9 T.C. 463 (1947)

When a close family relationship exists between a primary obligor and an endorser, and the facts suggest no expectation of repayment by the obligor, the endorser's payment of the obligation is treated as a gift, precluding a bad debt deduction.

Summary

Ellisberg endorsed notes for his son's struggling business. When the son couldn't pay, Ellisberg gave his own note to the bank. After the son's bankruptcy, Ellisberg paid his note and claimed a bad debt deduction. The Tax Court denied the deduction, reasoning that given the family relationship and the son's financial state, Ellisberg never intended a genuine debt to arise. The court concluded the transaction was effectively a gift to the son, not a loan, and thus not deductible as a bad debt.

Facts

In 1937, Ellisberg's unemployed son opened a retail business, receiving credit and capital from his father. The son then borrowed additional capital, with Ellisberg endorsing the notes. Ellisberg knew the business was struggling. In 1939, the son couldn't pay the notes. Ellisberg gave his own note to the bank. The son later declared bankruptcy, omitting any debt to Ellisberg from his liabilities, and Ellisberg didn't file a claim.

Procedural History

Ellisberg paid his note in 1941 and claimed a bad debt deduction. The Commissioner of Internal Revenue disallowed the deduction, leading to this Tax Court case.

Issue(s)

Whether Ellisberg is entitled to a bad debt deduction for the payment of a note he gave to a bank to cover his son's defaulted loan, given their familial relationship and the son's poor financial condition.

Holding

No, because the circumstances indicated the transaction was effectively a gift, not a bona fide debt intended to be repaid.

Court's Reasoning

The court reasoned that while an endorser can generally take a bad debt deduction when a primary obligor defaults, this doesn't apply when a close family relationship exists and there's no reasonable expectation of repayment. The court emphasized that Ellisberg knew his son's business was failing, yet he endorsed the notes anyway, merely wishing to help his son. After paying the notes, Ellisberg didn't pursue collection or file a claim in his son's bankruptcy. The Court cited *Pierce v. Commissioner*, noting the distinction that in *Pierce*, the son was solvent and the father demonstrably intended to hold the son liable. Here, all facts suggested Ellisberg intended a gift. The court stated, "when it appears that there is a close relationship between the endorser and the primary obligor, such as that of father and son…and that all of the facts present in the transaction show the intention of the parties at the time of the endorsement to be that upon payment of the obligation by the endorser no real and enforceable debt shall result in favor of the endorser, then the intention of the parties will prevail…and the entire transaction will be treated as in the nature of a gift."

Practical Implications

This case highlights the scrutiny applied to bad debt deductions in intrafamily transactions. Taxpayers must demonstrate a genuine intent to create a debt, with a reasonable expectation of repayment. Factors such as the debtor's solvency, the creditor's collection efforts, and how the transaction is documented are crucial. This decision reinforces the principle that tax deductions are not available for what are, in substance, gifts disguised as loans. Later cases applying *Ellisberg* focus on whether a genuine debtor-creditor relationship existed at the time the 'loan' was made, considering factors beyond mere promissory notes.

