I (DON'T) GUARANTEE IT: POTENTIAL PROBLEMS WITH THE USE OF PERSONAL GUARANTEES TO BACK LOANS TO FAMILY TRUSTS

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TABLE OF CONTENTS

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I. INTRODUCTION

Taxpayers and the Internal Revenue Service have sparred over related-party loans almost since the beginning of the federal income, estate, and gift taxes. For decades, planners assumed that interest-free loans could be made without gift tax consequences, until the Supreme Court held otherwise in *Dickman v. Commissioner*, 465 U.S. 330 (1984), and Congress codified that result in section 7872 of the Internal Revenue Code. Later, the fight shifted to other ground: Whether and when a loan may be recharacterized as a contribution or gift. Courts and the IRS have been skeptical of purported loans where the borrower is highly leveraged (or infinitely leveraged, in the case of a borrower with no other assets).

For example, the Seventh Circuit held that a purported loan to a closely held entity should be recast as a capital contribution, where the entity had a debt-to-equity ratio of over 43 to 1. *In re Larson*, 862 F.2d 112, 117 (7th Cir. 1988). Thus, the "lender" was actually an owner of an interest in the entity for federal tax purposes. Similarly, in Technical Advice Memorandum 9251004, the Service ruled that a purported sale of stock to an unfunded trust, in exchange for promissory notes from the trust, should be recast as a contribution to the trust subject to a retained income interest. Tech. Adv. Mem. 9251004 (Dec. 18, 1992). As a result, the lender-seller was actually a *beneficiary* of the trust for federal estate tax purposes, causing the trust to be included in her gross estate. The TAM did not address the gift tax consequences of these events, but those consequences would seem to flow clearly from the Service's position: The lender-seller's deemed contribution to the trust was a gift, and she could not offset that gift by the amount of the notes (since those notes were a retained interest and, as such, would be deemed to have zero value under section 2702 of the Internal Revenue Code).

In response to these concerns, taxpayers have generally taken two approaches. First, they may take care not to allow the borrower's debt-to-equity ratio to become "too high" – whatever that may be. Many planners follow a rule of thumb that the debt-to-equity ratio should not exceed nine-to-one (i.e., there should be at least 10% equity), but this is neither an official standard nor a safe harbor, just common practice. *Cf.* Steven R. Akers & Philip J. Hayes, *Estate Planning Issues with Intra-Family Loans and Notes*, 38 ACTEC L.J. 51, 137-38 (2012) ("One planner (who considers himself a conservative planner) has used less than 10% sometimes, and on occasions he is concerned whether 10% is enough."). But the wealthiest taxpayers often find that constraint to be too, well, constraining. It does not allow them to leverage their gifts nearly as much as they would like.

Second, some taxpayers will backstop a loan to a trust or family entity by encouraging a related party to personally guarantee the loan. For example, consider a thinly funded "intentionally defective grantor trust," or IDGT. An older parent makes a relatively modest gift to a trust for the primary benefit of her adult child, of perhaps $100,000. The parent then sells assets worth a vastly larger amount, perhaps $10 million, to the trust "on credit" (in exchange for a promissory note). The trust has a debt-to-equity ratio of a hundred to one, which makes the parent's estate planning attorney quite nervous. So to help give that loan substance, the adult child personally guarantees the debt. If this arrangement works and the loan is respected, the parent has shifted the future growth of very substantial assets to the trust without incurring gift tax, and frozen the amount subject to future estate tax at the amount of the debt. Meanwhile, the child enjoys the benefit of that growth through the trust, without incurring gift tax, without incurring estate tax at the parent's death, and (if the parent makes an appropriate allocation of GST exemption) without incurring generation-skipping transfer tax at the child's death.

But does it work?

I'm not convinced that it does. As discussed below, the Service has a strong argument under *Dickman*, other gift tax cases, and a seminal income tax case*, Plantation Patterns v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), that a personal guarantee may give rise to a taxable transfer (in the context of a donative transfer, a *taxable gift*). Further, the Service can likely distinguish the older cases that taxpayers often cite to the contrary.

II. PROVIDING AN ECONOMIC BENEFIT IS A GIFT, EVEN IF THE DONOR INCURS NO COST IN DOING SO

Let's start with *Dickman v. Commissioner*, 465 U.S. 330 (1984). I don't expect this case alone to persuade you, but it provides important conceptual background. You'll start to worry more once we get to *Plantation Patterns*.

In *Dickman*, the taxpayers lent large sums (for the era) to their son and a company owned in part by their son and his wife and children. 465 U.S. at 332. These were structured as interest-free demand loans. The taxpayers took the then-reasonable position that such loans did not give rise to any taxable gift. They based this position on the Service's past administrative practice, the view of the Tax Court, and the view of several other courts that the mere use of property was not subject to tax. (Indeed, the Tax Court had previously declared that "[t]he unanimity of those authorities is complete." *Crown v. Comm'r*, 67 T.C. 1060, 1064 (1977).)

The Supreme Court firmly rejected this view, explaining that "the gift tax was designed to encompass all transfers of property and property *rights* having significant value." *Dickman*, 465 U.S. at 334 (emphasis in original). The Court reiterated its own prior declaration 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." *Id.* at 335. And the Court reminded taxpayers that "the language of the gift tax statute 'is broad enough to include property, however conceptual or contingent.'" Thus, the Court had "little difficulty accepting the theory that the use of valuable property – in this case money – is itself a legally protectible property interest" whose transfer is subject to gift tax. *Id.*

The taxpayers attempted to avoid this result by pointing out that making a no-interest loan does not necessarily cost the lender anything. Indeed, a lender might otherwise keep his or her funds in a non-interest-bearing bank account. The Supreme Court rejected this argument as well, explaining that "[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. That the transferor himself could have consumed or wasted the use value of the money without incurring the gift tax does not change this result." *Id.* at 340. Further, the Court was unconcerned by potential difficulties in determining the "use value" of money, relegating such concerns to a footnote. *Id.* at 344 n.1.

The implications of *Dickman* for guarantees should be troubling to planners. A personal guarantee would seem to be a "property *right*" and a "legally protectible property interest." Indeed, in the commercial context, investors and debtors routinely pay for such rights in such instruments as credit default swaps and letters of credit. *See generally* Caleb Sainsbury, *Taxation of Credit Default Swaps: A Guaranteed Solution*, 30 REV. BANKING & FIN. LAW 443, 459 (2010); Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 153 (Mar. 2000). The fact that the guarantor was not otherwise using this right – not otherwise using his or her borrowing power – seems irrelevant under the Court's reasoning. And the *Dickman* court would presumably have been unimpressed by the argument that guarantees are difficult to value. The Service itself has connected these dots, *see* Priv. Ltr. Rul. 9113009 (applying *Dickman* to conclude that certain guarantees were "transfers (subject to gift tax) of the economic benefit conferred," though the Service currently has no official position on this issue, *see* Priv. Ltr. Rul. 9409018 (Mar. 4, 1994) (withdrawing Private Letter Ruling 9113009).

Of course, guarantees are one step further removed than loans themselves. If a loan is the "use" of money, a guarantee is the "use of the use" of money. Further, taxpayers sometimes argue that a guarantee is merely a promise to make a transfer in the future (if called on to do so). So let's consider the next set of authorities.

III. ENTERING INTO A BINDING OBLIGATION TO ACT IN THE FUTURE CAN BE A GIFT TODAY

Several cases hold that taking on a future obligation can be a gift today.

In *Autin v. Commissioner*, the taxpayer entered into a legally binding agreement with his son, obligating the taxpayer to transfer shares in a family company to the son when the son "called upon [the taxpayer] to do so." *Autin v. Comm'r*, 109 F.3d 231, 233 (5th Cir. 1997). The Fifth Circuit held that a gift occurred when this agreement was made, not when the taxpayer actually retitled the shares many years later. *Id.* at 235-36.

In *Harris v. Commissioner*, a man entered into a divorce settlement obligating him to make future payments to his ex-wife (during an era when transfers incident to divorce were not exempt from gift tax). *Harris v. Comm'r*, 178 F.2d 861, 864-65 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950). The Second Circuit determined that a gift occurred when the agreement was made, not when the taxpayer actually made the payments. *Id.* at 865.

In *Commissioner v. Copley's Estate*, a man entered into a premarital agreement obligating him to make certain payments to his fiancée after their wedding. *Comm'r v. Copley's Estate*, 194 F.2d 364, 364 (7th Cir. 1952). The Seventh Circuit determined that the taxpayer did not make a gift at the time of his

payments, *because he was legally bound then to make the payments*. It did not determine whether he made a gift at the time he entered into the agreement (since the gift tax was not in effect then), but that would seem to follow from the court's reasoning.

The obligation considered in each of these cases was fixed, not contingent. However, contracts and other legal instruments often embody contingent rights, and those rights are routinely valued for gift tax purposes. For example, consider a gift of a term life insurance policy, a gift of an option, or a gift of a contingent reversion in property. Gift tax regulations and rulings provide for the valuation and taxation of each of these items. *See* Treas. Reg. § 25.2512-6 (providing for the valuation of life insurance policies, including "the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date"); Rev. Proc. 98-34, 1998-1 C.B. 983 (providing for the valuation of options); Treas. Reg. § 25.2512-5 (providing for the valuation of reversions); *but cf.* Rev. Rul. 98-21, 1998-1 C.B. 975 (providing that a gift of an option is incomplete if the option's effectiveness depends on the donor's own voluntary future actions). And of course the Supreme Court reminded us in *Dickman* that the gift tax applies to "property, however conceptual or contingent." *Dickman*, 465 U.S. at 335. So the contingent nature of a loan guarantee would not (by itself) seem to preclude taxing it.

Fine, you say grudgingly. If you squint hard enough, you can see how the principles of *Dickman* might, in theory, be extended to loan guarantees, and how the principles of the other cases, regulations, and rulings we just considered might, possibly, support that. But as Walter Mondale would say, where's the beef? Has any court ever actually treated a loan guarantee as a transfer? And has anyone ever figured out how to overcome the difficulties in valuing a loan guarantee?

The answer to both questions is yes. Some courts *have* treated a loan guarantee as a transfer, and *have* devised a devious way of avoiding the valuation problem. If you haven't heard of these cases, that's because you spend your time in Subtitle B of the Internal Revenue Code, regarding estate and gift taxes, rather than Subtitle A, regarding income taxes. But while the context is different, the concepts are similar. And it all begins with a court of some modest importance to planners in Texas: the Fifth Circuit Court of Appeals.

IV. IN THE INCOME TAX CONTEXT, COURTS HAVE HELD THAT THE MAKING OF A GUARANTEE GIVES RISE TO A TRANSFER

In the income tax context, courts will sometimes recast a personal guarantee as a loan by the lender to the *guarantor*, followed by a contribution by the guarantor to the nominal borrower. We'll consider shortly why that approach would be so problematic for common estate planning transactions, but let's first unpack the concept.

A. *Plantation Patterns* Paves the Way to Taxpayer Trouble

In *Plantation Patterns v. Commissioner*, a woman established a corporation as sole shareholder and made a $5,000 capital contribution. *Plantation Patterns v. Comm'r*, 462 F.2d 712, 714-16 (5th Cir. 1972). The corporation then borrowed dramatically larger amounts from outside lenders to make acquisitions and conduct business. Of course, lenders would not normally finance such a thinly capitalized company without some other security or assurance, but the woman's husband addressed that issue by personally guaranteeing most of the corporation's debt. *Id.*at 722. This arrangement satisfied the lenders and satisfied the couple, but did not satisfy the IRS.

The problem came when the corporation sought to deduct its interest payments on the debt. The Service denied the deduction by asserting that the debt was really the husband's. In substance, the Service argued, the husband had borrowed the funds and contributed them to the corporation. When the corporation later made payments on the debt, those payments were best understood as nondeductible dividend payments from the corporation to the husband, followed by payments from the husband to the lender. *Id.* at 721.

The Fifth Circuit considered the guarantee's practical effect:

> [The husband's] guarantee simply amounted to a covert way of putting his money "at the risk of the business". Stated differently, the guarantee enabled [the husband] to create borrowing power for the corporation which normally would have existed only through the presence of more adequate capitalization of [the corporation].

Id. at 722-23. Conversely, the court disregarded the fact that the corporation was actually able to service the debt:

> We do not regard as significant the fact that ultimately things progressed smoothly for [the corporation] and that its debts were paid without additional financing. The question is not whether, looking back in time, the transaction was ultimately successful or not, but rather whether at its inception there was a reasonable expectation that the business would succeed on its own. The transaction must be judged on the conditions that existed when the deal was consummated, and not on conditions as they developed with the passage of time. . . . When [the corporation] was incorporated its prospects of business success were questionable indeed without the [husband's] guarantees.

Id. at 723. The court also noted the husband's outsize role in arranging all of the transactions and, indeed, in running the business. *Id.* at 722. Taking all of this into account, the court readily agreed with the Service that the transactions should be recast as suggested: The "real" borrower was the husband, and he effectively contributed the loan proceeds to the corporation in exchange for what amounted to an equity interest in the corporation. *Id.* at 722-24. By adopting this approach, the court avoided having to value the guarantee; the guarantor was deemed to have transferred *the entire loan proceeds*.

The parallels between the transactions at issue in *Plantation Patterns* and those in common estate planning transactions seem clear:

- In *Plantation Patterns*, one family member made a modest contribution to a corporation. In a typical leveraged sale to an Intentionally Defective Grantor Trust (IDGT) or Beneficiary Defective Inheritor's Trust (BDIT), one family member first makes a modest contribution to a trust.
- In *Plantation Patterns*, the corporation then borrowed much larger amounts than would normally have been feasible from such a small asset base. In a leveraged sale to an IDGT or BDIT, the same may be true.
- Finally, in both circumstances these otherwise "impossible" loans were and are facilitated by another family member's personal guarantee.

One potential difference is that in *Plantation Patterns*, the court indicated that the guarantor was pulling all the strings and driving everything that happened. But, of course, it is not unheard of for the guarantor of an IDGT or BDIT loan to have significant influence over the trust's activities.

If the *Plantation Patterns* methodology were applied to a leveraged sale to an IDGT or BDIT, the result would look something like this:

- The family member who lent funds to the trust would instead be deemed to have made a loan to the *guarantor*.
- The family member who guaranteed the loan would be deemed to have contributed the loan proceeds to the trust.
- As in *Plantation Patterns*, the guarantor's deemed contribution to the trust would result in deemed "equity" in the trust – though in the trust context we would label such "equity" a beneficial interest.
- The guarantor's deemed beneficial interest in the trust would be valued at zero under section 2702 of the Internal Revenue Code, so the guarantor's entire deemed contribution would be treated as a gift.
- The guarantor's deemed beneficial interest in the trust would also cause the trust to be included in the guarantor's gross estate upon the guarantor's death.

That's . . . not good. For the guarantor, anyway.

B. The First Circuit Follows the Fifth Circuit's Lead

While *Plantation Patterns* is particularly notable to us as residents of the Fifth Circuit, the First Circuit has adopted the same approach to the treatment of guarantees. In *Casco Bank & Trust Co.* v. United States, an individual owned a construction company that needed construction bonds to do business. *Casco Bank & Trust v. United States*, 544 F.2d 528 (1st Cir. 1976). The company was thinly capitalized, so its owner had to indemnify the insurer that provided the bonds. *Id.* at 529. The court observed that "the true character of the indemnity agreement is similar to the personal guarantee . . . described by Judge Simpson in *Plantation Patterns*." *Id.* at 533. However, unlike in *Plantation Patterns*, the guarantor here later had to make good on the guarantee – by actually providing funds for the company to satisfy its obligations – when the company ran into financial difficulties.

Regardless, the court had to decide how to characterize the guarantee, and ultimately the payments under the guarantee, for income tax purposes. The court analyzed this issue in the same way as the Fifth Circuit:

The taxpayer's "execution of the indemnity, followed by his advancements at a time when his company was in financial trouble, were contributions to capital rather than a loan." *Id.* at 535.

The significance of this case is muddled somewhat by the fact that the taxpayer actually made payments under the guarantee. But at a minimum, its explicit approval of *Plantation Patterns* is discouraging to taxpayers who wish to incorporate personal guarantees into their tax planning.

C. The Supreme Court has Hinted at a Similar Approach

Perhaps surprisingly, the U.S. Supreme Court has also considered the treatment of a guarantee for federal income tax purposes. *Putnam v. Comm'r*, 352 U.S. 82 (1956). In this case, an individual co-owned a company that borrowed to fund its operations. *Id.* at 83-84. To facilitate these loans, the individual personally guaranteed the company's obligations. *Id.* at 84-85. When the company collapsed and he was required to make good on these obligations, he claimed a bad debt deduction. *Id.* at 83-84.

The Service did not challenge his characterization of his obligations as debt, and did not attempt to recast them as equity. (The only dispute in the case was what *type* of debt the individual incurred: business or nonbusiness.) Accordingly, we do not know if the Supreme Court would have approached those issues in the same manner as the Fifth Circuit in *Plantation Patterns*. However, it did note that:

> 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 . . . .

Id. at 92-93. In other words, an individual who guarantees a loan to an entity should be treated the same as an individual who provides funds to the entity directly. This concept seems at least consistent with the Fifth Circuit's approach in *Plantation Patterns*.

V. THE IRS CAN DISTINGUISH THE AUTHORITY TO THE CONTRARY THAT TAXPAYERS SOMETIMES INVOKE

Taxpayers, of course, are not without arguments of their own. Those who incorporate personal guarantees in their estate planning transactions generally rely on two Tax Court cases, *Bradford v. Commissioner* and *Pleet v. Commissioner*, and a smattering of similar Depression-era cases. Let's consider each of those in turn.

A. Taxpayers' Shining Star, *Bradford v. Commissioner*, Flickers Under Close Inspection

Taxpayers who use personal guarantees in their planning often rely on *Bradford v. Commissioner*, 34 T.C. 1059 (1960), *acq.* 1961-2 C.B. 4. In this case, the Tax Court expressly refused to treat a personal guarantee as a taxable gift, declaring that a mere "promise to pay in the future if called upon to do so" is not property for gift tax purposes. *Id.* at 1064-65. Further, the Service acquiesced in the decision. That's about as good as it gets, isn't it?

Or maybe not. *Bradford* poses important problems, both factual and legal, for those who hope to rely on it.

1. *Bradford* is Factually Distinct from Typical Estate Planning Transactions

The facts in *Bradford* differ greatly from what we typically see in the estate planning context, and properly understood, might actually support the *Service's* position in that context.

In *Bradford*, a man ran a major investment firm with a seat on the New York Stock Exchange. 34 T.C. at 1060. He was deeply indebted to a bank, and feared that if the Exchange learned of his perilous personal financial status, the Exchange would strip his firm of its seat. So he and the bank concocted a plan to hide his debt: The bank agreed to accept a note from the man's wife in substitution for his own note. *Id.* at 1061. Nominally, then, the liability shifted from the husband to the wife, improving the husband's balance sheet.

The IRS alleged that the wife made a transfer to the husband by (purportedly) taking on his liability. *Id.* at 1062. At the time, transfers between spouses were generally subject to gift tax, so the IRS sought to tax the wife on the full amount of the supposed transfer. However, since the wife had few assets of her own, the Tax Court found this implausible: "[I]t seems incredible that a person having a net worth of only $15,780 could make a gift of $205,000." *Id.* at 1065.

With this in mind, the Tax Court recast the transaction. Although the wife purportedly became the only obligor on the note, it was apparent that in reality, the bank still looked to the husband for repayment. *Id.* at 1064. Thus, the court decided that notwithstanding its form, the wife's obligation was best understood as a guarantee. (The court did not use that word specifically, but the court's discussion makes clear that this is the concept it had in mind.) There was no real shift in liabilities, the husband remained the true obligor both

before and after they replaced the husband's note with the wife's. *Id.* And since the wife was just a guarantor, no gift tax could be imposed on her "unless and until" she was required to make good on the guarantee. *Id.*

While that rationale certainly is encouraging to estate planners, the court's recharacterization of each spouse's obligations seems more troubling. The court readily recast the transactions, applying a substance-over-form analysis that considered who the lender would *really* look to for satisfaction of its debt. Under the facts of *Bradford*, this resulted in a taxpayer victory, since the husband was at all times, substantively, the debtor. Under facts more typical of common estate planning transactions, it's not clear that even the *Bradford* court would reach the same result. A thinly capitalized trust that issues an outsize note is arguably in the position of the wife in *Bradford*, and the guarantor of that trust's debt is arguably in the position of the husband: the party on whom the lender would actually rely. Further, the impecunious wife in *Bradford* could not confer any meaningful economic benefit on her husband or his lender; she merely facilitated their dubious financial reporting. By contrast, the well-heeled guarantor in a typical estate planning transaction provides important economic backing.

These disparities in the facts also limit the value of the Service's formal acquiescence. *See Dixon v. U.S.*, 381 U.S. 68, 73 n.6 (1965) (quoting 1964-1 C.B. 3) ("Caution should be exercised in extending the application of [an acquiescence] to a similar case unless the facts and circumstances are substantially the same.").

Nevertheless, whatever the factual background, the Tax Court's stated rationale is helpful to estate planners. Let's turn, then, to the legal problem with *Bradford*.

2. *Bradford* Relies on a Legal Doctrine That Now Appears Obsolete

Bradford was one of several lower-court decisions during the mid-twentieth century that took a narrow view of what constitutes "property" for gift tax purposes. Those decisions culminated in *Crown v. Commissioner*, 67 T.C. 1060 (1977), which held that interest-free loans were not subject to gift tax. 67 T.C. at 1064-65. The *Crown* court acknowledged that the gift tax statute applies to any transfer of "property or property rights," *id.* at 1063, but found the theoretical profit that "could have been made" on the loans to be too indefinite. *Id.* at 1064. For the tax to apply – for there to be "property" subject to gift tax – the *Crown* court believed that "[t]he right to interest must arise from an express or implied contractual obligation or from statute." *Id.* at 1064 (quoting an earlier case with approval). Notably, and as discussed in Part II of this outline, in *Dickman v. Commissioner* the Supreme Court firmly rejected this view and, more generally, rejected the Tax Court's narrow construction of "property." (Recall how the *Dickman* court pointedly declared that the gift tax applied to all property rights, no matter how "conceptual or contingent," and explicitly disapproved of *Crown*. *Dickman*, 465 U.S. at 335.)

In short, the continued vitality of *Bradford* is doubtful in light of the Supreme Court's rejection of *Crown*. Both *Bradford* and *Crown* are rooted in the same, apparently obsolete, idea that "property" must be something more concrete than such ephemera as the mere *use* or *availability* of property. It also seems notable that in the 64 years since it was issued, *Bradford* has never been cited by any other case for the proposition that a guarantee is not a gift.

B. Another Case, *Pleet v. Commissioner*, has Likely Been Superseded by Statute

While IDGT and BDIT transactions are structured in various ways and with various guarantors, planners often arrange for the *primary beneficiary* of the trust to provide the guarantee. In doing so, they rely on *Pleet v. Commissioner*, 17 T.C. 77, 79-80 (1951), and other cases of the same era that follow the same reasoning.

In *Pleet*, an individual created an irrevocable life insurance trust for multiple beneficiaries, but most notably his wife and sons. 17 T.C. at 79-80. These three beneficiaries then paid the premiums on the policies. The IRS claimed that these premium payments were gifts, but at least one of the payor beneficiaries demurred, asserting that the 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." *Id.* at 81. The Tax Court not only agreed, but also stated 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." *Id.*

Initially, *Pleet* seems quite favorable for a beneficiary of an IDGT or BDIT who guarantees the trust's debt. Even if the guarantee would otherwise be a gift, one might reason, it is not a gift under *Pleet* if the beneficiary is making the guarantee primarily to protect the beneficiary's own interest. And, of course, that is precisely why the beneficiary *would* make such a guarantee.

The problem is that *Pleet* and similar cases appear to have been superseded by the adoption of section 2702 of the Internal Revenue Code. Section 2702 now provides that "for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift . . . the value of any interest in such trust retained by the transferor" is generally deemed to be zero. I.R.C. § 2702(a)(1), (2). Apply this provision to a beneficiary-guarantor: For purposes of determining whether the beneficiary's guarantee is a gift, the value of the beneficiary's interest in the trust is deemed to be zero. *So the beneficiary has no interest of any value that can be recognized.*

With that in mind, *Pleet*, too, is of doubtful current vitality. So far guarantors are batting 0-for-2. Do any other cases provide them with relief? You can surely guess my answer, but let's keep going.

C. A String of Depression-Era Income Tax Cases Doesn't Offer Much Help Either

Finally, planners sometimes point to a string of Depression-era income tax cases in support of the idea that a guarantee is not a gift. On close inspection, however, these cases don't provide meaningful support for that view.

1. *Shiman v. Commissioner* Sets the (Dubious) Pattern

In this case, an individual traded stocks on margin in the 1920s. *Shiman v. Comm'r*, 60 F.2d 65, 66 (2d Cir. 1932). He lacked sufficient credit on his own to make these purchases, so his brother-in-law provided the brokerage with a personal guarantee to satisfy any shortfall. *Id.* You know what happened next – the stock market collapsed – and the trader's hapless brother-in-law had to satisfy the ensuing shortfall. The brother-in-law claimed an income tax deduction for the payment, but the Service denied the deduction, in part because the Service viewed the payment as a *gift*. The Second Circuit held that the payment was not a gift because it was involuntary: "[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." The court did not, however, speak to whether the *issuance* of the guarantee was a gift, as that was not at issue in the case. So while this case is sometimes cited by commentators for the proposition that a guarantee is not a gift, it does not seem to provide any significant support for that view.

2. *Ortiz v. Commissioner* Follows *Shiman*

Ortiz v. Commissioner presents similar facts as *Shiman*. *Ortiz v. Comm'r*, 42 B.T.A. 173 (1940). A woman guaranteed her husband's brokerage accounts, later had to make good on the guarantees, and claimed a bad debt income tax deduction. *Id.* at 180-81. As in *Shiman*, the IRS challenged the deduction by asserting instead that she had made a gift by satisfying her husband's obligations. The court rejected the IRS' position by noting "the legal consequences that flow from the contract of guaranty," citing *Shiman* in support of its holding that complying with that contract was not a gift. *Id.* at 187. The court also noted that the value of the husband's securities exceeded his debt by 5.5% at the time the taxpayer first guaranteed that debt. *Id.* at 180. That may have helped justify the guarantee in the court's eyes. By contrast, when a person guarantees a trust's debt in a sale-to-IDGT or sale-to-BDIT transaction, it is typically because the value of the trust's assets will exceed its debt by a thinner margin.

3. *Pierce v. Commissioner* Relies on an Obsolete Rationale

Continuing the Depression-era speed run, this case considers a father and son who were both shareholders of a corporation. *Pierce v. Comm'r*, 41 B.T.A. 1261, 1262 (1940). The son pledged his stock as collateral for a loan; the father guaranteed the son's debt and ultimately was required to make good on the guarantee. *Id.* at 1262-63. The father claimed an income-tax deduction for his payments, which the IRS denied on the grounds that these payments were gifts. *Id.* at 1263-64. The court rejected the IRS position, in large part because the "primary objective . . . of the guarantees was to protect the market value of securities held by the" father, which would have been damaged by a fire sale of the son's stock. *Id.* at 1265. Since the father was protecting his own interest, his payments were not a gift. This is the same rationale as *Pleet*, discussed above, and fails for the same reason in most circumstances today. As in *Ortiz*, the court also noted that the son was "solvent by a safe margin at the time of the original guarantee," which again is not typically the case when a guarantee is used to bolster a sale-to-IDGT or sale-to-BDIT transaction.

4. *Fox v. Commissioner* is Marginally More Helpful to Guarantors, but not Much

In yet another Depression-era brokerage case, a wealthy woman first lent securities to her husband, and then guaranteed her husband's brokerage debts, to facilitate his stock trading. *Fox v. Comm'r*, 14 T.C. 1160 (1950), *rev'd on other grounds*, 190 F.2d 101 (2d

Cir. 1951). After her husband's death, she had to make good on these guarantees, and claimed an income tax deduction for her payments on her husband's debt. 14 T.C. at 1062. The IRS challenged the deduction, arguing that the payments were gratuitous. The Tax Court sided with the taxpayer, but this time suggested that the guarantee itself was not a gift because it was best understood as "*a loan of her credit*." *Id.* at 1064 (emphasis in original). Under the prevailing view at the time, even loans of *cash* that were made without interest or other compensation were not treated as gifts, even in part, so of course a loan of credit was not a gift either under this theory. The problem, of course, is that this loan-theory rationale is no longer viable under *Dickman*.

VI. COURTS MAY NOT BE DETERRED BY THE "PARADE OF HORRIBLES"

So there's a pretty good basis for the IRS to recast personal guarantees and impose gift tax, and the contrary authority can be distinguished. Planners might fall back on one last hope: That the consequences of going after guarantees would be too problematic for everyday transactions. Parents co-sign for their adult children all the time, to help them buy a car, say, or rent an apartment. Surely a court would recoil from taxing such everyday transactions.

The taxpayers in *Dickman* had the same hope in challenging taxation of the "use value" of property. They warned that "[c]arried to its logical extreme . . . the Commissioner's rationale would elevate to the status of taxable gifts such commonplace transactions as a loan of the proverbial cup of sugar to a neighbor or a loan of lunch money to a colleague," would tax parents who "provide their adult children with such things as the use of cars or vacation cottages," and would represent "an untenable intrusion by the Government into cherished zones of privacy, particularly where intrafamily transactions are involved." *Dickman*, 465 U.S. at 340-41.

The Supreme Court waved away this problem as a "parade of horribles," all-but-inviting the IRS to address the issue through the exercise of administrative discretion: "We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the Government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case." *Id.* at 341. Presumably, that would also be the *Dickman* court's answer to fears that the IRS would seek to attack more pedestrian guarantees.

Should the IRS wish to more formally exempt certain types of loan guarantees, it may have regulatory authority to do so under section 7872. *See* I.R.C. § 7872(i)(1)(C) (authorizing the Treasury to exempt "from the application of this section any class of transactions the interest arrangements of which have no significant effect on any Federal tax liability of the lender or the borrower"). While it is not completely clear that loan guarantees fall within the ambit of this subsection, the IRS also not infrequently declares by regulation, Revenue Ruling, or Revenue Procedure that it will not apply various provisions on the Internal Revenue Code in specified circumstances.

In any case, it seems risky to hope that the potential for the IRS to aggressively pursue even routine loan guarantees would dissuade a court from applying *Dickman* and *Plantation Patterns* to high-dollar and far-from-routine IDGT and BDIT transactions.

VII. PLANNERS CAN AVOID OR MITIGATE GUARANTEE RISKS IN SEVERAL WAYS

Enough, you say. Stop telling me about risks, tell me instead what I can do about them!

Fine. You and your clients have several options:

A. Maintain a Lower Debt-to-Equity Ratio

This one is obvious, though perhaps unappealing. You can limit leverage to a level low enough that you either don't need a guarantee, or rely on it less to give substance to the loan. *See Pierce v. Comm'r*, 41 B.T.A. 1261, 1262, 1265 (1940) (declining to treat a guarantee as gratuitous in part because the debtor was "solvent by a safe margin at the time of the original guarantee").

B. Seek Other Ways to Assure the Lender of Payment

More subtly, consider how else the lender can be reassured of payment, to perhaps justify a high debt-to-equity ratio and lean less on any guarantee. For example, if your client wishes to sell an interest in a limited partnership to a trust in a leveraged IDGT transaction, consider including a "tax distribution" clause in the partnership agreement. This will require the partnership to distribute at least enough of its income each year to meet its partners' assumed tax obligations at an assumed marginal income tax rate. From the perspective of a third party, this makes the partnership interest only moderately more valuable, since a hypothetical buyer still would not be assured of any net cash flow after tax. But from the perspective of a grantor trust and its lender, this provides meaningful cash flow to the trust that is not actually reduced by tax (since the *grantor*, rather than the trust, bears the income tax burden). That relatively assured cash flow

may help to support a higher debt-to-equity ratio, at least during the grantor's lifetime.

Consider also setting a partnership term that will end before the trust's debt comes due. If the term of the partnership and the loan are both fairly long, this seems unlikely to have a major impact on any claimed valuation discounts. (Is an interest in a partnership that will dissolve in 20 years substantially more marketable than an interest in a partnership with no set dissolution date?) But it does seem to provide more assurance that the debt will be paid at maturity, since by that time any discounted value will have been "unlocked."

Another possible approach would be to have the trust hold a life insurance policy on the life of the grantor, with a death benefit large enough to satisfy the trust's debt. Particularly if the term of the loan exceeds the grantor's life expectancy, this may help to assure repayment and make a guarantee either unnecessary or less important to give substance to the loan. (Of course, one would have to carefully structure the trust to ensure that the grantor does not have "incidents of ownership" in the policy under I.R.C. § 2042(2).)

C. Consider Loan Alternatives that do not require Equity, or as much Equity

Particularly if the trust is not generation-skipping, consider using an intermediate-term Grantor Retained Annuity Trust (GRAT) to fund the trust. If you might otherwise have sold assets to the trust in exchange for an amortized nine-year-note, you could instead establish a nine-year zeroed-out GRAT that pours into the trust at the end of its term. The economics of the two transactions are fairly similar, though the interest rate implicit in a GRAT is slightly higher than the midterm applicable federal rate, and GRAT payments cannot be backloaded as much as note payments. You do have higher mortality risk with a GRAT, but estate planning is often about balancing risks and accepting trade-offs. For a relatively young client, greater mortality risk may be an acceptable swap for lower legal risk.

Alternatively, a client might sell a remainder interest in a Qualified Personal Residence Trust (QPRT) to an IDGT, in exchange for a note. The transaction would have two levels of leverage baked into it – the leverage implicit in the QPRT, and the leverage reflected in the note – but only the "note leverage" would be taken into account in determining the IDGT's conventional debt-to-equity ratio. In this manner, one might achieve a higher *effective* debt-to-equity ratio (with or without the support of a guarantee) while still maintaining a moderate *stated* debt-to-equity ratio.

The possibilities here are limited primarily by your creativity and ingenuity as a planner. My purpose in this presentation is to spur you to use that creativity! Don't assume that a guarantee is an easy fix that avoids the need for more advanced planning or for care in existing planning. Guarantees pose significant risks of their own that planners should work to avoid or minimize.

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For a more extensive discussion of the issues presented in this outline, see Eric Reis, *Guaranteed Wealth? A New Way of Thinking About the Gift Tax Treatment of Loan Guarantees*, 27 FLA. TAX REV. 304 (2023).
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