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Guaranteed Wealth? A New Way of Thinking About the Gift Tax Treatment of Loan Guarantees

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FLORIDA TAX REVIEW

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GUARANTEED WEALTH? A NEW WAY OF THINKING ABOUT THE GIFT TAX TREATMENT OF LOAN GUARANTEES

by

Eric Reis[*]

ABSTRACT

Wealthy parents have found an ingenious way to magnify their children's assets without paying gift tax. Rather than transfer assets to the children directly, a parent may encourage her children (or trusts for the children's benefit) to borrow funds as needed to make investments. The parent stands behind that debt by making a personal guarantee, assuring the lender of repayment and thereby allowing the children to borrow and invest far more than they otherwise could. The Internal Revenue Service clearly believes that such guarantees should be treated as gifts but has hesitated to press that position or develop a framework for doing so. This Article provides that framework, drawing on analogous corporate tax cases to show the way.

For gift tax purposes, when a person guarantees a loan to a related party, the loan would be recharacterized as a loan from the

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lender to the guarantor, followed by a second loan on the same terms from the guarantor to the ultimate borrower. Each loan would then be tested under existing doctrines to see whether it should be respected as debt. In most cases, the second deemed loan (from the guarantor to the ultimate borrower) would not be respected as debt, because the ultimate borrower lacks the income or resources to justify the extension of credit. As a result, the second deemed loan would be recharacterized as a gift to the ultimate borrower rather than a loan. This framework would severely curtail the use of guarantees to grow dynastic wealth.

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I. Introduction

Nearly 40 years ago, the Supreme Court declared in *Dickman v. Commissioner* that a no-interest loan between family members or their companies would be treated as a gift of the forgone interest.[1] Congress codified this decision in section 7872, which calculates the amount of the gift by comparing the interest (if any) charged by the lending family member to a specified minimum interest rate.[2] Intra-family loans are sometimes controversial; former President Trump's loans to family members, for example, drew negative attention from Congress in its investigation of his tax returns.[3] Despite such controversies, these loans remain a staple of estate planning.[4]

Section 7872 leaves important gaps in its regulation of intra-family loans. It does not address circumstances where the borrower could not have obtained a loan from a disinterested party at *any* interest rate (because the borrower lacks sufficient resources to justify the extension of credit on any terms).[5] That issue is partly addressed by doctrines that recharacterize such "impossible" loans as something other than debt (e.g., an equity or other interest), typically with adverse tax consequences for the lender or borrower or both.[6] But those

[1] Dickman v. Comm'r, 465 U.S. 330, 344 (1984).

[2] § 7872(a), (e)(2).

[3] J. Comm. on Tax'n, 117th Cong., Rep. to the H. Comm. on Ways & Means Chairman Richard Neal 7 (2022).

[4] Steven R. Akers & Philip J. Hayes, *Estate Planning Issues with Intra-Family Loans and Notes*, 38 ACTEC L.J. 51, 54 (2012) [hereinafter Akers & Hayes].

[5] *See* § 7872(a) (providing that this section applies to certain loans, without defining the term "loan" or explaining how to determine whether a purported loan should be respected as such).

[6] *See In re* Larson, 862 F.2d 112, 117 (7th Cir. 1988) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio of more than 43 to 1); Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630–32 (6th Cir. 1986) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio in excess of 300 to 1); Astleford v. Comm'r, 33 T.C.M. (CCH) 793 (1974) (recharacterizing purported

doctrines seem to leave a loophole: another wealthy family member may add substance to an otherwise dubious loan by guaranteeing the debt. The Internal Revenue Service ("Service") has been flummoxed by such guarantees between family members or their trusts or companies. The Service clearly believes that these guarantees should be treated as gifts but has hesitated to press that position—likely because it has no good theory for how these gifts should be valued, and no solution for the administrative difficulties taxing these gifts would present.[7]

This article proposes a new framework for addressing these issues. Part II describes the problem in more detail, illustrating how taxpayers have used guarantees to benefit their families without reporting those guarantees as taxable gifts. Part III argues that many such guarantees should be treated as gifts under the rationale of *Dickman*, notwithstanding older contrary authority. Part IV considers past proposals for valuing such gifts and concludes that these proposals are difficult to apply and inconsistent with the policy behind section 7872.

Finally, Part V suggests a path out of this administrative quagmire, drawing on analogous corporate tax cases to approach the problem in a different way. For gift tax purposes, when a person guarantees a loan to a related party, the loan would be recharacterized as a loan from the lender to the guarantor, followed by a second loan on the same terms from the guarantor to the ultimate borrower. Each loan would then be tested under existing doctrines to see whether it should be respected as debt. The interest rate actually charged would not be considered in that inquiry, so long as it exceeds the minimum rate required by section 7872; rather, the relevant question would be whether a

loans to an entity as capital contributions where the entity had a debt-to-equity ratio in excess of 165 to 1), *aff'd*, 516 F.2d 1394, 1395 (8th Cir. 1975) (per curiam); I.R.S. Tech. Adv. Mem. 1992–51–004 (Dec. 18, 1992) (recharacterizing a purported sale of stock to an unfunded trust, in exchange for promissory notes issued by the trust, as a gift of the stock to the trust subject to a retained income interest). *Cf.* Estate of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220 (2006) (recharacterizing purported loans by an entity to an individual as distributions, where the individual was unable to meet her financial obligations without these funds).

[7] *Compare* P.L.R. 1991-13-009 (Mar. 29, 1991) (declaring that a taxpayer's guarantees of debts of his children's company "are transfers (subject to gift tax) of the economic benefit conferred") *with* P.L.R. 1994-09-018 (Mar. 4, 1994) (withdrawing P.L.R. 1991-13-009 and declaring that "no opinion is expressed as to the federal tax consequences" of the guarantees), *and* I.R.S. F.S.A. (Jun. 17, 1994), 1994 WL 1865994 ("The Service's position on this issue is still being reconsidered.").

disinterested lender would make a loan to the particular borrower at *any* interest rate. In most cases, the first deemed loan (from the lender to the guarantor) would survive this test, because the guarantor would have the wherewithal to support the debt. However, the second deemed loan (from the guarantor to the ultimate borrower) often would not survive this test, because the ultimate borrower lacks the income or resources to justify the extension of credit on any terms. As a result, the second deemed loan would be recharacterized as a contribution to the ultimate borrower rather than a loan, generally resulting in a gift by the guarantor in the full amount of the guaranteed debt. This article describes how this framework avoids the theoretical and administrative problems posed by past proposals and avoids imposing undue tax consequences on routine guarantees of everyday credit transactions, while impeding the more strategic use of guarantees to grow dynastic wealth.

II. The Problem

As discussed below and in Part III, cases and rulings in this area typically involve loans to family *companies* or *trusts* rather than to individuals directly. This reflects, first, the estate-planning truism that benefactors wish to retain some influence over how the wealth they generate is used;[8] second, the fact that benefactors do not want their family members to suffer personally if the loan cannot be repaid;[9] third, the desire in some cases to protect funds from divorcing spouses or other creditors of the intended beneficiary;[10] and fourth, the desire in most cases to protect funds from estate tax upon the death of the intended beneficiary.[11] Accordingly, this Part considers how these arrangements are commonly structured in actual practice.

[8] Kay W. Abramowitz, *Planning for the Less-Wealthy Client (With Forms)*, Prac. Tax Law. 53 (2008) ("Most clients want to retain control of their assets even from the grave.").

[9] Gary A. Zwick, *Intra-Family Loans*, Ohio Prob. L.J., 9 (Nov./Dec. 2013) (suggesting that clients lend funds to a trust without significant net worth, in order to make the loan a "no lose" proposition for their beneficiaries).

[10] John J. Scroggin, *Protecting and Preserving the Family—the True Goal of Estate Planning, Part I: Reasons and Philosophy*, Prob. & Prop., May/June 2022, at 29, 31 ("Clients . . . use trusts to restrict the claims of creditors. Asset protection also focuses on the potential claims of divorcing spouses.").

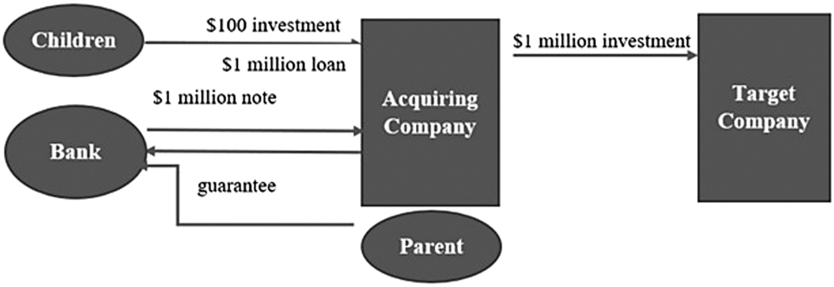
[11] *Id.* at 29 (acknowledging this traditional purpose, while suggesting that planners should give more attention to other concerns); Abramowitz,

A. Loans to Family Companies

1. Guarantee of Third-Party Loan to Company

The Service considered one common arrangement, a loan to a family company, in Private Letter Ruling (P.L.R.) 1991-13-009.[12] In this ruling, the taxpayer's adult children wished to acquire various "target" companies.[13] Rather than do so individually, they would form an acquiring company to make each purchase.[14] The acquiring company, in turn, would obtain a bank loan to fund its acquisition of the target.[15] The bank would require a personal guarantee, which the taxpayer would provide.[16] The transactions were substantial, sometimes in excess of $1 million (at a time when the amount exempt from federal estate or gift tax was $600,000[17]).[18] It appears that the acquiring company was only nominally funded apart from the loan, in view of the structure of the transactions and the bank's insistence on the taxpayer's personal guarantee, though the ruling does not specifically mention this. A typical transaction might appear as follows:

Figure 1: Guarantee of Bank Loan to Children's Company



supra note 8, at 53 ("Most clients want . . . to avoid estate and inheritance tax.").

[12] P.L.R. 1991-13-009 (Mar. 29, 1991).

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] § 2010 (as in effect prior to August 5, 1997).

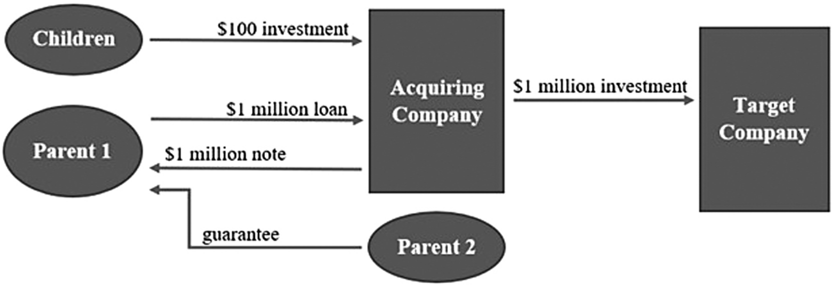
[18] P.L.R. 1991-13-009 (Mar. 29, 1991).

This arrangement created a no-lose proposition for the taxpayer's children. If the investments they made through their acquiring company appreciated, they could repay the loan and pocket the excess. If the investments they made through their acquiring company declined in value, they could abandon the acquiring company, allow the lender to reclaim what it could, and require the lender to recover any deficiency from the taxpayer as guarantor. Under these circumstances, the Service concluded that "valuable economic benefits [had been] conferred" by the taxpayer, and these benefits should be subject to gift tax.[19] Further, the Service determined that a gift occurred at the time the guarantee was made, rather than only if and when the guarantor was required to make good on the guarantee.[20] However, the ruling was conspicuously silent on how the amount of the gift would be computed. Perhaps for that reason, the Service withdrew the ruling three years later and has not addressed the issue since then, leaving its current position unclear.[21]

2. Guarantee of Family Loan to Company

While P.L.R. 1991-13-009 involved bank financing, taxpayers can easily construct similar arrangements with intra-family debt, avoiding the potential leakage of value to a third-party lender. Consider, for example, a married couple, each of whom has substantial assets and income, who wish to benefit their adult children. As in the ruling, the children could form and nominally fund a company to make investments. One spouse could then lend funds to that company while the other spouse guarantees repayment. The transaction would appear as follows:

Figure 2: Guarantee of Spouse's Loan to Children's Company



[19] *Id.*

[20] *Id.* (citing Rev. Rul. 84–25, 1984–1 C.B. 191).

[21] P.L.R. 1994-09-018 (Mar. 4, 1994).

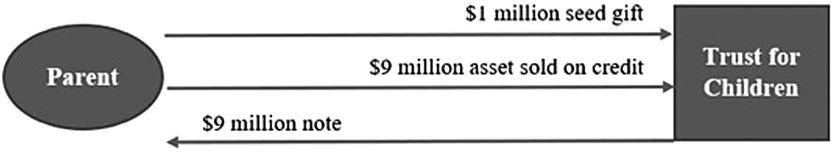
This arrangement would again create a no-lose proposition for the couple's children. If the investments they make through the acquiring company increase in value, the children benefit, and if the investments lose value, the guarantor spouse bears the loss (resulting in a transfer between the spouses, which generally is not subject to gift tax[22] or income tax[23]).

B. Loans to Family Trusts

1. Loan to Adequately Funded Trust

As appealing as the above transactions may be to taxpayers wishing to shift wealth to their descendants, taxpayers may construct even more favorable variations using family trusts. These transactions are often structured as a sale of existing assets to an irrevocable trust for the benefit of the taxpayer's descendants.[24] In a typical transaction, the taxpayer would first create the trust, then seed it with a moderate gift, and finally sell a much more valuable asset to the trust *on credit*, i.e., for a promissory note from the trust.[25] If the amount of the seed gift is $1 million and the assets sold to the trust are worth $9 million, this may be visualized as follows:

Figure 3: Leveraged Sale to Children's Trust



[22] § 2523(a).

[23] § 1041(a), (b).

[24] Akers & Hayes, *supra* note 4, at 54.

[25] *Id.* at 136–41. Strictly speaking, the note would be executed by the trustee of the trust, acting in the trustee's fiduciary capacity. *See* Americold Realty Trust v. Conagra Foods, 577 U.S. 378, 383 (2016) (explaining that a trust traditionally is classified as a fiduciary relationship rather than an entity, so the trustee acts for the trust).

In the above example, the trust has substantial assets independent of the loan, and immediately after the financed sale has a debt-to-equity ratio of nine to one. While there is no set rule for what amount of leverage is permissible for debt to be respected as such for tax purposes, there is some authority supporting a debt-to-equity ratio of nearly twenty to one,[26] and practitioners commonly employ leverage of up to nine to one.[27] Thus, this structure may allow taxpayers to provide substantial benefits to their descendants even without making use of guarantees. If the assets appreciate, the descendants benefit through the trust; if the assets decline, the descendants have "only" $1 million at risk of being clawed back in repayment of the debt.

2. Loan to Nominally Funded Trust, Supported by Spousal Guarantee

The preceding arrangement is not favorable enough, however, for some taxpayers. If the taxpayer has previously exhausted the gift tax credit available to him or her under the Internal Revenue Code, making even a $1 million gift may incur a substantial gift tax.[28] And if the asset is even more valuable than the $9 million assumed above, maintaining a nine-to-one debt-to-equity ratio would require a proportionately larger seed gift. With this in mind, a taxpayer may be tempted to employ much

[26] Akers & Hayes, *supra* note 4, at 138; McDermott v. Comm'r, 13 T.C. 468 (1949), *acq.*, 1950–1 C.B. 3.

[27] Akers & Hayes, *supra* note 4, at 137–38. *But see* Matthiessen v. Comm'r, 16 T.C. 781 (1951) (recharacterizing a purported loan to an entity as a capital contribution where the entity appears to have had a debt-to-equity ratio of nine to one), *aff'd*, 194 F.2d 659 (2d Cir. 1952); Note, *Thin Capitalization & Tax Avoidance*, 55 Colum. L. Rev. 1054, 1061 n.51 (1955) (specifying the debt-to-equity ratio of the entity in *Matthiessen*). In addition to the debt-to-equity ratio, the Tax Court in *Matthiessen* also looked to the fact that the purported loans were unsecured. *Matthiessen*, 16 T.C. at 786 ("Aside from the relationship of [the entity's] capital to the amount of advances, the lack of any adequate security for the advances negatives completely petitioners' insistence that they were bona fide loans and not capital contributions. The possibility is remote indeed that a disinterested lender of money would have made the initial unsecured loan . . . .").

[28] *See* §§ 2502(a), 2001(c) (imposing gift tax at a 40% rate once all credit has been exhausted, resulting in a tax of $400,000 on the $1 million gift).

higher leverage. For example, if the taxpayer gives only $10,000 to the trust and sells a $9.99 million asset to it for a promissory note, the same basic arrangement yields a debt-to-equity ratio of 999 to one—far in excess of what can ordinarily be justified as debt.[29] Absent something more, the taxpayer may be treated instead as having made a *contribution* to the trust (the $9.99 million asset) subject to a retained beneficial interest (the promissory note).[30] The consequences of that characterization would be dire, because a retained beneficial interest is valued for gift tax purposes only if it takes one of a handful of permitted forms, which the note does not.[31] As a result, the note would be deemed to have no value and the taxpayer would be treated as having made a $9.99 million gift.[32] Nevertheless, the existence of the note would be recognized for estate tax purposes as a retained interest, causing the trust assets to be subject to estate tax upon the taxpayer's death.[33]

This disastrous result might be avoided, though, through the use of a guarantee. As in Part II.A above, that guarantee may be provided by the taxpayer's spouse, as follows:

[29] *See, e.g.*, *In re* Larson, 862 F.2d 112, 117 (7th Cir. 1988) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio of more than 43 to 1); Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630–32 (6th Cir. 1986) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio in excess of 300 to 1); Astleford v. Comm'r, 33 T.C.M. (CCH) 793 (1974) (recharacterizing purported loans to an entity as capital contributions where the entity had a debt-to-equity ratio in excess of 165 to 1), *aff'd*, 516 F.2d 1394, 1395 (8th Cir. 1975) (per curiam). In addition to the debt-to-equity ratio, courts consider other factors that may be unfavorable to family loans. *See Roth Steel Tube Co.*, 800 F.2d at 630 (explaining that courts are less inclined to treat a purported loan as such if the loan is unsecured and the debtor is unable to obtain financing from outside lending institutions, among other factors).

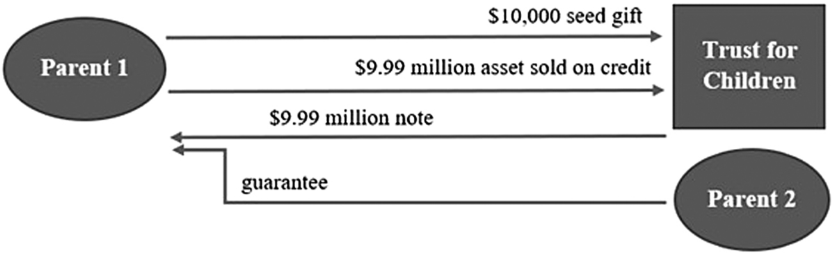
[30] T.A.M. 1992–51–004 (Dec. 18, 1992); *see also* Rev. Proc. 2013–3 § 4.01(55), 2013–1 I.R.B. 113 (declining to rule on whether a trust beneficiary's sale of property to the trust will be treated as a gift if, inter alia, "the trust purchases the property with a note and . . . the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased").

[31] § 2702(a)(2)(A), (b).

[32] § 2702(a)(2)(A).

[33] § 2036(a); I.R.S. Tech. Adv. Mem. 9251004 (Dec. 18, 1992).

Figure 4: Guarantee of Debt Incurred in Leveraged Sale



Assuming the taxpayer's spouse has the wherewithal to bear this level of debt, the trust's note would now seem to have substance. Accordingly, the taxpayer's loan should not be treated as a contribution to the trust and should not give rise to a gift (at least, not by the taxpayer). The taxpayer's descendants clearly benefit, however. As in the prior examples, they enjoy a larger trust if the trust's assets grow at a faster rate than the interest on its debt—but in this case they suffer virtually no loss if the trust assets decline in value, because the trust was only nominally funded. Unless the taxpayer's spouse's guarantee is treated as a gift, they enjoy this favorable position without anyone's suffering a gift tax consequence.

3. Loan to Nominally Funded Trust, Supported by Beneficiary Guarantee

Another variation on this structure is noteworthy because it has become popular among estate-planning practitioners for families with multi-generational wealth.[34]

Suppose a single taxpayer and her adult children are all wealthy (with far more assets than any of them will consume in their lifetimes) and wish to coordinate their planning to minimize the family's long-term estate tax liability. The taxpayer could minimize her own estate tax exposure by selling assets directly to her children in exchange for promissory notes issued directly by her children. Thereafter, her estate would grow only at the interest rate specified in the notes and would not include

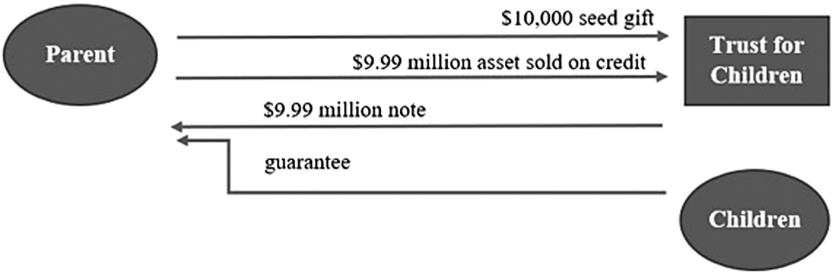
[34] *See generally* Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (2000) [hereinafter Hatcher & Manigault].

any further appreciation in the value of the sold assets. These financed sales would presumably be respected as such because the children have the wherewithal to service the debt. Over time, this arrangement might be expected to slow the growth of the taxpayer's estate (minimizing the estate tax due at her death) while accelerating the growth of her children's estates (increasing the estate tax due at their deaths).

The family in this example is better off from a tax perspective than if it had done no planning, as the taxpayer is likely to die decades earlier than her children. Still, the family would be even better positioned if the taxpayer could sell assets to a trust for her descendants (as in Part II.B.1 above) rather than to the children directly. That way, the trust assets could avoid estate tax not just at the taxpayer's death, but at her children's deaths too. Further, the family would be ideally positioned if the taxpayer could sell assets to a *nominally funded* trust for her descendants (as in Part II.B.2 above), as this would avoid the need for her to make a taxable gift of any significant amount to the trust.

In this case, however, the taxpayer does not have a spouse who could guarantee the trust's debt. Further, assume that she does not have any siblings or other collateral relatives who are willing and able to do so. To address this problem, she decides to create a trust for her descendants, fund it with a nominal amount, sell assets of enormous value to it in exchange for a promissory note, and have *the children themselves* guarantee the trust's debt. This would appear as follows:

Figure 5: Children's Guarantee of Debt Incurred in Leveraged Sale



This structure does not offer the children a "no-lose" proposition, as in other examples discussed above. If the trust assets decline in value, the children will suffer a real loss as they must make good on their guarantees. However, in many cases the likelihood of such a decline is minimal (e.g., because the asset is sold at an already-depressed value, or the family has private information suggesting that it will become worth much more than the market currently recognizes).[35] In these circumstances, the family's priority is to shift the future growth away from the parent's taxable estate, without adding that value to the children's taxable estates. This arrangement would seem to do just that, again without gift tax consequences for anyone—assuming the guarantee itself is not treated as a gift.

If the guarantee *is* treated as a gift, the arrangement is much less favorable, as the beneficiaries would then be considered to have made a contribution to the trust (valued at whatever amount the guarantee is deemed to be worth) while retaining an interest in that contribution (their interest as beneficiaries of the trust).[36] That, in turn, would subject at least a portion of the trust's assets to estate tax at the children's deaths.[37] But in view of the Service's quiescence over the past 32 years and some arguably favorable authority (discussed in Part III below), using beneficiary guarantees has become increasingly popular with taxpayers and their advisors.[38]

III. The Legal Rationale for Treating Guarantees as Gifts, and Objections Thereto

To address the policy problems created by guarantees, one must either persuade Congress to amend the Code (a herculean task) or establish that these problems can be addressed under current law. This Part explores the conceptual basis for treating a loan guarantee as a gift by (i) establishing that making property *available* to a donee is a gift and (ii) establishing that incurring a contractual obligation is a gift, while (iii) distinguishing contrary authority.

[35] *But see* I.R.S. Chief Couns. Mem. 2021–52–018 (Oct. 4, 2021) (advising IRS personnel that private information regarding a pending merger should have been considered in valuing a particular taxpayer's gift of stock).

[36] *See* P.L.R. 1991-13-009 (Mar. 29, 1991).

[37] § 2036(a).

[38] *See* Hatcher & Manigault, *supra* note 34, at 154 (asserting that "the clear weight of authority seems to support the absence of any gift by the beneficiaries to the trust"); Akers & Hayes, *supra* note 4, at 140–41 (stating more cautiously that "the guarantee arguably is not a gift to the trust" and suggesting alternatives for planners who are "squeamish").

A. Making Property Available to a Donee Is a Gift Under Dickman v. Commissioner

The strongest, albeit indirect, conceptual support for treating guarantees as gifts comes from the Supreme Court's decision in *Dickman v. Commissioner*.[39] During the years at issue in that case, an individual could make gifts of up to $3,000 per year per recipient,[40] and additional gifts of up to $30,000 (total) to all recipients over the course of the donor's lifetime,[41] without incurring gift tax. These limits created a strong incentive for taxpayers to provide benefits to their descendants in indirect ways. The taxpayers in *Dickman* employed one such scheme: they lent hundreds of thousands of dollars to their son and to a company owned by the taxpayers and their son, daughter-in-law and grandchildren.[42] The loans bore no interest and had no fixed maturity; instead, they were payable upon demand.[43] The taxpayers contended, and the Tax Court agreed, that this arrangement did not constitute a "transfer of property by gift" within the meaning of section 2501(a)(1).[44]

In analyzing this claim, the Supreme Court began with a related provision, section 2511(a).[45] Then as now, this section explains that "the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, *whether the gift is direct or indirect*, and whether the property is real or personal, tangible or intangible . . . ."[46] The Court also looked to the congressional committee reports accompanying the precursors of these sections, which explain that "[t]he terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; the term 'property' reaching every species of right or interest protected by law and having an exchangeable value."[47] Finally, the Court cited sweeping language from its own

[39] Dickman v. Comm'r, 465 U.S. 330 (1984).

[40] § 2503(b) (as in effect for gifts on or before December 31, 1981); § 2521 (as in effect for gifts made on or before December 31, 1976).

[41] § 2521 (as in effect for gifts made on or before December 31, 1976).

[42] *Dickman*, 465 U.S. at 332.

[43] *Id.* at 322–23.

[44] *Id.* at 333.

[45] *Id.* at 333–34.

[46] § 2511(a) (emphasis added).

[47] *Dickman*, 465 U.S. at 334 (citing H.R. Rep. No. 708, 72d Cong., 1st Sess., 27–28 (1932) and S. Rep. No. 665, 72d Cong., 1st Sess., 39 (1932)).

prior decisions, explaining that "Congress intended to use the term 'gifts' in its broadest and most comprehensive sense . . . [in order] to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech" and that the gift tax statute "is broad enough to include property, however conceptual or contingent."[48] Having laid such an expansive predicate, it is unsurprising that the Court concluded that "the gift tax statutes clearly encompass within their broad sweep the gratuitous transfer of the *use* of money."[49]

The *Dickman* decision does not by its terms address loan guarantees. However, it establishes the principle that a gift may arise from making property available for the *use* of a beneficiary. Further, the decision notes that its conclusion does not depend on the taxpayer's suffering any diminution of his or her assets.[50] Specifically, the opinion observes that taxpayers are free "to waste the use value of money," by not taking advantage of that value themselves, and that in itself does not trigger gift tax; but "[i]f the taxpayer chooses not to waste the use value of money . . . but instead transfers the use to someone else, a taxable event has occurred."[51] In the context of the *Dickman* case, this meant that the taxpayers could leave their money uninvested (e.g., in a non-interest-bearing checking account) without tax consequences; but when they chose to make no-interest loans to their son and his descendants, that did have consequences as a taxable gift.[52] In the context of the guarantees considered by this Article, the analogy would be: a taxpayer is free not to use her borrowing capacity to make investments herself; but if she chooses to transfer that borrowing capacity to her descendants, that is a gift.

Foreshadowing one of the concerns discussed in Part IV below, the majority in *Dickman* also briefly noted, but chose not to address, concerns that the "use value" of money would be difficult to determine.[53] The dissenting justices, by contrast, emphasized

[48] *Id.* at 335 (citing Comm'r v. Wemyss, 324 U.S. 303, 306 (1945) and Smith v. Shaughnessy, 318 U.S. 176, 180 (1943)) (brackets in original).

[49] *Id.* at 337 (emphasis added).

[50] *Id.* at 340.

[51] *Id.*

[52] *Id.*

[53] *Id.* at 344 n.14.

> the valuation problems that certainly will result from the Court's holding. . . . In the three decided cases in which the Commissioner belatedly pursued the theory that the Court adopts today, the Service used three different methods for determining the interest rate that should be used to establish the use-value of the borrowed money.[54]

Likewise, the majority was untroubled by the suggestion that its rule might extend to "such commonplace transactions as a loan of the proverbial cup of sugar to a neighbor or a loan of lunch money to a colleague," or to parents providing their adult children "with such things as the use of cars or vacation cottages."[55]

The majority simply "assume[d] that the focus of the Internal Revenue Service is not on such traditional familial matters" and declared that "[w]hen the Government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case."[56] (The majority also noted that the gift tax statutes' large annual and lifetime exclusions would make the issue moot for many small transactions.[57])

The majority's bottom line was that the policy of the gift tax statutes is clear, and it is up to the Service to decide how far to take that policy and up to Congress to decide what limits, if any, to place on it. Congress accepted that invitation a few months after the Court issued the *Dickman* decision by codifying the majority rule for loans between related parties while making it easier to apply (by specifying the interest rate that should be used to establish the use value of borrowed money).[58] The statute also clarified that these principles would apply not just for gift tax purposes, as in *Dickman*, but also for income tax purposes.[59]

B. Incurring a Contractual Obligation Is a Gift Under Key Decisions of the Fifth and Second Circuits

As further support for treating guarantees as gifts, key decisions of the Fifth and Second Circuit Courts of Appeal hold that incurring a

[54] *Id.* at 350.

[55] *Id.* at 340–41.

[56] *Id.* at 341.

[57] *Id.* at 341–42; *see* §§ 2503(b), 2505(a), 2510(c).

[58] § 7872.

[59] *See* § 7872(a)(1), (b)(1) (stating that these rules apply "[f]or purposes of this title," i.e., the entire Code).

contractual obligation for less than full and adequate consideration is a gift for federal gift tax purposes.[60] A decision of the Seventh Circuit also supports that conclusion, albeit more weakly.[61]

In *Autin v. Commissioner*, the taxpayer wished to transfer a business to his son while still presenting himself to customers as the owner for public relations purposes.[62] Accordingly, he retained record ownership of a majority of the company's shares, but entered into an "agreement to convey" obligating himself to execute transfer documents in favor of his son whenever the son "called upon [him] to do so."[63] The agreement was made in 1978, but the parties did not change record ownership of the shares until 1988.[64] The Fifth Circuit held that a "legally enforceable promise to give is subject to gift tax at the time the promise is made, not when the property is actually transferred," so for tax purposes the gift was made in 1978, not 1988.[65]

In *Harris v. Commissioner*, a divorcing couple entered into a settlement under which the wife was obligated to make ten annual payments to the husband.[66] Under current law, transfers incident to a divorce would generally be exempt from gift tax,[67] but at the time, the Second Circuit held that they were taxable.[68] The court then had to determine whether the gift occurred "at the time when the divorce decree [incorporating the settlement] passed," or if instead the payments represented "a series of independent gifts, each maturing when made."[69] The court concluded that the gift occurred at the time of the divorce decree, based on the "present actuarial value" of the payments to be made later.[70]

In *Commissioner v. Copley's Estate*, a man entered into a premarital agreement with his fiancée, contractually obligating him to pay

[60] Autin v. Comm'r, 109 F.3d 231 (5th Cir. 1997); Harris v. Comm'r, 178 F.2d 861 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950).

[61] Comm'r v. Copley's Estate, 194 F.2d 364 (7th Cir. 1952).

[62] *Autin*, 109 F.3d at 232–33.

[63] *Id.* at 233.

[64] *Id.*

[65] *Id.* at 235–36.

[66] Harris v. Comm'r, 178 F.2d 861, 864 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950).

[67] § 2516.

[68] *Harris*, 178 F.2d at 865.

[69] *Id.*

[70] *Id.*

her $1 million after their wedding.[71] They married as expected, and he made payment thereafter in two installments.[72] Crucially, they entered into the premarital agreement (and married) *before* the federal gift tax was enacted, but the payments were made *after* the federal gift tax was enacted.[73] Further, the early gift tax applied even to gifts between spouses.[74] Thus, the Service asked the court to determine that a gift occurred when the taxpayer actually made payment under the agreement.[75] The Seventh Circuit emphasized instead that the man incurred "a binding and legally enforceable obligation" upon marriage.[76] Accordingly, no gift tax was due on the later transfers he made in discharge of that obligation.[77] The court declined to determine whether incurring the obligation was itself a gift, as it could not have been taxable regardless.[78] However, that conclusion seems consistent with the court's reasoning.

Thus, two Circuit Courts of Appeal agree that a gift occurs when an individual gratuitously incurs a contractual obligation for another person's benefit, and the Seventh Circuit's decision in *Copley's Estate* is at least consistent with that conclusion. The Service also now accepts this principle.[79] This would seem to provide a strong basis for treating a binding loan guarantee as a gift at the time the guarantee is made.

A loan guarantee does differ from the contractual obligations considered by these cases in that it is a *contingent* obligation. Arguably, that could justify postponing the taxable event until and unless the obligation becomes certain.[80] However, as noted above in Part III.A, the Supreme Court has firmly stated its view that the gift tax

[71] Comm'r v. Copley's Estate, 194 F.2d 364, 364 (7th Cir. 1952).

[72] *Id.* at 364–65.

[73] *Id.* at 365, 366, 367.

[74] *Cf.* § 2523 (allowing an unlimited marital deduction for most gifts between spouses who are citizens of the United States, but only for gifts made after December 31, 1981).

[75] *Copley's Estate*, 194 F.2d at 365.

[76] *Id.*

[77] *Id.* at 369.

[78] *Id.* at 368–69.

[79] *See* Rev. Rul. 84–25, 1984–1 C.B. 191 (holding that a taxpayer made a gift at the time the taxpayer issued a promissory note to a donee, obligating the taxpayer to pay a specified amount in the future).

[80] *See* Bradford v. Comm'r, 34 T.C. 1059, 1065 (1960) (suggesting that contingent contractual obligations should be treated differently than fixed

applies even to "conceptual or contingent" rights, making this distinction dubious.[81] Further, in other contexts it is well-established that contingent rights may be the subject of a gift. For example, a taxpayer who gratuitously transfers a term life insurance policy has made a gift, notwithstanding that the policy has no cash surrender value, and notwithstanding that the recipient will benefit from the policy only in the unlikely event that the insured dies during the policy term.[82] Similarly, a taxpayer who gratuitously transfers an option to purchase property has made a gift, notwithstanding that the recipient will realize a benefit from the option only if the property's value rises above a certain level during the option term.[83] Outside the realm of contract, a taxpayer who gratuitously transfers a reversionary interest in property has made a gift of the actuarial value of that interest, notwithstanding that the reversion will occur only if an individual does not survive a specified period.[84] Valuing a loan guarantee poses more *practical* difficulties than valuing these other contingent interests, as discussed below in Part IV, but a guarantee does not seem fundamentally different on a conceptual level.

C. Contrary Authority

As a counterpoint to these authorities, estate planning attorneys look primarily to three lines of authority to challenge the proposition that a

obligations, and distinguishing *Copley's Estate* on that basis), *acq.* 1961–2 C.B. 4. The *Bradford* case is considered in more detail in Part III.C, *infra*.

[81] Dickman v. Comm'r, 465 U.S. 330, 335 (1984) (citing Smith v. Shaughnessy, 318 U. S. 176, 180 (1943)).

[82] *See* Reg. § 25.2511–1(h)(8) (explaining that the taxpayer has made a gift at least "to the extent of the premium paid"); Rev. Rul. 76–490, 1976–2 C.B. 300 (applying this regulation to a more complex contractual division of rights in a life insurance contract).

[83] *See* Rev. Proc. 98–34, 1998–1 C.B. 983 (providing for the valuation of options for gift, estate, and generation-skipping transfer tax purposes, using a model incorporating factors similar to those established by the Financial Accounting Standards Board); *but cf.* Rev. Rul. 98–21, 1998–1 C.B. 975 (postponing the taxable event in cases where the option's effectiveness depends on the transferor's own voluntary future actions).

[84] *See* Reg. § 25.2512–5 (providing for the valuation of such interests for gift tax purposes).

guarantee is a gift.[85] First, and most directly on point, is the Tax Court's decision in *Bradford v. Commissioner*, holding on the particular facts of that case that a (deemed) guarantee was not taxable as a gift.[86] Second, as to loan guarantees provided by the *beneficiaries* of a trust, is the Tax Court's decision in *Pleet v. Commissioner*, holding that a beneficiary's expenditures to preserve trust assets are not gifts.[87] Finally, as to guarantees generally, are a series of income tax cases concerning whether a guarantor who is required to make good on the guarantee may claim a tax deduction, or if the deduction should be denied on the grounds that the guarantor's payment is a gift.[88] On closer inspection, however, each line of authority is of doubtful current relevance.

1. Bradford v. Commissioner

Bradford's facts are unusual and unrepresentative of common estate planning transactions. In this case, the taxpayer's husband ran an investment firm that was a member of the New York Stock Exchange.[89] During the latter part of the Great Depression, the exchange adopted a rule requiring the general partner of each member firm to submit a detailed statement of accounts.[90] The taxpayer's husband had borrowed hundreds of thousands of dollars from a bank, and worried that if this debt appeared on his balance sheet, his firm would lose its seat on the exchange.[91] The court noted that this would "seriously curtail his earning power," which was a problem for the taxpayer's husband, but also presumably for the bank as his creditor.[92]

[85] *See* Akers & Hayes, *supra* note 4, at 139–40; Hatcher & Manigault, *supra* note 34, at 153–56 (both citing cases on which practitioners commonly rely).

[86] Bradford v. Comm'r, 34 T.C. 1059, 1064–65 (1960), *acq*. 1961–2 C.B. 4.

[87] Pleet v. Comm'r, 17 T.C. 77 (1951).

[88] Shiman v. Comm'r, 60 F.2d 65 (2d Cir. 1932); Fox v. Comm'r, 14 T.C. 1160 (1950), *rev'd on other grounds*, 190 F.2d 101 (2d Cir. 1951); Pierce v. Comm'r, 41 B.T.A. 1261 (1940). *See also* Ortiz v. Comm'r, 42 B.T.A. 173 (1940) (relying on the holding and rationale of *Shiman* to reach a similar result on similar facts).

[89] *Bradford*, 34 T.C. at 1060.

[90] *Id.* at 1060–61.

[91] *Id.* at 1061.

[92] *Id.*

To address this problem, the bank agreed to accept a promissory note from the taxpayer in substitution for a note previously signed by her husband.[93] On paper, this moved the liability from the husband's balance sheet to hers, and on that basis, the Internal Revenue Service tagged the taxpayer with a taxable gift to her husband in the full amount of the note ($205,000).[94] However, the note was 13 times larger than her assets ($15,780, consisting mostly of her interest in the family home), she had no independent source of income, and she had "no prospects of acquiring any [additional assets] except through her husband."[95] As the court observed, "it seems incredible that a person having a net worth of only $15,780 could make a gift of $205,000."[96]

Rejecting that premise, the court suggested instead that the transaction should be recast as, effectively, a guarantee, explaining that "it is reasonable to assume that all parties involved looked to [the husband's] assets and his earning power to liquidate the loan" and the taxpayer "only made a promise to pay in the future if called upon to do so."[97] In other words, the court treated the taxpayer's husband as the primary obligor on the debt, and treated the taxpayer as a mere guarantor of that obligation.

This deemed guarantee differed greatly from a normal guarantee, under which the lender obtains meaningful reassurance from a creditworthy guarantor. The taxpayer in *Bradford* did not confer a significant economic benefit, in the sense that a typical guarantor would, but merely facilitated a reporting sham (though the court was too polite to describe it as such). Unsurprisingly, then, the court found she provided nothing of value for gift tax purposes.[98]

To be fair, the court's conclusion did not *rely* on the unusual facts of this case. Indeed, the court suggested more broadly that a mere "promise to pay in the future if called upon to do so" is not property for gift tax purposes.[99] That comment, however, is consistent with the Tax Court's general reluctance in the mid-1900s to characterize indefinite

[93] *Id.*

[94] *Id.* at 1062.

[95] *Id.* at 1062, 1064.

[96] *Id.* at 1065.

[97] *Id.* at 1064–65.

[98] *Id.* at 1065 ("We hold that petitioner did not make a transfer of property by gift in 1938.").

[99] *Id.*

interests as "property" under the gift tax— a reluctance the Supreme Court later criticized.[100] Further, the *Bradford* case has been cited only once in the 62 years since it was issued (by the Tax Court itself, in a nonprecedential memorandum decision that also predated *Dickman*, and that did not concern loan guarantees).[101] So it is a slender reed to which to tie the proposition that guarantees are not taxable as gifts.

The Service acquiesced in the *Bradford* decision, suggesting that it would not further litigate the issue of whether a guarantee is a gift.[102] This provides some encouragement to taxpayers who wish to invoke it.[103] However, the Service has stated that "[c]aution should be exercised in extending the application of [an acquiescence] to a similar case unless the facts and circumstances are substantially the same." [104] Few cases will satisfy that requirement, considering how unusual the "facts and circumstances" were in *Bradford*. Further, the Service is free to revoke its acquiescence at any time and may do so retroactively in some cases.[105] In any event, the Service's past acquiescence has little bearing on how it should approach the issue *prospectively*.

[100] *Compare id.* at 1064–65 (conceding that property may be "conceptual or contingent," but nevertheless declining to impose gift tax on contractual promises unless "there was a definite obligation to pay a fixed amount") *and* Crown v. Comm'r, 67 T.C. 1060, 1064 (1977) (holding, prior to *Dickman*, that no-interest loans were not taxable as gifts, because all that was transferred was a hypothetical "profit [that] could have been made from a wise investment" by the donor) *with* Dickman v. Comm'r, 465 U.S. 330, 340 (1984) (explaining that *Crown*'s focus on hypothetical profit "misses the mark" by placing undue emphasis on the indefinite nature of what the donor may be giving up rather than the benefit the donor is providing).

[101] *See* Powe v. Comm'r, 25 T.C.M. (CCH) 218 (1966) (citing *Bradford* only for the proposition that the gift "tax is measured by the value of the property passing from the donor and not the value of the property received by the donee").

[102] 1961–2 C.B. 4.

[103] *See* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQUESNE L. REV. 323, 365–66 (2008) (noting that "the acquiescence program . . . keep[s] [taxpayers] informed of the Commissioner's current litigating position").

[104] Dixon v. U.S., 381 U.S. 68, 73 n.6 (1965) (quoting 1964–1 C.B. 3).

[105] *Id.* at 79–80 ("Insofar as petitioners' arguments question the policy of empowering the Commissioner to correct mistakes of law retroactively when a taxpayer acts to his detriment in reliance upon the

2. *Pleet v. Commissioner*

As to guarantees issued by the *beneficiaries* of a trust, taxpayers have also relied on cases holding that a beneficiary may incur expenses to safeguard the trust's interests without incurring gift tax, notably *Pleet v. Commissioner*.[106] However, a careful examination of this authority indicates that it has been displaced by later developments in the law.

In *Pleet*, a family patriarch transferred life insurance policies to a trust for the primary benefit of his wife and two sons, though the trust made provision for other individuals as well.[107] Thereafter, the three primary beneficiaries began paying the premiums on these policies in equal shares.[108] The Internal Revenue Service pursued at least one of these beneficiaries (the plaintiff in this case), contending that his premium payments were taxable gifts.[109] That beneficiary, in turn, protested that his payments were "made purely for the protection of [his] own substantial pecuniary interest as a beneficiary of the trust which held the insurance policies and therefore did not constitute a taxable gift."[110] The court agreed, and added that "if other beneficiaries of the trust indirectly derived a benefit through a payment to the insurance companies as a consideration for maintaining the policies in full force, that is an immaterial circumstance."[111]

The court's conclusion in *Pleet* is reasonable, and consistent with the approach of other cases of that era.[112] However, these cases would seem to be nullified by the enactment of Chapter 14 of the Code in 1990.[113] The provisions of this chapter are notoriously complex, but

Commissioner's acquiescence in an erroneous Tax Court decision, their arguments are more appropriately addressed to Congress. Congress has seen fit to allow the Commissioner to correct mistakes of law, and in § 7805(b) has given him a large measure of discretion in determining when to apply his corrections retroactively.").

[106] Akers & Hayes, *supra* note 4, at 140 (citing Pleet v. Comm'r, 17 T.C. 77 (1951)).

[107] Pleet v. Comm'r, 17 T.C. 77, 79–80 (1951).

[108] *Id.* at 81.

[109] *Id.*

[110] *Id.*

[111] *Id.* at 83.

[112] *See, e.g.*, Seligman v. Comm'r, 9 T.C. 191 (1947) (reaching the same conclusion on similar facts).

[113] §§ 2701–2704.

provide a new framework for determining whether a gift has been made, and the amount of the gift, in cases where the taxpayer makes a transfer of property in or to an entity or trust while retaining an interest in the entity or trust.[114] If a taxpayer contributes property to a trust that benefits both the taxpayer and members of the taxpayer's family, in most cases the value of the taxpayer's retained interest is deemed to be zero.[115] Thus, taxpayers can no longer claim an offset (or deny that a gift has been made at all) merely because they also benefit from their contributions to a trust, since that reciprocal benefit is *deemed* to be valueless.

Against this backdrop, *Pleet* would appear to be good law only for the narrow subset of trusts where the beneficiary's interest in the trust is so tightly circumscribed that it satisfies one of the statute's exceptions. Generally, this would require that the trust distribute only a fixed dollar amount or fixed percentage of its assets to the beneficiary each year and satisfy an exhaustive set of technical requirements set forth in Treasury regulations.[116] In that case, a beneficiary might guarantee the trust's debt and argue under *Pleet* that she is merely protecting her own interest. But for the vast majority of trusts, where the settlor wishes for the trustee to have some discretion over the timing and amount of distributions, *Pleet* and related cases appear to have little relevance.

3. *Income Tax Cases*

Finally, taxpayers have relied on a series of early income tax cases for the proposition that a guarantee is not a gift.[117] However, these cases provide only weak support, if any, for that contention.

[114] *See generally* §§ 2701(a)(1), (e)(5); 2702(a)(1).

[115] § 2701(a). Exceptions apply if the contribution is revocable or the retained interest fits within certain limited statutory niches. § 2702(a)(2)(B), (3).

[116] § 2702(b); Reg. § 25.2702–3. A trust that distributes only a fixed dollar amount to the grantor each year is commonly known as a grantor retained annuity trust, or "GRAT," while a trust that distributes only a fixed percentage of its assets to the grantor each year is commonly known as a grantor retained unitrust, or "GRUT." *See, e.g.*, Reg. § 20.2039–1(e) (using this terminology).

[117] Hatcher & Manigault, *supra* note 34, at 153–56 (citing Shiman v. Comm'r, 60 F.2d 65 (2d Cir. 1932); Fox v. Comm'r, 14 T.C. 1160 (1950),

In *Shiman v. Commissioner*, the taxpayer guaranteed his brother-in-law's brokerage accounts to enable his brother-in-law to speculate in stocks on margin during the 1920s.[118] The brother-in-law later became insolvent and the taxpayer was required to make good on the guarantee.[119] The taxpayer claimed an income tax deduction for this payment, which the Internal Revenue Service denied.[120] Among other objections, the Service claimed that the taxpayer's payment was nondeductible because it was a gift.[121] The Second Circuit rejected that position, noting that the taxpayer's *issuance* of the guarantee may have been voluntary, but his *performance* under the guarantee was not: "[I]t is absurd to treat the performance as it would have been had it been freely made at the time. That cannot be a gift which the putative giver was powerless to withhold."[122] The court observed that the brother-in-law was solvent at the time the guarantee was issued, but the court made that observation, it seems, only to support the idea that the guarantee was a valid contractual obligation and not a sham from the start.[123] Thus, *Shiman* is authority for the proposition that performing under a guarantee is not a gift, but does not really speak to whether making the guarantee in the first place can be a gift.

Fox v. Commissioner presents a somewhat similar fact pattern. In this Depression-era case, the taxpayer lent securities to her husband to use as collateral for securities investments.[124] When those investments went poorly, the taxpayer threw good money after bad by guaranteeing his accounts, in the hope that this would allow him to recover and repay her.[125] After her husband died insolvent, she made payments on the guarantee over a period of years, and claimed an income tax deduction for at least those payments that she made in the year at issue in the

rev'd on other grounds, 190 F.2d 101 (2d Cir. 1951); Pierce v. Comm'r, 41 B.T.A. 1261 (1940); Ortiz v. Comm'r, 42 B.T.A. 173 (1940)).

[118] Shiman v. Comm'r, 60 F.2d 65, 66 (2d Cir. 1932).

[119] *Id.*

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] Fox v. Comm'r, 14 T.C. 1160, 1160 (1950), *rev'd on other grounds*, 190 F.2d 101 (2d Cir. 1951).

[125] *Id.* at 1161 ("The petitioner executed the guaranty because . . . she thought she would protect the securities she had theretofore loaned him.").

case.[126] As in *Shiman*, the Service rejected that deduction, this time suggesting that the whole arrangement was gratuitous from beginning to end.[127] The Tax Court addressed that directly: "Petitioner was not making a gift to her husband, but rather was making him a loan of some of her securities and through the guaranty of his account *a loan of her credit*."[128] At first glance these comments seem helpful to taxpayers who wish to argue that a guarantee is not a gift, but the court's characterization of a guarantee as a "loan" rather than a gift is self-refuting in view of the Supreme Court's later holding that an interest-free loan *is* a gift (of "the reasonable value of the use of the money lent").[129]

The Depression era was fertile ground for cases of this type, and *Pierce v. Commissioner* presents another permutation of the same theme. In this case, a man and his son both owned stock in a corporation.[130] The son had pledged his stock as collateral on a bank debt, but the bank later demanded additional collateral.[131] To prevent the sale of the son's stock, the father guaranteed the debt, and the father was later required to make payment on this guarantee.[132] The father claimed a bad-debt income tax deduction because his son was unable to repay him.[133] The IRS denied the deduction on the grounds that the father had made a gift, but the Board of Tax Appeals (the predecessor to the Tax Court) disagreed.[134] First, the Board noted that the son was "solvent by a safe margin at the time of the original guarantee."[135] (By contrast, in the type of loans discussed in Part II of this article, *supra*, the debtors are solvent only by the thinnest of margins, not remotely "safe.") Second, the Board noted that the father's "primary objective" in making the guarantee was "to protect the market value of [his own] securities" from being depressed by a forced sale of his son's stock in the same corporation.[136] Thus, the father was protecting his own interest—not

[126] *Id.* at 1162.
[127] *Id.* at 1164.
[128] *Id.* (emphasis added).
[129] *See* Dickman v. Comm'r, 465 U.S. at 344 (1984).
[130] Pierce v. Comm'r, 41 B.T.A. 1261, 1262 (1940).
[131] *Id.*
[132] *Id.* at 1262–63.
[133] *Id.* at 1263.
[134] *Id.* at 1264–65.
[135] *Id.* at 1265.
[136] *Pierce*, 41 B.T.A. at 1265.

making a gift—under the same rationale as in *Pleet v. Commissioner*.[137] For the reasons discussed above in Part III.C.2, that rationale should provide little comfort to taxpayers under current law.

Finally, from the same era, *Ortiz v. Commissioner* rounds out this group of cases. In *Ortiz*, the taxpayer (a member of the DuPont family) guaranteed her husband's margined brokerage accounts after the crash of 1929 to prevent his holdings from being liquidated.[138] At the time of this guarantee, the value of his securities exceeded the margin debt by about 5.5%, though she was later required to renew the guarantee at a time when the securities were worth less than the debt.[139] After her husband's securities declined in value yet again, she terminated the arrangement, had the securities liquidated, required her husband to pay her what he could (including by deeding his remaining real estate to her) and paid the deficiency to the brokerage firm.[140] She claimed a bad debt deduction for this deficiency on her income tax return.[141] The Service challenged her deduction by advancing the same argument as in *Shiman* (that her payment under the guarantee was a gift), and the Board ruled for the taxpayer in reliance on *Shiman* and applying the same reasoning (that making a payment under a guarantee is not a gift).[142] Accordingly, *Ortiz*, like *Shiman*, does not provide meaningful support for the idea that *issuing* a guarantee is not a gift. Further, the facts of *Ortiz*—where the debtor initially had a 5.5% "cushion" of equity before the guarantee would be called upon—were more favorable to the taxpayer than in many of the planning scenarios discussed in Part II of this article, *supra*.

Thus, there seems to be little in this collection of Depression-era cases, mostly from the Tax Court and Board of Tax Appeals, to weigh against the modern-era Supreme Court's support in *Dickman* for treating transfers of the "use value" of property as a gift.

[137] *Id.*

[138] Ortiz v. Comm'r, 42 B.T.A. 173, 180 (1940).

[139] *Id.*

[140] *Id.* at 180–81, 186.

[141] *Id.* at 181.

[142] *See id.* at 187 ("The facts and circumstances [here] are so similar to the facts and circumstances existing in *Shiman v. Commissioner*, and the arguments advanced in the two cases are so alike, that a detailed analysis of the Circuit Court's decision will be helpful in disposing of the present issue.") (internal citation omitted).

IV. Approaches to Valuing Guarantees

As the Supreme Court noted in *Dickman*, Congress intended for the gift tax to reach "every species of right or interest protected by law *and having an exchangeable value*."[143] That raises the question of whether a loan guarantee has an "exchangeable value." If not, then arguably *Dickman* would not apply and a guarantee could not be taxed as a gift. However, property should not be considered to lack an "exchangeable value" merely because that value is difficult to determine,[144] and *Dickman* itself waved away concerns that the Service had used a different method for determining the use value of property every time it considered the issue.[145] Accordingly, this Part considers various ways a guarantee might be valued. Several of the methods described in this Part provide a valid basis for valuing a guarantee and therefore for treating a guarantee as a gift, though Part V ultimately suggests a different approach for reasons of administrative convenience and conceptual consistency with other Code provisions.

A. Proposed Valuation Approaches

1. Credit Default Swap Model

One commenter has noted that guarantees closely resemble financial instruments known as "credit default swaps" (CDSs), and suggested that "[t]he IRS should treat guarantees and CDSs similarly for tax purposes . . ."[146] He describes the basic structure of a CDS as follows:

> Suppose Company A issues $100 in corporate bonds. Company B buys those corporate bonds, yet worries about Company A's financial stability. So Company B negotiates an agreement with Company C where Company C would pay a specified sum if the bonds

[143] Dickman v. Comm'r, 465 U.S. at 334 (1984) (citing H.R. Rep. No. 72–708 (1932) and S. Rep. No. 72–665 (1932)) (emphasis added).

[144] *See, e.g.*, Reg. §§ 25.2512–2(f), 25.2512–3 (providing for a case-by-case, facts-and-circumstances analysis of the value of unmarketable securities or business interests).

[145] *Dickman*, 465 U.S. at 344 n.14, 350.

[146] Caleb Sainsbury, *Taxation of Credit Default Swaps: A Guaranteed Solution*, 30 Rev. Banking & Fin. L. 443, 459 (2010).

> default. That contract is a CDS, the bonds are the reference obligation and the default of the bonds is a credit event. For that protection guarantee, Company B would pay Company C a specified premium.[147]

This arrangement is similar to several of the examples described in Part II of this article, *supra*. In those examples, a family trust or company (in the role of "Company A") issued a promissory note to a family's matriarch or patriarch as lender (in the role of "Company B"), and that note was guaranteed by another family member (in the role of "Company C"). The difference, of course, is that in the examples from Part II the guarantor was not paid for providing its assurance. The market for CDSs provides a measure of the value of this uncompensated benefit. Similarly, if the guarantor is paid for making the guarantee, the market for CDSs provides a means for evaluating whether the amount paid is appropriate.

Unfortunately, the market for CDSs is still "relatively young," even as to debts far less obscure than intra-family loans.[148] However, pricing models may be used to estimate an appropriate price.[149] These models can be quite complex and mathematically dense, but the key point is that "valuation of a credit default swap requires estimates of the risk-neutral probability that the reference entity will default at different future times."[150] For a public entity, the probability of default may be calculated by comparing the price of the entity's bonds to the price of similar U.S. Treasury bonds.[151] For a family trust or closely held family business, of course, such pricing data generally is not available. Instead, an appraiser faces the unenviable task of *estimating* the probability of default based on the nature of the trust's or business's assets and the likelihood that such assets will appreciate or

[147] *Id.* at 446.

[148] Antulio N. Bomfim, *Credit Default Swaps* 1 (Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2022–023, May 2022).

[149] *See, e.g.*, John C. Hull & Alan White, *Valuing Credit Default Swaps I: No Counterparty Default Risk*, J. Derivatives, Fall 2000, at 29 (providing "a methodology for valuing credit default swaps," testing whether such methods "give accurate valuations" and "provid[ing] an example of the application of the methodology to real data").

[150] *Id.* at 30.

[151] *Id.*

depreciate.[152] That process is difficult and subjective, but does not seem inherently more so than the risk assessment required in any business valuation.[153] Further, it does not seem fundamentally different than the risk assessment the Supreme Court contemplated in *Dickman* in determining the appropriate interest rate for a loan between family members.[154]

2. Bank Letter of Credit Model

Guarantees have also been compared to a bank letter of credit.[155] Letters of credit have been used for centuries to facilitate transactions between businesses that would otherwise lack confidence in each other's performance.[156] In a typical transaction, a bank would issue a letter of credit on behalf of a buyer of goods, to assure the seller of those goods that payment will be forthcoming (from the bank itself, if necessary).[157] The bank is willing to provide that assurance (for a fee) because it is familiar with the buyer, while the seller is not.[158] However, bank letters of credit may be given in connection with a variety of credit transactions.[159]

The "going rate" for a bank letter of credit has been reported as between one and two, or possibly three, percent of the loan balance, payable annually.[160] The relatively narrow range of fees, however, points to a problem with using letters of credit as a point of comparison. Letters of credit are generally issued in cases where the bank does not perceive substantial risk, and is providing the requested reassurance

[152] *Cf.* Rev. Rul. 59–60, 1959–1 C.B. 237 (setting forth factors an appraiser should consider in valuing a business for which market quotations are not available and observing that "[u]ncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future" and "[t]he appraiser must exercise his judgment as to the degree of risk attaching to the business").

[153] *See id.*

[154] *See* Dickman v. Comm'r, 465 U.S. 330, 344 n.14 (1984).

[155] *See* Hatcher & Manigault, *supra* note 34, at 153 ("Probably the closest commercial analogy is a bank's charge for a letter of credit.").

[156] Carl A. Mead, *Documentary Letters of Credit*, 22 Colum. L. Rev. 297, 298 (1922).

[157] *Id.*

[158] *Id.*

[159] *Id.* at 298–99.

[160] Akers & Hayes, *supra* note 4, at 141.

just to accommodate a third party who lacks the bank's detailed knowledge of the debtor's financial condition.[161] By contrast, in the estate planning transactions described above in Part II of this Article, a guarantee is made not merely to address an information asymmetry, but to mitigate an objectively serious risk of default. Thus, the fees typically charged for a bank letter of credit may understate the value of guarantees in the estate planning context.

3. Option Model

A guarantee may also be compared to an option:

> A guarantee's value is the present value of future contingent events that can result in either a large loss, if the guarantee requires full payment by the guarantor, or no loss. These contingent states lend themselves to either binomial or Black-Scholes option modeling, two widely accepted methods for valuing options.[162]

Or in plain English: the guarantor is giving the borrower the right to sell its illiquid assets to the guarantor for a set price (specifically, the amount by which the borrower's debt exceeds its liquidity). That type of option is commonly known as a "put,"[163] and, like the CDSs discussed above, can be valued by plugging risk estimates into a mathematical model.[164] If the debtor's assets appreciate, the debtor keeps all the gain, while if the debtor's assets decline in value, the guarantor bears all the loss (at least in those cases where the debtor is too thinly capitalized to have a meaningful amount of its own capital at risk).

On closer inspection, however, the analogy between an option and a guarantee is imperfect. Once the debtor is in default and the

[161] *See* Martin Shenkman*, Role of Guarantees and Seed Gifts in Family Installment Sales*, 37 Est. Plan. 3, 5 (2010) (noting that some practitioners "reject the letter of credit paradigm based on the circumstances that often accompany their issue," including "an ongoing commercial banking relationship").

[162] William S. Forsberg & Randall Schostag, *Valuing Loan Guarantees in a Sale to an Intentionally Defective Grantor Trust*, 7 Valuation Strategies 20, at *5 (2003).

[163] Black's Law Dictionary 1237 (6th ed. 1991).

[164] Forsberg & Schostag, *supra* note 162, at *5.

guarantee comes into play, the debtor does not just have the *right* to sell its remaining assets to the guarantor for the amount of the outstanding debt, it has an *obligation* to do so.[165] The debtor cannot choose to sit on its rights (e.g., to see if the value of its assets will recover), because the required transfers are not in fact "optional." Ignoring that aspect of the arrangement may overstate the value of the benefits the debtor derives from the guarantee. Further, the term of the arrangement—a key factor in option valuation[166]—is uncertain. The guarantee may remain in place for as long as the underlying debt is outstanding, or may terminate earlier in the event of a default or if the debtor acquires enough equity to refinance the debt and extinguish the guarantee. With these issues in mind, it seems appropriate to use the "option value" of a guarantee as one factor, but not the only factor, in determining the guarantee's actual value.

4. Cost of Equity Capital Model

Finally, the value of the guarantee might be determined by reference to the return that an investor making an *equity* investment in the debtor would require to make the investment.[167] Under this approach, described by two commenters as the "most definitive method" of calculating a guarantee fee,[168] the appraiser would determine the amount the guarantor actually has at risk (recognizing that the debtor's assets are unlikely to fall to zero), multiply that amount by the probability that the risk will occur, and then multiply the result again by difference between the rate of return an equity investor would expect here and the rate of return an investor could obtain from a risk-free alternative.[169] For example, suppose the loan amount is $1 million but the debtor's assets assuredly would not fall below $250,000 even in extreme conditions, so the

[165] *See* Brian D. Hulse, *After the Guarantor Pays: The Uncertain Equitable Doctrines of Reimbursement, Contribution, and Subrogation*, 51 Real Prop. Tr. & Est. L.J. 41, 50 (2016) (explaining that the debtor is obligated to reimburse the guarantor on "the due date of the underlying obligation" or when the guarantor makes payment, whichever comes later).

[166] Lynn Curtis, *Valuation of Stock Options in Dividing Marital Property upon Dissolution*, 15 J. Am. Acad. Matrim. L. 411, 440–41 (1998).

[167] *See* Forsberg & Schostag, *supra* note 162, at *4.

[168] *Id.*

[169] *Id.*

amount actually at risk is only $750,000.[170] Assume further that there is a five percent chance the debtor will default over the term of the loan.[171] Finally, assume that an equity investor would expect a 25% return from such a risky venture over the term of the loan, but could earn a ten percent return from a risk-free alternative investment like a U.S. Treasury bond.[172] In that case, the guarantor's "average" (or probability weighted) liability under the guarantee would be five percent of $750,000, or $37,500, and the profit the guarantor would demand for incurring that liability would be 15% of $37,600, or $5,625.[173] Thus, the price the guarantor should demand under this model would be $37,600 plus $5,625, or $43,225. That is about 4.3% of the guaranteed loan balance, which (depending on the term of the loan) may not be dramatically different from the one to three percent annual fee described for bank letters of credit in Part IV.A.2. Of course, the result will depend greatly on the probability of default and the expected rate of return that are input into the model, so this method of computing value still requires an appraiser to make highly subjective judgments.

B. Conceptual Objection to Use of Valuation Models

The models described above provide feasible (though difficult) methods for valuing loan guarantees, with the credit default swap approach appearing most realistic since it is derived from actual pricing of similar financial instruments in real-world arm's-length transactions. One may reasonably question, however, whether guarantees *should* be valued "realistically," given the more taxpayer-friendly approach the Supreme Court suggested for determining the use value of money in *Dickman*, and the even more taxpayer-friendly approach Congress adopted in response to that case.

[170] *Id.* More precisely, the amount at risk is *up to* $750,000, as there would be default scenarios in which the losses are lower. For ease of discussion and calculation, however, assume here that the loss will be either $750,000 or zero.

[171] *Id.*

[172] *Id.*

[173] *See* Forsberg & Schostag, *supra* note 162, at *4. The authors actually refer to the $5,625 figure as the *value* of the guarantee, but that appears to be an error as the guarantor should expect to receive an amount equal to the average liability it incurs plus a profit.

In *Dickman*, the Supreme Court suggested that the value of an interest-free loan could be determined by reference to the rate the donor could have earned on the lent funds: "to support a gift tax on the transfer of the use of $100,000 for one year . . . it is sufficient for the Commissioner to establish that a certain yield could readily be secured. . . ."[174] That measure of value—focusing as it does on the *donor's* alternative investment options—does not reflect the rate at which the *debtor* could borrow from a third party. If the debtor could otherwise obtain credit only at a very high interest rate, determining the use value of money in this manner would seem to understate the benefit provided.

Nevertheless, Congress doubled down on that approach when it enacted section.[175] Section 7872 provides that the use value of money is determined by reference to the "applicable federal rate," which is based on the average yield of U.S. Treasury securities.[176] The interest rate at which the debtor could have borrowed is irrelevant, and even the interest rate at which the donor typically invests is irrelevant. Instead, the statute assumes that the donor would have purchased only U.S. Treasury securities (which are among the lowest-yielding investments) and uses the interest rate on such securities as the measure of the donor's gift.[177]

Section 7872 by its terms applies only to the valuation of actual loans between related parties,[178] not to the valuation of loan guarantees. Nevertheless, if one assumes as a policy matter that the gift tax treatment of loans and loan guarantees should be similar, section 7872 poses a problem for the use of any of the guarantee valuation models described above. Conceptually, a guarantee offers two sources of value to a borrower: First, it may allow a loan to be made that otherwise could not be justified at *any* interest rate. Second, in cases where a loan could still have been made at some high rate without a guarantee, the guarantee may allow that loan to be made at a lower rate. It is appropriate to take the first source of value into account under the gift tax, but taxing the second source of value is problematic. If a donor can make a

[174] Dickman v. Comm'r, 465 U.S. 330, 344 n.14 (1984). The Court's discussion of this question is dicta, however, as the Court also noted that "[t]he valuation issue is . . . not presented on the record before us." *Id.*

[175] § 7872.

[176] §§ 7872(f)(1), (2), 1274(d)(1)(C).

[177] § 7872(a)(1), (e), (f)(1).

[178] § 7872(a)(1).

loan directly at the artificially low rate allowed by section 7872, without making a taxable gift, then arguably a donor should be able to induce a third party to make a loan at that same low rate, without making a taxable gift.

Unfortunately, this objection makes hash of any market-based valuation model, as those models do not separate out the component of a "market" guarantee's value that is attributable merely to the reduction in the interest rate at which a loan can be made. One must either ignore the problem (which the Service might do, because section 7872 does not by its terms apply to loan guarantees and the objection is just conceptual), build a new valuation model from the ground up . . . or find a way to avoid having to value the guarantee.

V. A New(ish) Path Forward

As it happens, there is a way to appropriately account for guarantees in the gift tax system, without having to value the guarantee itself. The path forward draws on an approach the Fifth[179] and First[180] Circuits have applied to an analogous problem in corporate tax. These Circuits have declared that the guarantor of an impecunious *corporate* debtor's obligations should be treated as having incurred those obligations directly and then retransferred the amount at issue to the debtor.[181] In the particular cases at issue, the debtor lacked substantial resources of its own, so the courts had no difficulty determining that the guarantor's deemed transfer to the debtor should be characterized as a capital contribution rather than a loan.[182] Although not directly on point, a Supreme Court case also seems to support the same general approach.[183]

This approach can be readily adapted for gift tax purposes. In an estate planning context, the debtor would typically be a trust rather than a corporation, but that does not seem to be an important detail. A guarantor of an impecunious trust's debt may still be treated as having incurred that debt directly and then retransferred the amount at issue to

[179] Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972).

[180] Casco Bank & Trust v. U.S., 544 F.2d 528 (1st Cir. 1976).

[181] *Casco*, 544 F.2d at 533–34; *Plantation Patterns*, 462 F.2d at 722–23.

[182] *Casco*, 544 F.2d at 533–34; *Plantation Patterns*, 462 F.2d at 722–23.

[183] Putnam v. Comm'r, 352 U.S. 82 (1956).

the trust. In cases where that deemed transfer cannot be justified as a loan, the guarantor would be deemed simply to have made a gift to the trust. The guarantor has retained an interest in that gift—the guarantor's right to be repaid by the trust (to the extent possible) if the guarantor is required to make good on the guarantee—but that retained interest is *deemed* to be worthless for federal gift tax purposes.[184] This neatly avoids the valuation difficulties discussed in Part IV, above. It also avoids imposing gift tax on guarantees that merely reduce the interest rate at which a borrower may obtain credit, maintaining conceptual consistency with section 7872.

A. Plantation Patterns

The Fifth Circuit illuminated this path with its decision in *Plantation Patterns, Inc. v. Commissioner*.[185] The facts of *Plantation Patterns* are complex, involving layers of subordinated debts, some of which the court respected as debt and some of which the court did not.[186] At its core, though, the case concerned the efforts of an individual taxpayer, John Jemison, to help a new company incorporated in his wife's name acquire assets far in excess of what its meager resources would otherwise permit.[187] Mrs. Jemison contributed a total of $5,000 to the company; the company, in turn, incurred a vastly larger amount of debt to finance various acquisitions.[188] The company's debt-to-equity ratio may be determined in different ways, depending on how one accounts for a tranche of debt that was paid off fairly quickly, but was conservatively calculated by the Service as in excess of 125 to 1.[189] Mr. Jemison guaranteed most of the company's debt.[190] When the company later attempted to deduct its interest payments on the debt, the Service demurred.[191] The Service argued, and the Tax Court agreed, that most

[184] § 2702(a)(2)(A).

[185] *Plantation Patterns*, 462 F.2d 712.

[186] *See id.* at 723 ("Our holding does not require that we find [another debt of the same company] to be equity interests. . . . We agree with the Tax Court that [the other debt] was a legitimate loan.").

[187] *Id.* at 714–16.

[188] *Id.*

[189] *Id.* at 721.

[190] *Id.* at 715–16.

[191] *Id.* at 717.

of the debt was really Mr. Jemison's, not the company's.[192] Therefore, not only could the company not deduct its interest payments, those payments constituted taxable dividends to the Jemisons as owners.[193]

On appeal, the Fifth Circuit first referenced a prior case's listing of factors to consider in evaluating whether a purported loan to a corporation should be respected as such:

> (1) the names given to the certificates evidencing the indebtedness;
> (2) the presence or absence of a maturity date;
> (3) the source of the payments;
> (4) the right to enforce the payment of principal and interest;
> (5) participation in management;
> (6) a status equal to or inferior to that of regular corporate creditors;
> (7) the intent of the parties;
> (8) "thin" or adequate capitalization;
> (9) identity of interest between creditor and stockholder;
> (10) payment of interest only out of "dividend" money; and
> (11) the ability of the corporation to obtain loans from outside lending institutions.[194]

The Fifth Circuit also mentioned an additional "critical" factor: whether the borrowed funds were used to acquire capital assets (which was the case here).[195]

[192] *Id.* at 717–18.

[193] *Id.* at 718. Neither the Service nor the Tax Court appears to have thought it significant that *Mrs.* Jemison was the only owner of record, though the Fifth Circuit took note of that fact. *See id.* at 714 (implying that the stock may have been the Jemisons' community property, as "[t]he record does not indicate whether or not the funds for the purchase of the stock came from the separate estate of Mrs. Jemison"), 715 (observing nevertheless that "Mrs. Jemison was the sole shareholder of record"), 722 (characterizing Mr. Jemison as "the 'constructive' owner" of the stock).

[194] *Id.* at 718–19 (citing Montclair, Inc. v. Comm'r, 318 F.2d 38, 40 (5th Cir. 1963)).

[195] *Id.* at 722.

The taxpayers invoked several of these factors in their favor, noting among other things that the company paid the notes when due (touching on the third, fourth and seventh factors) and that the lender had the same rights as at least a general creditor (touching on the sixth factor).[196] However, the Fifth Circuit zeroed in on the eighth and eleventh factors: "[c]entral to this appeal is the taxpayers' contention that the Tax Court erroneously concluded that New Plantation was thinly capitalized. . . . While the sellers were ostensibly to look to the corporation for payment of the debt, it is apparent from the meager capital position of the company that Mr. Jemison's guarantee was regarded as the real undergirding for the deal.[197] The court also pointedly noted Mr. Jemison's role as the prime mover behind the company, relevant under the fifth factor.[198] These facts led the court to conclude that the transaction should be recast:

> The guarantee enabled Mr. Jemison to put a minimum amount of cash into [the corporation] immediately, and to avoid any further cash investment in the corporation unless and until it should fall on hard times. At the same time he exercised total control over its management . . . [W]e think that the result is that Mr. Jemison's guarantee simply amounted to a covert way of putting his money "at the risk of the business." Stated differently, the guarantee enabled Mr. Jemison to create borrowing power for the corporation which normally would have existed only through the presence of more adequate capitalization of [the corporation].[199]

Finally, the court was unimpressed by "the fact that ultimately things progressed smoothly . . . and [the corporation's] debts were paid without additional financing," as "[t]he transaction must be judged on the conditions that existed when the deal was consummated," when the corporation could not plausibly have obtained financing on its own.[200] Thus, the transaction was treated for income tax purposes as if

[196] *Id.* at 719–20.

[197] *Id.* at 719, 722.

[198] *Id.* at 722.

[199] *Id.* at 722–23.

[200] *Id.* at 723.

Mr. Jemison had borrowed the funds and transferred them to the company.[201] That transfer could not be justified as a loan, only as a capital contribution.[202] Mr. Jemison retained an indirect interest in the deemed contribution, but only as an *owner* of the company (directly or through his wife), not as a *creditor*.[203]

The analogy to loans made and guaranteed in the estate planning context is clear. A trust with only "a minimum amount of cash," and no other assets, would be unable to obtain loans from an outside lending institution. If a family member facilitates a loan to the trust by offering her personal guarantee, the family member is "putting [her] money 'at the risk of the [trust's] business'" and "creat[ing] borrowing power for the [trust] which normally would have existed only through the presence of more adequate capitalization."[204] Further, in many cases the guarantor will exercise significant influence, if not "total control," over the trust's management, though savvy planners might avoid this factor.[205] As in *Plantation Patterns*, it is appropriate in these circumstances to treat the guarantor, not the trust, as the actual borrower, and to treat the guarantor as having transferred the borrowed funds to the trust.

B. Casco Bank & Trust Co.

The First Circuit followed the Fifth Circuit's lead in *Casco Bank & Trust Co. v. United States*.[206] In this case, the taxpayer, William Preston, owned substantially all the stock in a construction company, M & P.[207] The company had only a modest amount of capital, so it was unable to obtain bonds for construction projects without Preston's personal guarantee.[208] The company's fortunes waned, complications arose on pending projects, unpaid contractors filed liens, and the issuer of the bonds, Maine Bonding & Casualty Company, began fielding complaints from aggrieved parties and directed Preston to make good on his guarantee.[209] Preston

[201] *Id.* at 721–22.

[202] *Id.* at 721–22.

[203] *Id.* at 722.

[204] *See id.* at 722–23.

[205] *See id.* at 722.

[206] Casco Bank & Trust v. United States, 544 F.2d 528 (1st Cir. 1976).

[207] *Id.* at 529.

[208] *Id.* at 529–30.

[209] *Id.* at 530.

did so by making advances to his company to enable it to meet its obligations, but the company ultimately collapsed and he wrote off these advances as a bad business debt.[210] The Service disallowed his claimed income tax deduction and the district court upheld that determination, finding that Preston had made capital contributions, not true loans, to his company.[211]

On appeal, the First Circuit focused more closely on the effect of Preston's guarantee, because his advances were made pursuant to that guarantee.[212] The court observed that in making the guarantee he "did not loan money" but rather "his personal credit," and found that this arrangement was "similar to the personal guarantee made by [the taxpayer] in [*Plantation Patterns*]."[213] As in *Plantation Patterns*, the arrangement was best viewed as Preston obtaining capital using his credit and transferring that capital to his company.[214] Under the circumstances, neither the guarantee nor any payments made thereunder could "be viewed as establishing a meaningful debtor-creditor relationship" between Preston and his company.[215] While Preston may have "hoped, if business improved, to recover" the payments he made under this arrangement, that hope indicated only that he retained an equity interest in the company.[216]

Here, too, the analogy to loans made and guaranteed in the estate planning context seems reasonably close. Preston's corporation was unable to obtain credit without his personal backing, much as a nominally funded family trust is unable to obtain (or at least justify) credit without a family member's personal backing. Preston's guarantee, and the money he later advanced pursuant to that guarantee, were recast as contributions in which he retained an equity interest; in the context of a family trust, the family member's guarantee would be

[210] *Id.*

[211] *Id.* at 532.

[212] *See id.* at 533 ("[W]hether or not the advances to M & P were technically in discharge of his obligations under the indemnity agreement, Preston had to pay; his only choice was as to the form and timing of the payments. It seems unrealistic, therefore, to view the advances in isolation from the indemnity agreement which compelled them.").

[213] *Id.* at 533.

[214] *Id.*

[215] *Id.*

[216] *Id.* at 535.

recast as a gift in which the guarantor retained a beneficial interest (valued at zero under section 2702).

C. Putnam v. Commissioner

Finally, the Supreme Court's decision in *Putnam v. Commissioner* seems generally consistent with the reasoning of *Plantation Patterns* and *Casco Bank*.[217] In this case the taxpayer, Max Putnam, established a publishing company that ultimately failed.[218] The company financed its operations in part through bank loans that Putnam personally guaranteed.[219] The company liquidated but was unable to pay its debts in full, so Putnam paid the deficiency and claimed an income tax deduction for the loss.[220] Importantly, the Service did not dispute that this loss related to a debt rather than an equity interest: the only issue for the Court to decide was whether it was a *business* debt ("incurred in [a] transaction . . . for profit") or a *nonbusiness* debt, as that distinction affected the manner in which Putnam could deduct the loss.[221] In the course of resolving that issue, the Court made a striking observation:

> There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same. . . .[222]

Thus, while the Court was not asked to, and did not, recharacterize the guarantee as a capital contribution, it did indicate that the guarantee should be viewed in the same manner as if the guarantor had provided the funds to the borrower directly.[223] That seems consistent with the

[217] Putnam v. Comm'r, 352 U.S. 82 (1956).

[218] *Id.* at 84–85.

[219] *Id.* at 85.

[220] *Id.* at 83–85.

[221] *Id.* at 83–84; *see also* Casco Bank & Trust v. United States, 544 F.2d 528, 534 (1st Cir. 1976) ("The Court was not called upon in *Putnam* to distinguish, as we are here, between a business . . . debt and an advance in the nature of a capital contribution.").

[222] *Putnam*, 353 U.S. at 92–93.

[223] Interestingly, two other commenters recognize this aspect of *Putnam* but do not follow it through to the same conclusion. *See* Hatcher &

treatment of guarantees for income tax purposes in *Plantation Patterns* and *Casco Bank*, and with this article's suggested treatment of guarantees for gift tax purposes.

D. Benefits of the Proposed Approach

As noted in the introduction to this Part, the primary benefit of this Article's suggested approach to loan guarantees is that it avoids the need to value the guarantee for gift tax purposes. But it also has other notable advantages.

First, it avoids tagging the guarantor with a taxable gift in cases where the debtor could have borrowed funds on its own without a guarantee, just at a higher interest rate. In such cases, the arrangement would be recast as two *valid* loans (one from the lender to the guarantor and one from the guarantor to the debtor on the same terms). Assuming the interest rate exceeds the very modest "applicable federal rate" under section 7872, as would nearly always be the case, no gift would result.[224] This may help shelter everyday non-abusive loan guarantees among family members. For example, parents may guarantee their adult son's car loan, to allow the son to finance the car on reasonable terms. So long as the son could have obtained financing without the guarantee, perhaps at an onerous, loan-shark rate from the seediest car lot around, the guarantee could be made without gift-tax implications.

Second, this approach can make use of (and if necessary expand upon) existing safe harbors under section 7872 for non-abusive intra-family loans. For example, section 7872(c)(2) waives any imputed gift so long as the aggregate outstanding loan amount does not exceed

Manigault, *supra* note 34, at 156 (citing *Putnam* to suggest that "[t]here should be no difference . . . between the gift tax consequences of back-to-back loans and the gift tax consequences of a guaranteed loan," but not acknowledging that a "back-to-back" loan would itself be vulnerable to challenge when the intermediate lender is extending credit to a very shaky borrower). *Cf.* Smith v. Comm'r, 23 T.C.M. (CCH) 1689 (1964), *aff'd*, 370 F.2d 178 (6th Cir. 1966) (holding that where an individual borrowed funds from a bank and re-lent these funds to his thinly capitalized corporation, the second loan should be recharacterized as a capital contribution).

[224] *See* § 7872(e)(2) (defining the amount of "forgone interest" that is taxable as a gift as the amount by which the applicable federal rate exceeds the interest actually charged).

$10,000.[225] Further, section 7872(i)(1)(C) gives regulatory authority to the Treasury to exempt "any class of transactions the interest arrangements of which have no significant effect on any Federal tax liability of the lender or the borrower."[226] This provision might be used to exempt guarantees of car loans and home loans (capped at a level high enough to accommodate the needs of all but the wealthiest families), and exempt guarantees by a trust of its beneficiaries' debts (of any magnitude). While guarantees arguably relate to more than just "interest arrangements," the Treasury has invoked its regulatory authority under this section liberally: for example, by exempting most home loans made by an employer to an employee, and by exempting student loans and other government-guaranteed loans, even though some of these loans are surely made to individuals who are not otherwise creditworthy.[227] It would not seem difficult to extend similar relief to routine guarantees of debt incurred by family members, nor would anyone appear to have standing to object to such relief.[228] Further, the Supreme Court has all but invited the government to take a practical approach to taxing the use value of property, noting that "[w]e assume that the focus of the Internal Revenue Service is not on such traditional familial matters" as providing "adult children with such things as the use of cars or vacation cottages."[229] Accordingly, it should be possible to implement this Article's suggested approach to guarantees while still formally or informally exempting innocuous everyday transactions.

Third, this approach can incorporate additional safe harbors to provide greater certainty in the administration of tax laws. For example, the Treasury could use its regulatory authority under section 7872(i)(1)(C) to exempt guarantees of loans where the borrower has a debt-to-equity ratio of at least nine-to-one.[230] Establishing safe harbors of this

[225] § 7872(c)(2).

[226] § 7872(i)(1)(C).

[227] Temp. Reg. § 1.7872–5T(b)(5), (c)(1)(i).

[228] *See* Freedom From Religion Foundation v. Lew, 773 F.3d 815, 819 (7th Cir. 2014) (holding that the plaintiff lacked standing to object to a tax benefit allowed to ministers, because it did not suffer a "concrete and particularized" injury from this benefit being provided to others, beyond just "every citizen's interest in proper application of the Constitution and laws").

[229] Dickman v. Comm'r, 465 U.S. 330, 341 (1984).

[230] *Cf.* Petter v. Comm'r, 98 T.C.M. (CCH) 534 (observing that the planner in that case "believed there was a rule of thumb that a trust capitalized with a gift at least 10 percent of its assets would be viewed by the IRS

type would accommodate conservative estate planning and avoid unnecessary litigation over the boundaries of what is permitted, while chilling more aggressive planning techniques.

VI. Conclusion

The Internal Revenue Service tolerated no-interest family loans for decades, before finally imposing gift tax on these arrangements with the approval of the Supreme Court.[231] The Service has now tolerated no-fee family guarantees for decades more, without seeking to impose gift tax on these arrangements since an ill-fated trial run in the early 1990s.[232] It is time for the government to act, relying on the Supreme Court's recognition that a gift may arise when a taxpayer makes property available for another's use,[233] and accepting the Fifth Circuit's invitation to recharacterize a guaranteed loan as a loan from the lender to the guarantor followed by a transfer from the guarantor to the borrower.[234] The recharacterization approach is simple and administratively feasible, and would bring the gift tax treatment of loan guarantees in the estate planning context into harmony with the income tax treatment of loan guarantees in the corporate tax context. Accordingly, the Service should revoke its acquiescence to *Bradford*,[235] the Treasury should issue regulations adopting the recharacterization approach suggested by *Plantation Patterns*[236] while establishing appropriate exemptions and safe harbors, and, following the issuance of such regulations, the Service should begin recharacterizing abusive loan guarantees as gifts.

as a legitimate, arm's-length purchaser in [a] later sale"); Akers & Hayes, *supra* note 4, at 137–38 (noting that this rule of thumb is common "lore" among practitioners).

[231] *Dickman*, 465 U.S. at 342–44.

[232] *See* P.L.R. 1991-13-009 (Mar. 29, 1991) (ruling that a guarantor is subject to gift tax on the value of the guarantee); P.L.R. 1994-09-018 (Mar. 4, 1994) (withdrawing P.L.R. 1991-13-009); F.S.A. (Jun. 17, 1994), 1994 WL 1865994 (declaring that "The Service's position on this issue is still being reconsidered.").

[233] *Dickman*, 465 U.S. at 344.

[234] Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712, 722–23 (5th Cir. 1972).

[235] Bradford v. Comm'r, 34 T.C. 1059 (1960), *acq.* 1961–2 C.B. 4.

[236] *Plantation Patterns*, 462 F.2d at 722–23.