Estate of Winifred Hughes, Deceased, Dean McBride, Executor and Trustee, v. Commissioner, T.C. Memo 2005-296.

The Facts: Winifred Hughes ("Decedent") was the sole owner of the stock of Bob Hughes Motors, Inc., dba Advance Leasing ("Advance Leasing") from 1996 until she died in 1999. Advance Leasing was founded in 1971 by her husband Bob Hughes, who died in 1996. After Bob died, Winifred became the sole beneficial owner of the stock (owned via a family trust) and the business was operated by Dean McBride ("McBride") who was the sole officer and director of Advance Leasing. Furthermore, Decedent issued a durable power of attorney to McBride in 1996. McBride indicated, on Bob Hughes estate return, that Advance Leasing had no value in 1996 because the liabilities exceeded the fair market value of the assets.

In 1997, McBride executed an agreement and a promissory note on behalf of Decedent and Advance Leasing which stated that decedent promised to pay $400,000 to Advance Leasing on demand in exchange for 4,000 shares of Advance Leasing's common stock. Advance Leasing issued a stock certificate to Decedent for the 4,000 additional shares. This was done to help guarantee that Billy Hughes, son of Bob and Winifred, always had a place to work. The terms of the stock subscription agreement were not negotiated, and Advance Leasing was not appraised. McBride paid the $400,000 to Advance Leasing after Decedent died in 1999.

Neither the $400,000 promissory note nor the 4,000 shares were identified on Advance Leasing's 1997 and 1998 financial statements or on its 1997 and 1998 corporate income tax returns. Furthermore, neither Advance Leasing's bookkeeper nor its certified public accountant knew about the stock subscription agreement or the $400,000 promissory note.

Decedent's estate tax return deducted the $400,000 promissory note as a liability of the estate. Furthermore, Decedent's estate reported that the stock of Advance Leasing had no value because the liabilities exceeded the fair market value of the assets.

The Arguments:

The Estate contends that the $400,000 promissory note is a valid deduction on the basis of its obligation to pay the promissory note. The Estate contended that the note was the result of a bona fide contract for full and adequate consideration in money or money's worth. The estate also contends that Decedent received full and adequate consideration for her promise to pay because she received 4,000 shares of stock in a corporation that appeared ready to become profitable (the estate reported that the evidence for this turnaround was that (in contrast to its losses for 1994, 1995, and 1996, Advance Leasing reported $29,663 of taxable income in 1997).

The Estate also contended that the funds from the stock subscription agreement reduced Advance Leasing's debt obligations, made the balance sheet cleaner, and made it easier for the company to secure outside financing (even though they didn't receive the funds until after decedent died in 1999).

The IRS argued that an estate should not be able to claim the liability as a deduction because it was not contracted bona fide and for full and adequate consideration in money or money's worth.

The Findings:

The Court does not believe that the value of Advance Leasing's stock increased from $0 on April 10, 1996 (per Bob Hughes estate return) to $400,000 on April 29, 1997, then fell to zero on July 25, 2999 (Decedent's date of death). The Court concluded that the 4,000 shares issued to Decedent had little or no value when McBride signed the stock subscription agreement on April 29, 1997. Thus, Decedent did not receive full and adequate consideration for the $400,000 promissory note.

The Court also does not believe that the transaction was contracted "bona fide". McBride was Decedent's attorney in fact and Advance Leasing's sole director and officer, thus he was on both sides of the transaction. The Court said that the terms of the stock subscription agreement were (1) not negotiated at arm's length, (2) Advance Leasing's business was not appraised, (3) Advance Leasing had annual net losses and a negative net worth in 1996, 1997, and 1998, (4) The 4,000 shares and $400,000 note payable to Advance Leasing were not reflected on the 1997 or 1998 financial statements or tax returns for the business, (5) Advance Leasing's bookkeeper and CPA did not know about the stock subscription agreement and $400,000 note payable and (6) Advance Leasing and McBride did not demand payment of the $400,000 before Decedent's date of death. Thus, this was not a "bona fide" transaction.

The Court concluded that the estate may not deduct the $400,000 liability from Decedent's gross estate.