conclusive evidence of the fair market value of such securities.” This Revenue Ruling also indicates that the proper way to value promissory notes is to consider all available financial data and all relevant factors affecting the fair market value.<sup>1</sup> However, this indication is too broad for valuation analysts to apply in estimating the value of a promissory note. This discussion (1) examines relevant regulations and judicial decisions and (2) describes the promissory note valuation methodologies covered in the relevant judicial decisions and finance literature.*

## INTRODUCTION

High net worth families often structure intrafamily loans and promissory notes to source needed liquidity for family members.

When a family member—or a related entity (such as a child’s trust)—has a poor credit history or needs capital and cannot get a loan from a bank or similar institution, intrafamily loans and promissory notes can provide liquidity.

A loan and a promissory note are slightly different. Loan agreements are evidenced by the signing of a loan agreement.

A loan agreement is a contract between the lender and the borrower. A loan agreement sets forth the terms and conditions of the loan and the rights and obligations of both parties.

By contrast, a promissory note is simply a written promise by the borrower to pay a stated amount of principal and interest until a maturity date. A promissory note is also characterized as a negotiable instrument (as a check, which can be endorsed over to another party).

Using a promissory note, instead of a loan agreement, benefits the lender in terms of liquidity. Because a promissory note can be transferred without the borrower’s permission, unless the promissory note restricts a transfer, the lender can transfer ownership of the note fairly easily.

This discussion focuses on estimating the value of promissory notes, although this valuation methodology can also be applied in estimating the value of loan agreements.

This discussion addresses issues concerning the estimation of the fair market value of intrafamily promissory notes (intrafamily notes or notes).

First, this discussion examines relevant gift and estate tax regulations in estimating the value of intrafamily notes.

Second, this discussion delves into relevant court cases and presents note valuation methodologies covered in relevant court cases and finance literature.

Finally, this discussion suggests financial data and relevant factors that valuation analysts may consider in estimating the value of intrafamily notes

within the meaning of Internal Revenue Service Technical Advice Memorandum (TAM) 8229001.

## BONA FIDE LOANS

The Service may treat the transfer of assets and property between family members as a gift, although a promissory note was given in return for the transfer. If the loan is not bona fide or there appears to be an intention that the loan would never be repaid, the Service will regard the transfer as a gift.

Transfers between family members are presumed to be gifts unless the transferor can prove the receipt of “an adequate and full consideration in money or money’s worth.”<sup>2</sup>

However, a taxpayer may rebut that presumption by showing that, at the time of the transfer, the transferor had:

1. a real expectation of repayment and
2. an intention to enforce the loan.<sup>3</sup>

In the *Estate of Lockett v. Commissioner* case, when the transferor made a demand for payment, the promissory notes transferred between family members were treated as loans.<sup>4</sup>

The U.S. Tax Court considered the following factors to determine a real expectation of repayment and an intention to enforce the loan.

The following nine factors were originally listed in *Miller v. Commissioner*:<sup>5</sup>

1. Whether there was a promissory note or other evidence of indebtedness
2. Whether interest was charged
3. Whether there was any security or collateral
4. Whether there was a fixed maturity date
5. Whether a demand for repayment was made
6. Whether any actual repayment was made
7. Whether the transferee had the ability to repay
8. Whether any records maintained by the transferor and/or the transferee reflected the transaction as a loan
9. Whether the manner in which the transaction was reported for federal tax purposes is consistent with a loan

*Miller v. Commissioner* involved a non-interest-bearing unsecured demand note for which a taxpayer made transfers to her son in return.<sup>6</sup>

In this case, the court concluded that the transfer was a gift and not a bona fide loan, based on the fact that “the mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise will not be enforced is not afforded significance for Federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money’s worth.”<sup>7</sup>

## RELEVANT COURT CASES RELATED TO NOTE VALUATION

Once a promissory note between family members is determined as a deemed gift or includable in an estate, valuation analysts may need to be engaged to estimate the value of the note for tax reporting purposes.

In estimating the value of a promissory note for gift or estate tax purposes, estimating the fair market value of promissory note future cash flow constitutes the fundamental part of valuation.

Treasury Regulation Section 1.148-5(d) defines the fair market value of an investment as “the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm’s-length transaction.”

In addition, Regulations Sections 20.2031-(b) and 25.2501-1 define fair market value as “the price at which 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.”

For gift or estate tax purposes, the fair market value of a promissory note is “the sum of the unpaid amount of principal and accrued interest to the date of gift or death, unless the evidence shows that the note is worth less than the unpaid amount or is uncollectible either in whole or in part.”<sup>8</sup>

Thus, the burden of proof is on the taxpayer to submit satisfactory evidence that the note is worth less than the face value plus accrued interest.<sup>9</sup>

A good starting point is to review relevant court cases that involve the estimation of the fair market value of promissory notes.

This is because there are no safe harbor guidelines provided by the Service as to appropriate market rates, discounts, or methodologies, except for Revenue Ruling 67-276, which stipulates that market surveys (i.e., bid and ask quotations in the over-the-counter market), quotations, and opinions of brokers and real estate appraisers will not be accepted as conclusive evidence of fair market value.<sup>10</sup>

## Estate of Berkman

In *Estate of Berkman*, Mr. Berkman made several transfers to his daughter and son-in-law between 1968 and 1970 in exchange for five promissory notes with a total face amount of \$275,000.<sup>11</sup>

Each of these five promissory notes was a 20-year unsecured note, bearing 6 percent annual interest, payable monthly, with no payment of the principal until the maturity of the note.

At maturity, the full balance of the principal was due. At the time of his death in 1974, Mr. Berkman owned these five promissory notes and had not reported the transfers as taxable gifts.

In defining the term “taxable gift,” the Tax Court recognized, pursuant to Section 2512(b), that “where 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 as a gift.”

However, the court also considered that an exception to Section 2512 includes all bona fide transfers at arm’s length in which no donative intent presents.<sup>12</sup> Finally, the court held the decedent’s transfers were not at arm’s length within the meaning of Regulations Section 25.2512-8.<sup>13</sup>

The following factors were considered by the court:

1. The decedent was over 75 years old when he began making the transfers in exchange for promissory notes due in 20 years.
2. The decedent took no security on these notes.
3. The notes did not require any principal payments until maturity.
4. In his will, the decedent directed that all his property be divided equally between his daughters.

Taking all of these factors into account, the court held that the estate failed to submit satisfactory evidence that the transfers were at arm’s length and free of donative intent.

Accordingly, the court determined the amount of gift as the difference between the amount of the loans and the fair market value of the promissory notes under Section 2512(a) and (b).<sup>14</sup>

To calculate the fair market value of the promissory notes, the court considered the following factors:

1. The rate of interest available in the market (i.e., the U.S. prime rate) compared to the interest rate of the notes
2. The date of maturity
3. The lack of security
4. The solvency of the debtors

Exhibit 1 presents the fair market value of the first four promissory notes and amounts of gift. Issued in 1972 within three years of the date of death, the fifth note was included in the decedent’s estate—and excluded from Exhibit 1.

The court also held that the promissory notes were includable in the decedent’s gross estate at fair market value on the date of his death, since the decedent died owning the five promissory notes.<sup>15</sup>

The court considered the valuation of notes under Regulations Section 20.2031-4 as follows: “[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.”

Exhibit 2 presents the fair market value of the five promissory notes on the date of the decedent’s death, including accrued interest.

The court considered that the transfer of \$55,000 by the decedent to his daughter and son-in-law within three years of his death was in contemplation of death. Therefore, this amount was includable in the decedent’s gross estate under Section 2035.<sup>16</sup>

However, the transfer was applied to an exception of Section 2035, where a bona fide transaction for adequate and full consideration exists.<sup>17</sup>

From the promissory note, the decedent received 6.00 percent interest at a time when the U.S. prime rate was only 4.75 percent.

**Exhibit 1**  
**Fair Market Value and Amount of Gift of Promissory Notes**

Issue Date	Face Amount	Fair Market Value	Amount of Gift
November 15, 1968	\$100,000	\$85,000	\$15,000
April 24, 1969	50,000	37,500	12,500
November 19, 1970	30,000	24,000	6,000
November 19, 1970	40,000	32,000	8,000

Source: *Bernat v. Commissioner*, T.C. Memo. 1979-46.

## Exhibit 2 Fair Market Value of Promissory Notes for Estate Taxes

Issue Date	Face Amount	Fair Market Value
November 15, 1968	\$100,000	\$50,080
April 24, 1969	50,000	24,040
November 19, 1970	30,000	13,524
November 19, 1970	40,000	18,032
March 2, 1972	55,000	22,044

Source: Bernat v. Commissioner, T.C. Memo. 1979-46.

Considering the higher interest rate of the note than the market provided, the court held that the loan resulted in a bona fide transfer for adequate and full consideration and the transfer was not includable in the decedent's gross estate.

### *Estate of Smith*

*Estate of Smith* involved the valuation of a promissory note in an original principal balance of \$10.3 million, which was payable over 20 years in equal annual principal payments of \$515,600 with 6.0 percent simple interest computed from inception to the date of payment.<sup>18</sup>

This type of accrued interest resulted in each payment of the note being progressively larger due to the increasing amount of time. There was a dispute as to the promissory notes valued by Ms. Crosby (the decedent) on the date of her death.

This promissory note was not issued between family members, but the valuation methods applied in this case are generally applicable to intrafamily notes.

The original promissory note was issued by St. Regis Paper Company on May 17, 1977, and the required payments due under the note were paid to Mr. Crosby until his death in 1978. His will bequeathed a two-thirds interest in the promissory note to Mrs. Crosby.

Accordingly, on May 17, 1981, two separate promissory notes were executed by St. Regis Paper Company to Mrs. Crosby and Ochsner Medical Foundation (the one-third beneficiary) in exchange for their respective interests in the original promissory note of \$10.3 million.

One promissory note had a face amount of approximately \$5.5 million with yearly principal payments of approximately \$343,733 payable to Mrs. Crosby.

The yearly payments were scheduled to start on May 17, 1982, and end on May 17, 1997. The remaining one-third interest (approximately \$2.7 million) was given to Ochsner Medical Foundation located in New Orleans, Louisiana.

St. Regis Paper Company merged into Champion International Corporation (Champion), a Fortune 500 company, on January 31, 1985. Champion was expected to pay the unpaid note balance of approximately \$5.5 million to Mrs. Crosby.

When Mrs. Crosby died on April 28, 1988, the unpaid principle due under the note approximated \$3.4 million, and the interest required to be paid over the remaining term of the note amounted to approximately \$4.1 million.

In estimating the value of Mrs. Crosby's promissory note, the plaintiff's valuation expert, testifying on behalf of the estate, used a 10.09 percent effective interest rate of a publicly traded bond that Champion issued as a starting point.

The valuation expert then added a series of adjustments to the starting point in order to compensate for the differences between the publicly traded debt of the issuer and the promissory note of the estate.

Exhibit 3 shows a series of adjustments that the expert made to estimate the value of the promissory note.

The adjustments were made based on the following characteristics of the Champion publicly traded debt instruments:

1. Well documented (i.e., prospectus supplement, financial statements, and legal opinions)
2. Tradeable in denominations as low as \$1,000
3. Having significant legal protections in the event of default
4. Having restrictions on the business operations of Champion to provide further security.

The plaintiff valuation expert testified that the absence of these factors were important in determining potential buyers for the estate's promissory note. Additionally, the valuation expert made an adjustment based on a lack of response from the issuer, Champion.

When the valuation expert tried to obtain adequate information for valuation from Champion, he only received a one-page letter with incorrect information about the promissory note. The valuation

expert found it as an indication that a hypothetical purchaser would also have problems obtaining information concerning the estate's promissory note.

Finally, the U.S. District Court for the Southern District of Mississippi found the plaintiff's expert valuation of the promissory note was reasonable.

The court found the plaintiff's valuation was in line with the facts existing at the time that Mrs. Crosby's interest in the promissory note was determined and would have been available to a good faith purchaser at that time.

### *Estate of Hoffman*

*Estate of Hoffman* involved the valuation of two unsecured promissory notes issued from a family partnership held by Mrs. Hoffman (decedent) with a 20-year term.<sup>19</sup>

At the time of her death, the decedent owned a 27.5 percent ownership interest in Clubside, the family partnership owned by the decedent and her family. The estate and the Service disputed the value of the two promissory notes issued by Clubside.

One promissory note was payable to the decedent and the other payable to Hoffman Associates, Inc. At the time of her death, the decedent owned all 7,500 shares of stock in Hoffman Associates, an S corporation.

The estate valuation expert determined the value of the Clubside promissory notes based on a required rate of return on similar investments available in the market.

The estate valuation expert relied on Moody's, Standard & Poor's, and Fitch ratings agencies to find comparable debt securities. In addition, the estate valuation expert considered the lack of marketability discount because the Clubside notes lacked a public market for sale.

Taking account of this lack of marketability, the estate valuation expert concluded an investor would require a rate of return of at least 25 percent higher than the 18 percent return offered by his comparable publicly traded bonds.

### Exhibit 3 Adjustments to Required Yields

Base Yield	10.09%
Adjustments:	
1. Lack of marketability	0.5%
2. Lack of indenture/covenant	1.0%
3. Lack of formal acknowledgement by the borrower	1.0%
4. Subordination to all better documented debt of the borrower	1.0%
5. Uncertainty regarding the legal entity bearing liability	1.0%
6. Unusual payment schedule	0.5%
7. Lack of divisibility	0.5%
Semiannual payout rate	15.6%
Convert to annual convention (note payments on annual basis)	<u>16.2%</u>
Required Yield Used	<u>16.0%</u>

Source: Smith v. United States, 923 F.Supp. 896 (S.D. Miss. 1996).

Therefore, the estate valuation expert determined the appropriate rate of return for the Clubside notes was 22.5 percent.

The Service valuation expert determined the value based on the timing of payments and the rate of return that a holder of the notes would require.

To determine an appropriate rate of return, the valuation expert considered the following factors:

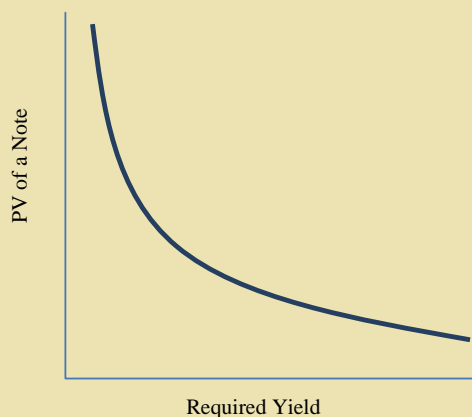
1. Interest rates of various debt securities
2. Corporate bonds of various ratings
3. Interest rates for 30-year conventional mortgages
4. Yields on U.S. Treasury securities
5. U.S. prime rate
6. Venture capital returns

In addition, the Service valuation expert found that the promissory notes did not possess characteristics of highly speculative and default bonds. Based on these factors, the Service valuation expert concluded 12.5 percent as the appropriate rate of return required for the promissory note inclusive of the lack of marketability of the promissory note.

The Tax Court held that a 12.5 percent rate was appropriate and the Service valuation expert correctly valued the promissory notes.



**Figure 1**  
**Relation between Required Yield and Present Value of a Note**



Source: Frank J. Fabozzi, *Handbook of Fixed Income Securities*, 4<sup>th</sup> ed. (Chicago: Richard D. Irwin, 1995).

## NOTE VALUATION METHODOLOGY

In the above three cases, the court considered the fair market value of a promissory note under Sections 20.2031-4 and 25.2512-8. The court and valuation experts offered evidence to prove that the fair market value of a promissory note was lower than the sum of unpaid principal and accrued interest.

In *Estate of Berkman*, the court determined the fair market value of the promissory notes, considering the following factors:

1. Interest rates available in the market as compared to the interest rate of the notes
2. The date of maturity
3. The lack of security
4. The solvency of the debtors

In *Estate of Hoffman*, the Service valuation expert determined the fair market value of the notes based on a required rate of return and the timing of payments.

In estimating the value of promissory notes, both cases used a required rate of return that a note holder would demand of an issuer, considering rates of return on similar investments available in the market as of the valuation date.

The required rate of return applicable to the notes is determined based on the risk inherent in the investment. In other words, an investor (or lender) would accept a rate of return no lower than that available from other investments with equivalent risk.<sup>20</sup>

The value of a financial instrument generating future payments at a specific time is determined by its present value at the transaction date. To the lender, the fair market value of a promissory note equals the present value of future principal and interest payments discounted at a risk-adjusted rate of return to the valuation date.<sup>22</sup>

When the rate of return on the note properly reflects the risk of the borrower, the fair market value of the note equals its principal amount (or its “face value”).<sup>21</sup>

When the risk associated with the future payments of the note becomes greater, the rate of return the lender requires will increase, and, thus, the present value of the note will decrease. The opposite is true when the risk and the required rate decrease.<sup>23</sup>

Figure 1 presents the relationship between the present value of a note and the required yield.

Accordingly, the required rate of return of a note reflects the risk associated with the future payments and determines the fair market value of the note. For example, if a note secures collateral, the required rate of return will be lower than that of an unsecured note.

In *Estate of Hoffman*, to determine an appropriate required rate of return, the Service valuation expert considered rates of return available in the market, such as interest rates of debt securities, corporate bonds ratings, interest rates for conventional mortgages, U.S. Treasury securities yields, the U.S. prime rate, and venture capital returns.

Once an appropriate required rate of return is determined based on inherent risk in the note, a valuation analyst should consider carefully how to calculate the fair market value of the note discounted at such required rate of return to the valuation date.

One example is a promissory note required to pay periodic interest payments with the principal balance due at maturity (similar to an ordinary annuity).<sup>24</sup>

The present (i.e., fair market) value of the periodic coupon payments and maturity value (or par value) is calculated using the following formula according to the *Handbook of Fixed Income Securities*:<sup>25</sup>

$$\begin{aligned}
 PV &= \frac{c}{(1+i)^1} + \frac{c}{(1+i)^2} + \frac{c}{(1+i)^3} \dots + \frac{c}{(1+i)^n} + \frac{M}{(1+i)^n} \\
 &= c \left[ \frac{1 - \left[ \frac{1}{(1+i)^n} \right]}{i} \right] + \frac{M}{(1+i)^n}
 \end{aligned}$$

where:

PV = Present value of a note

c = Periodic interest payment (\$)

n = Number of periods

i = Required yield

M = Maturity value (or face value)

$$PV = c \left[ \frac{1 - \left[ \frac{1}{(1+i)^n} \right]}{i} \right] + \frac{M}{(1+i)^n}$$

$$= 75,000 \left[ \frac{1 - \left[ \frac{1}{(1+0.078)^{11}} \right]}{0.078} \right] + \frac{1,500,000}{(1+0.078)^{11}} = 1,197,232$$

Exhibit 4 provides a simple illustration of fair market value of a promissory note with a face value of \$1.5 million due at maturity.

In this example, the expected principal payment at maturity and interest payments are discounted to the valuation date based on the required yield and are summed to determine the fair market value of the note.

In addition, the present value formula results in the same value as in Exhibit 4.

Exhibit 5 provides an example of valuation of a promissory note with annual principal and interest payments paid over the holding period.

## IRS Technical Advice Memorandum 8229001

In *Estate of Smith*, in order to calculate an appropriate required yield, the plaintiff's valuation analyst made adjustments to the publicly traded debt of the promissory note issuer, increasing the required yield from approximately 10.1 percent to

### Exhibit 4 Note Valuation Table A Note with Annual Interest Payments and Principal Due at Maturity

Terms of the Note:

Principal Balance (or face value)	\$ 1,500,000
Annual Interest Rate	5.0%
Annual Interest Payment	\$ 75,000
Required Yield (market interest rate)	7.8%
Issue Date	12/31/2008
Maturity Date	12/31/2023
Valuation Date	1/1/2013

Year Period	Date	Payment Schedule of Note				Present Value of Note	
		Beginning Principal	Principal Payments	Interest Payment	Ending Balance	PV Factor	PV of Cash Flow
1	12/31/2013	\$ 1,500,000	\$ -	\$ 75,000	\$ 1,500,000	0.928	\$ 69,573
2	12/31/2014	1,500,000	-	75,000	1,500,000	0.861	64,539
3	12/31/2015	1,500,000	-	75,000	1,500,000	0.798	59,869
4	12/31/2016	1,500,000	-	75,000	1,500,000	0.740	55,537
5	12/31/2017	1,500,000	-	75,000	1,500,000	0.687	51,519
6	12/31/2018	1,500,000	-	75,000	1,500,000	0.637	47,791
7	12/31/2019	1,500,000	-	75,000	1,500,000	0.591	44,333
8	12/31/2020	1,500,000	-	75,000	1,500,000	0.548	41,125
9	12/31/2021	1,500,000	-	75,000	1,500,000	0.509	38,150
10	12/31/2022	1,500,000	-	75,000	1,500,000	0.472	35,389
11	12/31/2023	1,500,000	1,500,000	75,000	-	0.438	689,405
Totals			1,500,000	825,000			1,197,232

Discount from Face Value	-20.2%
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PV = Present value

**Exhibit 5**  
**Note Valuation Table**  
**A Note with Annual Interest Payments and Principal Payments (Amortization)**

Terms of the Note:

Principal Balance (or face value)	\$ 1,100,000
Annual Interest Rate	5.0%
Annual Principal Payment	\$ 100,000
Required Yield (market interest rate)	7.8%
Issue Date	12/31/2008
Maturity Date	12/31/2023
Valuation Date	1/1/2013

Year Period	Date	Payment Schedule of Note				Present Value of Note	
		Beginning Principal	Principal Payments	Interest Payment	Ending Balance	PV Factor	PV of Cash Flow
1	12/31/2013	\$ 1,100,000	\$ 100,000	\$ 55,000	\$ 1,000,000	0.928	\$ 143,785
2	12/31/2014	1,000,000	100,000	50,000	900,000	0.861	129,078
3	12/31/2015	900,000	100,000	45,000	800,000	0.798	115,748
4	12/31/2016	800,000	100,000	40,000	700,000	0.740	103,670
5	12/31/2017	700,000	100,000	35,000	600,000	0.687	92,734
6	12/31/2018	600,000	100,000	30,000	500,000	0.637	82,838
7	12/31/2019	500,000	100,000	25,000	400,000	0.591	73,889
8	12/31/2020	400,000	100,000	20,000	300,000	0.548	65,801
9	12/31/2021	300,000	100,000	15,000	200,000	0.509	58,496
10	12/31/2022	200,000	100,000	10,000	100,000	0.472	51,905
11	12/31/2023	100,000	100,000	5,000	-	0.438	45,960
Totals			<u>1,100,000</u>	<u>330,000</u>			<u>963,904</u>

Discount from Face Value	-12.4%
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PV = Present value

16.0 percent. The increase in the required yield reflected the risk of the promissory note (due mainly to the limited universe of potential willing buyers of the note), compared to that of publicly traded debt in the market.

In addition, in *Estate of Berkman*, the court considered not only the rate of interest available in the market (the U.S. prime rate), but also the maturity date, the lack of security, and the solvency of the debtors.

The rationale for these adjustments exists in the TAM 8229001.<sup>26</sup>

TAM 8229001 sets forth the meaning of Revenue Ruling 67-276 in determining the value of a mortgage owned by a decedent at the date of death.<sup>27</sup>

According to TAM 8229001, although a sentence of the Revenue Ruling indicates a mortgage that is amply secured must be valued at face value,<sup>28</sup> the meaning of the Revenue Ruling is that “the proper way to value notes and mortgages is to consider all available financial data and all relevant factors affecting the fair market value.”<sup>29</sup>

To discuss what kind of financial data and relevant factors an analyst should consider in estimating the value of a promissory note, the following list of factors provides a brief review of TAM 8229001. These factors are also illustrated in the previously mentioned court cases.<sup>30</sup>

### 1. Presence or Lack of Promissory Note Covenants

Covenants are set forth in an indenture, or a formal debt agreement. They outline certain activities that will (affirmative covenants) or will not (negative covenants) be carried out.

Covenants include working capital requirements, interest coverage ratios, prepayment penalties, debt/equity ratios, and dividend payments. These covenants protect the interests of the lender, and, therefore, reduce the risk for the lender and lower the required yield.



## 2. The Solvency of the Borrower

In *Estate of Berkman*, the court considered the solvency of the borrowers as one of relevant factors in estimating the fair market value of the promissory notes.

Strong debt solvency and repayment capacity of the borrower will result in lower risk for the lender and a lower required rate of return.

## 3. Value of the Security

Both Revenue Ruling 67-276 and TAM 8229001 indicate the value of the security as an important factor in estimating the value of the promissory note. "Security" here specifies collateral or the pledged security of the borrower. The higher the security value, the lower the risk of the lender, and the lower the required rate of return.

## 4. Term of the Note

Investors holding debt instruments face interest rate risk—the risk that the investment value would change due to a change in interest rate. These investors also face reinvestment risk when they cannot reinvest cash flow from the existing debt at the same interest rate as the current rate of return.

The longer the term of the note, the higher the interest rate risk and reinvestment risk, and the higher the required rate of return.

## 5. Comparable Market Yield

In *Estate of Hoffman*, to determine an appropriate required rate of return, the Service valuation expert considered market yields, such as interest rates of debt securities, corporate bond rates, mortgage rates, U.S. Treasury securities rates, the U.S. prime rate, and venture capital returns.

A comprehensive valuation analysis will consider a wide range of financial instruments with different risk and return characteristics.

## 6. Payment History of the Borrower

Payment history of the borrower is important to measure the risk of the borrower. If payments are



current and have been made in a timely manner, the risk associated with the promissory note decreases, and, therefore, the required rate of return decreases.

## 7. Size of the Note

In *Estate of Smith*, the plaintiff's valuation analyst calculated the required yield to discount the promissory note by comparing the note to the publicly traded debt of the issuer (or lender). One of the differences between the promissory note and the publicly traded debt is that the publicly traded debt was tradeable in denominations as low as \$1,000.

Potential buyers of the note will be limited because buying the note requires sizable money to invest. Accordingly, the larger the size of the note, the higher the required rate of return.

In addition, TAM 8229001 states that the effect of Section 20.2031-4 is to recognize "(1) that any principal amount payable in the future normally carries an interest accrual with it and (2) that when the stated interest rate on the obligation is fair (equal to the current market rate of interest for such type of obligation), the total present value of all payments of principal and interest will equal the principal amount of the obligation."<sup>31</sup>

The TAM also indicates that the present value of such payments is less if the stated rate of interest on the note is less than the current market rate of interest.

In summary, under TAM 8229001, the Service has agreed that “all available data and all relevant factors affecting the fair market value must be considered,”<sup>32</sup> in determining the value of a promissory note.

Accordingly, face value plus accrued interest<sup>33</sup> is not necessarily the value to be included in the gross estate or taxable gift. A promissory note can be valued at less than face value plus accrued interest if the donor or estate demonstrates by satisfactory evidence that the value is lower.<sup>34</sup>

## CONCLUSION

Valuation analysts are often asked to estimate the fair market value of a promissory note for gift or estate tax purposes.

The fair market value of a promissory note is the sum of the unpaid principal and accrued interest to the date of gift or death under Section 25.2512-4 and 20.2031-4.

However, these regulations also indicate that the taxpayer may rebut this value by showing evidence that the promissory note is worth less than the sum of the unpaid principal and accrued interest.

This discussion presented note valuation methodologies and various factors the analyst may consider in estimating the value of a promissory note. It also presented a review of relevant court cases and finance literature.

Especially, this discussion clarifies the meaning of TAM 8229001 and its application in estimating the value of promissory notes.

In conclusion, in estimating the value of an intrafamily promissory note, the analyst may need to consider carefully the following:

1. Whether the note represents a bona fide transaction for adequate and full consideration
2. Whether the required yield reflects the inherent risk of the note and its issuer (borrower), considering various factors that this discussion suggests

Accordingly, the analyst may estimate the fair market value of the promissory note future cash flow by discounting the note based on an appropriate required yield.

### Notes:

1. IRS Technical Advice Memorandum 8229001 (February 1, 1982).
2. Treasury Regulations §25.2512-8; 25.2511-1(g) (1).

3. Estate of Lockett v. Commissioner, T.C. Memo 2012-123 (April 25, 2012) at 21 (citing Van Anda v. Commissioner, 12 T.C. 1158, 1162 (1949)).
4. Estate of Lockett v. Commissioner at 22-23, 25-27.
5. Miller v. Commissioner, T.C. Memo. 1996-3 (January 11, 1996).
6. Ibid.
7. Ibid.
8. Treasury Regulations § 25.2512-4, §20.2031-4.
9. Hoffman v. Commissioner, T.C. Memo. 2001-109 (May 9, 2001).
10. Revenue Ruling 67-276, 1967-2 C.B. 321.
11. Bernat v. Commissioner, T.C. Memo. 1979-46 (January 31, 1979).
12. Treasury Regulation. § 25.2512-8.
13. Ibid.
14. IRC § 2512 (a), (b).
15. IRC § 2031.
16. IRC § 2035.
17. IRC § 2035(d).
18. Smith v. United States, 923 F.Supp. 896 (S.D. Miss. 1996).
19. Hoffman v. Commissioner, T.C. Memo. 2001-109.
20. Aaron M. Stumpf and Jesse A. Ultz, “Intra-Family Loan Valuation Issues,” Stout Risius Ross newsletter (Spring 2010).
21. Robert Schweihs, “AFR and the Value of Debt,” *Insights* (Summer 2012).
22. Ibid.
23. Frank J. Fabozzi and T. Dessa Fabozzi, *Handbook of Fixed Income Securities*, 4th ed. (Chicago: Richard D. Irwin, 1995), 55.
24. A series of equal payments made at the end of each period over a fixed amount of time.
25. Fabozzi and Fabozzi, *Handbook of Fixed Income Securities*.
26. IRS Technical Advice Memorandum 8229001.
27. Revenue Ruling 67-276, 1967-2 C.B. 321.
28. Ibid.
29. IRS Technical Advice Memorandum 8229001.
30. Carsten Hoffmann, “The Evolution of Note Valuation,” *Tax Notes* (September 1, 2003).
31. Treasury Regulation §20.2031-4.
32. Ibid.
33. Ibid., Treasury Regulation § 25.2512-4, §20.2031-4.
34. IRS Technical Advice Memorandum 8229001.

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