***Frazee v. Commissioner, 98 T. C. 554 (1992)***

The fair market value of property for gift tax purposes is determined by its highest and best use, and below-market interest rates on intrafamily promissory notes result in additional taxable gifts.

**Summary**

The Frazees transferred a flower distribution property to their children, receiving a promissory note. The court determined the property's fair market value for gift tax purposes was $1 million, considering its potential for industrial rezoning as its highest and best use. Additionally, the court ruled that the 7% interest rate on the promissory note was below market, resulting in an additional taxable gift under section 7872, not section 483(e). The case highlights the importance of accurate property valuation based on potential future use and the tax implications of below-market interest rates in intrafamily transfers.

**Facts**

Edwin and Mabel Frazee, after over 50 years in the flower bulb business, decided to retire and transfer their Carlsbad, California property to their four children in 1985 as part of an estate plan. The property included a 12. 2-acre tract with a warehouse used for flower processing and storage. The Frazees received a $380,000 promissory note bearing 7% interest, payable over 20 years. They reported the transfer on their gift tax returns, valuing the property at $985,000, with $380,000 assigned to the land and $605,000 to the improvements. The IRS challenged this valuation, asserting a higher value of $1,650,000 and that the below-market interest rate on the note resulted in an additional taxable gift.

**Procedural History**

The IRS issued a notice of deficiency to the Frazees for gift tax and additions to tax for the years 1985 and 1986. The Frazees filed a petition in the U. S. Tax Court. The IRS later conceded some issues, reducing the property's claimed value to $1,650,000 and dropping the addition to tax under section 6660. The Tax Court then heard the case, focusing on the property's fair market value and the applicability of section 7872 to the promissory note's interest rate.

**Issue(s)**

1. Whether the fair market value of the improved real property transferred by the Frazees to their children was $1 million, with $950,000 allocated to the land and $50,000 to the improvements, for purposes of computing gift tax under section 2501?
2. Whether the Frazees must use the interest rate provided in section 7872 to value the promissory note received in exchange for the transfer of improved real property to their children for gift tax purposes, or whether they may instead rely on the

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interest rate provided in section 483(e)?

**Holding**

1. Yes, because the court determined that the highest and best use of the property was industrial, given the surrounding area's development trends and the potential for rezoning, justifying a value of $1 million.
2. Yes, because section 7872 applies to below-market loans for gift tax purposes, and the 7% interest rate on the promissory note was below the applicable Federal rate, resulting in an additional taxable gift.

**Court's Reasoning**

The court applied the fair market value standard from section 2512, which requires valuing property based on its highest and best use. It considered the property's location near a developing industrial area, the surrounding properties' rezoning to industrial use, and expert testimonies. The court rejected the Frazees' valuation based on agricultural use, finding industrial use more probable and economically feasible. It also dismissed the use of local property tax assessments for valuation.

Regarding the promissory note, the court determined that section 7872, not section 483(e), applied to value the note for gift tax purposes. Section 7872 mandates using the applicable Federal rate for below-market loans, treating the difference between the loan amount and its present value as a gift. The court rejected the use of section 483(e)'s safe-harbor rate for gift tax purposes, following precedents like Krabbenhoft v. Commissioner, which held that section 483(e) does not apply to gift tax valuation. The court also noted that section 1274, which deals with imputed interest on seller financing, was irrelevant for gift tax valuation.

The court emphasized that the transaction was not at arm's length, as it involved family members, and thus did not qualify as an ordinary course of business transfer. It also considered the legislative history of sections 483, 1274, and 7872, concluding that Congress intended section 7872 to apply broadly to below-market loans for gift tax purposes.

Key quotes from the opinion include: "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 sell, and both having reasonable knowledge of the relevant facts. " and "Under section 7872, a below-market loan is recharacterized as an arm's-length transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the issue price of the loan over the present value of all the principal and interest payments due under the loan. "

**Practical Implications**

This case informs how attorneys should approach property valuation for gift tax

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purposes, emphasizing the importance of considering the highest and best use of the property rather than its current use. It highlights the need to assess potential future developments, such as rezoning, in determining value. Practitioners must also be aware of the tax implications of below-market interest rates on intrafamily loans, as section 7872 will apply, potentially increasing gift tax liability.

For legal practice, attorneys should advise clients on the importance of obtaining accurate appraisals that consider all relevant factors, including potential future uses and development trends. They should also caution clients about the use of below-market interest rates in intrafamily transactions, recommending the use of the applicable Federal rate to avoid additional gift tax.

Business implications include the need for companies engaging in similar transactions to carefully structure their deals to minimize tax exposure, particularly when transferring assets to family members or related parties. Societally, the case underscores the government's interest in ensuring accurate valuation and taxation of wealth transfers.

Later cases, such as Estate of Thompson v. Commissioner, have applied the principles established in Frazee, confirming the importance of considering highest and best use in property valuation and the application of section 7872 to below-market loans in gift tax contexts.

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