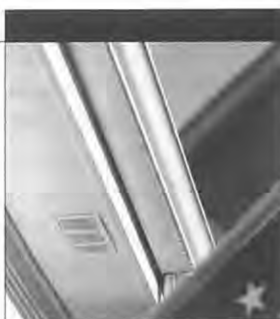

Role of Guarantees and Seed Gifts in Family Installment Sales

Guarantees have been used to support the economic substance of intra-family installment sale transactions and thereby reduce the taxable gift element.

MARTIN M. SHENKMAN, ATTORNEY

Intra-family sale transactions have become almost ubiquitous in estate planning for larger estates. In particular, the installment sale to a grantor trust (an intentionally defective grantor trust, or "IDGT"), is used as a wealth freeze and transfer technique. Primarily to give the transaction economic substance, funding the IDGT with some assets prior to consummating the sale ("seed gift"), or having either the beneficiaries of the IDGT, other family members or entities, or others guarantee some portion of the note the IDGT gives back to the seller in the sale transaction, have become integral parts of IDGT/note sale structure. The guarantee arguably supports the economic substance of the entire transaction, "back stops" the valuation of the note, and helps support the determination that the note should be valued at its face.

While seed gifts and guarantees can arise in other types of intra-family transactions, the discussion that follows will use the IDGT/buyer as its paradigm in analyzing the law and practice relating to seed gifts and guarantees.

A significant unresolved issue in the structure of an installment sale to an IDGT is whether a certain quantum of equity in the IDGT is required for the transaction to be respected by the Service. Without adequate equity, will the Service:

- Recast the note issued in the transaction as equity instead of the debt characterization intended?
- Recharacterize the intended sale as a transfer with a retained interest under Section 2036, as a sham, or as a part sale/part gift?[1]
- Challenge the transaction under a Section 2702 theory, because the note would not be a "qualified interest"?

These general questions raise a series of lower-tier questions including:

- How much seed money should be used?
- Can guarantees be used in lieu of seed gifts?
- How relevant is the often-quoted 10% rule of thumb?

Interrelationship of seed gifts and guarantees

For a transaction of more modest size, seed gifts alone may suffice. The term "modest," however, is defined relative to the component of taxpayers whose wealth would justify their engaging in these types of transactions. The $1 million gift tax exclusion ($2 million if the donor's spouse consents to gift split) serves as a restriction on the size of the transaction that can be structured with only a seed gift. A seed gift of up to $1 million can

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be used without gift tax, assuming that the donor has not made any prior adjusted taxable gifts. If the seller wants to come within the 10% rule of thumb, this is a limiting factor.

Although the 10% equity figure is merely a rule of thumb, it too is subject to varying interpretations. Many commentators believe its application implies a 9:1 ratio meaning that a $1 million seed gifts supports a $9 million sale, such that the seed gift is 10% of the total. Advocates of this perspective would disagree with a $1 million seed gift supporting a $10 million sale, a 10:1 ratio.

For donors who have little lifetime gift tax exclusion remaining, or are desirous of preserving some of their gift tax exclusion for future planning, relying on a seed gift alone becomes the limiting factor. In these instances, additional techniques are necessary. Pairing a seed gift with a guarantee of some portion of the note used in the transaction can imbue economic substance to the sale when a seed gift alone will not suffice or is impractical.

Another variant on the above theme is what might be referred to as the "serial" transaction. Suppose a client completes a note sale transaction in year one, and subsequently equity builds up inside the purchasing trust. At a later date, consummating a new sale transaction to the same trust might require little, if any, seed gift or additional guarantee if the equity in the trust has grown to a sufficient level to support the prior and contemplated transactions.

"To be or not to be"—divergent views

Practitioners have widely divergent views as to what is necessary, or advisable, with respect to incorporating seed gifts or guarantees into family sale transactions. Some practitioners view seed gifts and guarantees as being essential for an intra-family sale transaction to be respected. Other practitioners view the use of seed gifts or guarantees as unnecessary or even superfluous. The latter view would seem to follow the rule that if a person makes a loan or sale to a child, there is no gift if the AFR is used as the stated interest rate, even if the child/borrower does not own any assets. According to the proponents of this position, no security is needed. In fact, for some, the result would not differ if a trust for the child, rather than the child directly, were the borrower. On the other hand, according to other practitioners, protecting the downside supports making a loan of an unlimited amount not a gift.

The real litmus test in many cases will be whether the transaction can support a guarantee fee for the guarantee to be given.

Once this threshold issue is addressed, the next issue becomes whether a fee should be paid for any guarantee given. This issue is analyzed below, and the analysis can become circular. The real litmus test in many cases will be whether the transaction can support a guarantee fee for the guarantee to be given. This will, in turn, depend on how that fee should be calculated—yet another issue for which there are widely divergent views. Without the determination of the fee, the cash flow of the intended transaction cannot be evaluated to determine if it can support the fee.

The two divergent views as to whether guarantees should be used can also be analyzed from the perspective of how the different approaches appear to have evolved over time.

- Initially, little or no use of guarantees was made in family sale transactions.
- Then some practitioners began using guarantees to help support family sale transactions, but generally without charging any guarantee fee.
- Eventually, some practitioners using guarantees began charging guarantee fees. Yet, some professionals continue to maintain that no fees need to be paid by the buyer/borrower to its beneficiaries for providing a guarantee.
- Finally, guarantees with fees ascertained by independent appraisers seem to be the most recent evolution in this process.

Illustrative approach to use of seed gifts and guarantees

Given the widely disparate application of seed gift and guarantee techniques in note sale and other family transactions, it will prove helpful to the following discussions to provide a hypothetical framework for discussion purposes. Analyzing this approach is not to suggest that it is the correct or preferable approach, but it will provide a framework for later discussions. This discussion demonstrates the component decisions of the process, each of which will be explored in more depth below.

- Corroborate that the guarantor has the economic wherewithal to support the guarantee, so that it will be able to meet its guarantee obligation if the debtor defaults. This should be documented by obtaining relevant objective financial data for the guaran-

[1] See Handler and Dunn, *Drafting the Estate Plan* (CCH 2010), § 11.06(2)(a).

tor, including financial statements, if feasible. Ideally, an independent party, such as an appraiser or CPA, should review this data and provide some assurance that the assets support the guarantee and that the guarantor has the wherewithal to pay the guarantee if called on. The guarantee should be reflected on the balance sheet of the guarantor.

- The guarantor should negotiate a guarantee fee from the debtor. If the guarantor is an heir (e.g., child) of the seller, a motivation to use a guarantee fee is to avoid the possibility that a gift potentially will be triggered by a gratuitous guarantee, even though there appears to be authority that the gift would occur only if and when the guarantee is called on. The Service has ruled that the provision of a guarantee is a gift, measured by the donee's reduction in borrowing costs. The Service further stated in Ltr. Rul. 9113009 that any payment of the guarantee would be an additional gift. This ruling, however, was withdrawn in Ltr. Rul. 9409018 on other grounds concerning the marital deduction. If the guarantor is another family trust or family entity, payment of a fee for the guarantee may be necessary to demonstrate that the fiduciaries of the trust providing the guarantee are meeting their fiduciary obligations. If the guarantor is a family entity, payment of a fee may be essential to maintaining the independence of the entity involved. This could be critical from an asset protection perspective.
- The fee, according to some practitioners, should be determined by an independent appraiser. Some practitioners look to the fees charged for a "letter of credit" as a benchmark. Others reject the letter of credit paradigm based on the circumstances that often accompany their issue (e.g., an ongoing commercial banking relationship, security, etc.).
- Determine what portion of the note will be guaranteed. Some practitioners adhere to an arbitrary 10%-of-equity benchmark. Furthermore, to the extent that this figure has been satisfied by a seed gift, it need not be duplicated with the guarantee. Thus, the guarantee protects the excess of 10% of the sales price over the seed gift to the trust. Other practitioners use a multiple, e.g., guaranteeing 20% of the value of the note used in the transaction, to be "conservative" relative to the often-used 10% arbitrary benchmark. The theory behind this approach is that an independent party may well prefer a guarantee of 20% of the amount by a guarantor with sufficient economic substance, than a trust-obligor holding a mere 10% of the purchase money note. Double an arbitrary figure, however, remains arbitrary. Finally, others find this entire analysis faulty and unrealistic. They advocate that the bona fides of each transaction should be judged based on the reasonable expectation of success of the underlying business interests, or growth in the actual underlying assets sold to the trust.
- The selection of fiduciaries may also be relevant to an analysis of the viability of the transaction. Some practitioners want an institutional, independent, trustee to have sole responsibility for tax-sensitive decisions and in determining whether to consummate a purchase of hard-to-value assets from a seller who might be viewed as making a gratuitous transfer to the trust. This results in additional costs, as the institution would require representation by separate counsel, input from an appraiser, and so forth.
- According to some practitioners, the person providing the guarantee should also have separate counsel to assure that he or she has been fully apprised of the risks involved, that the guarantee is real, and will be called on to be paid if the borrower defaults on the note. For example, an adult child who is making a guarantee may believe that the family estate planning attorney is also representing him or her. If separate counsel is not used, at a minimum, a conflict letter should be considered.

While there are perhaps as many variations of each of these points as there are practitioners who handle these transactions, the above discussion provides a framework for the analysis that follows.

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Seed gifts or guarantees: avoiding thin capitalization

The key issue is whether a trust that is going to consummate a purchase has to have some minimal level of net worth in order for the transactions to be respected. The need for seed money is not statutory and, indeed, many respected practitioners do not feel it is necessary. More specifically, is some level of seed gift or guarantee necessary so that the sale to the IDGT will be treated as having been consummated for a bona fide installment obligation? If the installment note received by the seller is not respected, or its value impaired, the transaction could be recast by the Service as a gift to the trust of the asset transferred, with the transferor retaining an income interest in the asset.

If the buyer/trust is too thinly capitalized, adverse tax consequences can result from the purported sale transaction. The fact of insufficient assets or security for the loan could impair the value of the note, making it worth less than the value of the assets transferred. Although Section 2036 applies to lifetime gifts with certain retained interests, it does not apply to retained interests from lifetime transfers for "adequate and full consideration in money or money's worth." Thus the validity of the note becomes integral to supporting the "adequate consideration" to avert a Section 2036 issue.

Inadequate capitalization of the IDGT could also raise the specter of the Chapter 14 valuation issues. Section 2702 applies to a transfer to a trust for the benefit of a member of the transferor's family if the transferor, or an applicable family member, retains an interest in the trust. Unless one of the statutory exceptions apply, the retained interest is valued at zero. That means the entire value of the asset transferred is deemed a gift to the trust. If the note represents a valid debt, the transferor will not be deemed to have retained an interest in the assets sold to the trust. If the note is not respected, however, the "interest" payments could be viewed by the Service as being a retained interest—thereby triggering the valuation rules under Section 2702.

Similar issues were raised by the Service in *Karmazin*,[2] in which it asserted that the notes issued in connection with an intra-family sale transaction were in fact equity. The Service argued that no commercial lender would have made a similar loan because:

1. The debt/equity ratio of the trust was too high.
2. There was insufficient security for the purported debt (no guarantees were used in the transaction).
3. There was no seed money.

Karmazin was successfully settled, however, with results favorable to the taxpayer.

Application of corporate concepts

Issues of thin capitalization arose initially in the context of planning for corporate transactions. The corporate concepts of valid debt are based in part on statute. If the transfer of appreciated assets to a corporation for stock in a purported tax-free transaction under Section 351 was recast by the Service as being for debt, gain would have to be recognized on the transfer.[3] Further, a corporation's issuance of debt in lieu of stock could have substantial income tax benefits. In properly characterizing the instrument involved as debt or equity, the courts have considered many factors. While the debt-to-equity ratio (based on the fair value of the corporation's assets) is an obvious consideration, the courts have acknowledged that there is substantial variation in what is reasonable by industry, and even by transaction. Therefore, many courts have instead focused on the corporation's ability to repay the debt as it comes due as a primary factor, rather than the formulistic approach of simply analyzing the debt-to-equity ratio of the entity.[4]

Traditional factors supporting treatment as debt in the corporate context are listed below, re-framed for the context of a sale to an IDGT, with issues and concerns noted:

- An unconditional promise to repay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future. These requirements should be readily present in all transactions.
- Realistic terms similar to what would be agreed to in an arm's-length transaction. This is perhaps the crux of the issue for many estate planning transactions and the basis for the concern over seed money, to make the transaction as comparable as possible to an arm's-length transaction. Having parties represented by different counsel may bolster the bona fides of the transaction in a related-party IDGT sale. The interest rate used for the note is generally the Section 1274 applicable federal rate (AFR). The rate will depend on whether the note is short-term, mid-term, or long-term. This rate contrasts with the Section 7520 rate used to value interests in a private annuity, GRAT, etc. which is based on 120% of the federal mid-term AFR rate. The terms of the note, other than the

[2] Dkt. No. 002127-03.

[3] Section 351(b).

[4] See Section 385, Treatment of certain interests in corporations as stock or indebtedness; Notice 94-47, 1994-1 CB 357.

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interest rate, require consideration as well. Are the remedies in the event of default comparable to what an unrelated lender would insist on? The use of independent counsel has received attention in the profession, while the significant terms of the actual loan have not seemingly been the subject of as much discussion.

- The lender/holder of the purported note has the right to enforce the repayment of principal and interest. While this right is likely to be governed by the standard language in the promissory note instrument, the economics of the transaction should also support the reality of that right. Hence, this factor circles back in part to the economics of the transaction, including the use of a seed gift or guarantee. Perhaps the most significant factor, however, is the viability of the asset or business interest sold. Does the asset sold generate sufficient cash flow, or is it readily capable of being sold, to support the payments due under the note? Can the note be expected to be repaid according to its terms? If a guarantee fee is added, the question is whether the economics of the transaction will support the payment of the guarantee fee in addition to the required debt service payments. If the cash flow from the transaction can support both a current interest payment and a current payment of a guarantee fee, does that suggest that the cash flow might be high relative to the underlying asset value? Might this suggest that the asset is undervalued? Is this really economically sound when another asset or business interest may in fact have less current cash flow but better long-term prospects? Is it likely to appreciate post-sale? Has the asset appreciated post-sale?
- The rights of the lender are not subordinated to the rights of general creditors. In most IDGT note sale transactions, the trust has no other creditors. There may, however, be lenders to the assets held in the IDGT (e.g., mortgages on real estate held by an LLC sold to the IDGT, or a bank having debt to the entity whose interests were sold to the IDGT).
- The purported loan document does not give the lender the right to participate in the management of the trust. This should easily be met by the use of standard note language, but what of the inter-related nature of many IDGT transactions, with related parties serving in various fiduciary capacities? What about the right to substitute property (which is often given to a grantor in order to achieve grantor trust status) whereby the lender has the ability to reclaim the assets in question?
- The trust/borrower is not thinly capitalized. This directly relates to the seed money and guarantee issues. This is the key factor that suggests the need for seed gifts or guarantees.
- The lender and the trust are not the same persons or entities. While they may not be the same persons, the lender may hold a right to substitute property and other rights, and the fiduciaries of the IDGT will likely include related parties. The lender/seller is generally the grantor of the IDGT.
- The parties refer to the purported note as a loan in all respects. This should be simple to address. In the context of most family trust transactions, however, little reporting may occur other than tax filings. While the parties should report the asset/debt on balance sheets, preparation of financial statements is not common.
- The purported note is treated as debt for nontax purposes. In many IDGT note sale transactions, there may simply be no significant nontax treatment.

While it is common to have highly leveraged transactions outside of the estate planning realm, intra-family estate planning transactions are subject to greater scrutiny. In many transactions, the net worth of the buyer is an important factor addressed in some detail in representations and warranties. Due diligence efforts endeavor to confirm the buyer's real net worth and ability to pay. In many arm's-length transactions, the net worth of the buyer is not significant. But all of this must be evaluated within the framework of the inescapable related-party nature of the note in an IDGT sale transaction and the factors that courts have considered in evaluating whether an instrument that purports to be debt should be respected as such.

The real test should be whether the trust has adequate resources to satisfy its repayment obligation under the note, including but not limited to any seed gifts and guarantees. If the asset or business interest sold to the trust has adequate cash flow, it is not clear that a seed gift or guarantee is necessary, although many practitioners seem to be moving in the direction of favoring seed gifts or guarantees. As noted above, however, the often-cited response is that they are not necessary but being used because others are doing so.

In the context of a family loan, a transfer of money to a family member is presumed to be a gift, not a loan.[5] Taxpayers can rebut that presumption if they can demonstrate a real expectation of repayment.

In *Miller*,[6] the Tax Court weighed each of the following factors necessary to determine if the transaction was in fact a loan:

- Written promissory note evidencing the debt.
- Borrowers have reasonable ability to repay the loan.
- Books and records of the lender and borrower reflect the transfers as loans.
- Interest charged on the note.
- Reasonable security or collateral for the note.
- Demand for repayment made if a default occurred.
- Required payments were actually made on the note.
- The transaction was reported for federal tax purposes consistent with it being a loan.
- The note has a fixed maturity date.

If the real issue is the validity of the note and the likelihood of repayment, perhaps the trend towards employing guarantees to supplement whatever seed gifts are made is a distraction from this more essential objective. The efforts to corroborate the purported arm's-length nature of a guarantee in a transaction that is anything but arm's length is not a simple task. Perhaps the focus should be on demonstrating that the note is valid and that the assets or business interests sold to the IDGT, coupled with whatever other assets may be in the trust, collectively demonstrate a likelihood of repayment. With this approach, the amount of seed gift or guarantee would be determined by what is necessary (if anything) to supplement the assets sold to the trust to enhance the validity of the transaction, rather than by reference to an arbitrary percentage.

Tax consequences of seed gift

Whether a seed gift is an essential prerequisite to note sale transactions is important; if the seed gifts are completed gifts, they will use up lifetime gift tax exclusion—or perhaps trigger gift tax if they exceed the donor's available gift tax exclusion amount. Because note sale transactions, leaving aside the anomaly of the 2010 repeal year, have gen-

[5] Harwood, 82 TC 239 (1984).
[6] TCM 1996-3.

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erally been made to GST exempt trusts, seeding the trust will use GST exemption. The use of a guarantee will not use GST exemption as a seed gift would. If guarantees provide a viable alternative to seed gifts, they can avoid the gift tax and GST tax implications while potentially still enabling note sale transactions to withstand IRS scrutiny.

Is a 10% equity required, advisable, or conjecture

An often-cited "rule of thumb" is that a trust purchasing assets should be funded with at least 10% of the value of the assets purchased. The genesis of this legend, according to some commentators, is attributable to a meeting which Byrle Abbin, Esq., had with the IRS that resulted in the issuance of a private letter ruling that required that the applicants for the ruling contribute equity of at least 10% to the trust to have a valid transaction. If the capitalization of the trust is too "thin," will the "trust" be characterized as something else for tax purposes? The story behind this ruling was that a 10% capitalization is required to avoid a trust being characterized as an association taxable as a corporation.

While the above Ltr. Rul. is a tenuous authority at best for the proposition that a 10% seed gift is necessary, there is yet another issue pertaining to its relevance. A trust is an arrangement under which a trustee holds title to property to conserve it for the beneficiaries under the ordinary rules applied in probate courts. If the arrangement is treated as a trust for income tax purposes, the trust beneficiaries are not treated as associates in a joint venture operated for profit. Thus, historically the issue of whether to classify an arrangement properly as a trust or business venture had to be addressed. This issue was rendered academic on the 1/1/1997 effective date of the current check-the-box system of classifying entities for tax purposes.[7] The aforementioned letter ruling was issued before these regulations and, therefore, the issue being addressed may well have been influenced by the classification issue—which itself is no longer relevant.

Regardless of its origin, some practitioners ascribe to the belief that if the IDGT has a net worth of at least 10% of the value of the assets being purchased, the transaction is more likely to be respected in the event of a tax challenge. Consider the rationale for the 10% benchmark under various circumstances (leaving aside the issue as to whether the 10% figure is 10% of the other assets or 10% of the whole):

- An FLP owns $10 million of real estate investments and the grantor/seller proposes to sell 36%, or $3.6 million, to an IDGT. Ignore discounts at this point for simplicity. According to some practitioners, this would translate to an aggregate transfer valued at $4 million [$3,600,000 / 90%] and a $400,000 combination of seed gift and guarantee. This could arguably be met by the grantor/seller transferring $400,000 of cash. If securities instead of cash are used as a seed gift to the IDGT prior to the sale of the 36% FLP interest, other issues arise. The underlying value of these "seed" securities declined by 40% in 2008, perhaps more. What is the impact on the transaction? Should the litmus test be applied only at inception? Is there any basis to require reconsideration?
- Assume that the FLP interests being sold have been discounted by 30%. Thus, the 36% FLP interest that is nominally valued at $3.6 million, net of a 30% discount, is now valued at $2,520,000. This would imply a seed gift of $280,000 [$2,520,000 / 90%]. Is such a gift of securities, even if they maintained their value, sufficient to support the transaction? Would a reduction of the discount, on audit, obviate the benefits of the seed gift or guarantee that is now inadequate? A $280,000 seed gift will be far less than the 9:1 ratio of the post-audit revalued figure. Does an audit adjustment negate the good-faith calculation of the seed gift at inception?
- Do guarantees carry the same weight as a seed gift? Does a guarantee of a $400,000 tier of the note provide the same protection and economic impact as a seed gift of $400,000? While the IRS might argue against a partial guarantee or tier of guarantees, that arrangement is common in real-world real estate and other transactions. The bottom line in any arm's-length commercial transaction is that the seller, in a deal using seller financing (i.e., purchase money financing) wants the note repaid without having to resort to a guarantee. Even the most solid of guarantees will nonetheless require that the seller incur costs, time delays, and more to collect. Thus, a guarantee by another person or entity is really not the equivalent to a net worth of the seller.

What real authority exists concerning seed gifts/guarantees? Most appears to be anecdotal in the form

[7] Reg. 301.7701-3.

of articles speculating on related areas of the law.

Sources supporting the use of a 10% seed equity

In Ltr. Rul. 9535026, the Service suggested a benchmark of 10% of the value of the trust's assets. The applicability of the ruling's concepts to current note sale transactions, however, is not clear. In the ruling, the Service held that Chapter 14 would not apply if the promissory notes are subsequently determined to be equity or not debt. The ruling expressed no opinion about whether the notes were debt or equity "because that determination is primarily one of fact...."[8] The IRS noted that "This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the RST's [trust's] ability to pay the notes is not otherwise in doubt." These latter factual determinations are the key issues that warrant a practitioner's attention in any transaction, with the determination of the amount of seed gift or guarantee to be the result of that analysis.

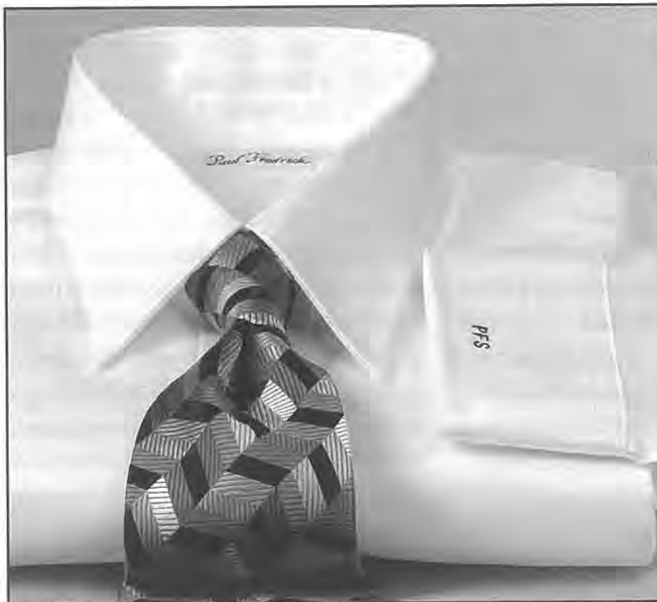
A second purported source for the 10% seed gift is Section 2701(a)(4):

> 4) Minimum valuation of junior equity.
>
> (A) In the case of a transfer described in paragraph (1) of a junior equity interest in a corporation or partnership, such interest shall in no event be valued at an amount less than the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of—
>
> (i) the total value of all of the equity interests in such entity, plus
>
> (ii) the total amount of indebtedness of such entity to the transferor (or an applicable family member).
>
> (B) Definitions. For purposes of this paragraph—
>
> (i) Junior equity interest. The term "junior equity interest" means common stock or, in the case of a partnership, any partnership interest under which the rights as to income and capital (or, to the extent provided in regulations, the rights as to either income or capital) are junior to the rights of all other classes of equity interests.
>
> (ii) Equity interest. The term "equity interest" means stock or any interest as a partner, as the case may be.

The above provision addresses the minimum equity that must be held by junior family members in order for the preferred interests held by the senior family members to be eligible for valuation under Section 2701. It does not address the determination of the validity of a note.

The issue pertinent to the use of seed money and guarantees is whether the equity within the IDGT, together with any other security or collateral, provides a reasonable expectation that the note will be paid in accordance with its terms. Financial projections and sensitivity analysis as to the anticipated performance of the assets sold to the trust, as well as other trust assets, should be the primary line of defense to any challenge as to the validity of the note or the transaction, not an arbitrary 10% rule of thumb. Some practitioners argue that mere adherence to seed money in a 9:1

[8] Citing section 4.02(1) of Rev. Proc. 95-3, 1995-1 CB 385.



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ratio does not itself legitimize the sale transaction. Some practitioners argue that any material seed gift that would be a material loss to the taxpayer should suffice to support the transaction even if well below the hypothetical 10% rule of thumb. For example, would a $1 million seed gift support a $25 million transaction simply because $1 million is so much to lose?

Some thus argue that not the ratio, but the underlying assets, should be tested. The test should reflect the appearance, at the time of the transaction, that the note would be paid off according to its terms. Certainly, seed gifts to enhance the cash reserves and earnings of the trust, or guarantees to support the payment under the note in the event of an unforeseen adverse financial circumstance, can only help, but the real test remains the viability of the transaction.

At least one commentator has suggested that inquiry be made of a commercial lender to confirm that a loan on similar terms would have been made. This touchstone too may be inadequate in that purchasers of closely held business interests, as well as sellers taking back purchase money debt on a sale, often invest or extend credit based on their likely perception of future performance. This standard would preclude many start-up ventures from receiving funds.

In an effort to clothe sales to IDGTs in the garb of arm's-length transactions, many of the touchstones and rules of thumb seemingly exceed, or are more rigid or arbitrary than, those used in many actual sales that are not tax motivated.

Ancillary seed gift considerations

If assets are given as gifts to a trust to "seed" the trust to support a subsequent note sale transaction, can that very gift be used as the down payment on the sale transaction? Some advisers recommend against it; others do it routinely.

If the seed gifts are to be used as part of the down payment, might the Service use a step-transaction argument to undermine the transaction? The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of a transaction.[9] Successfully invoking the step-transaction doctrine might recast the gift followed by a return of the gift property in the form of a down payment as an incomplete initial gift thereby undermining the seeding of the trust, the existence of a down payment, and perhaps the economic substance of the overall transaction. Another perspective might be that if the property being sold to the IDGT has been properly valued, the transaction might be characterized as a part gift/part sale with the seed gift being the gift portion.

The step-transaction doctrine provides that if a series of steps in a transaction are so integrated and interdependent, economic reality may be better reflected by collapsing the various steps into a single integrated transaction. The doctrine might be applied if there is a binding commitment to consummate all of the steps involved, or if the various steps involved are interdependent steps. In other words, the legal implications of one step would be fruitless if the other step was not also completed. Finally the step-transaction doctrine might be invoked by applying an "end result" test.[10] Under this test, purportedly separate transactions will be amalgamated as a single transaction when it appears that they were really component parts of a single transaction intended from the outset to reach the ultimate result. One commentator contends that taxpayers are permitted to engage in tax planning, and the step-transaction doctrine should not be argued to prevent that. Further, arbitrarily delaying components of a plan should not affect the validity of that plan.

An approach that may mitigate somewhat against the step-transaction doctrine's application might be to establish and fund the trust with a seed gift prior to an appraisal of the assets that may be sold to the trust being obtained. Because it is not possible prior to obtaining an appraisal to know the value of the asset, and hence the rule of thumb for a seed gift (assuming the application of this approach), the gift has to be made somewhat independently of the value of the asset.

Guarantees in lieu of some portion or all of a seed gift

Some practitioners advocate that guarantees can be used in lieu of, or in addition to, seed gifts to enhance the economic viability of a note sale transaction, and hence the likelihood that the note will be respected. A key advantage of guarantees over seed gifts is that no gift or GST tax exemption needs to be allocated to the trust for the amount that is guaranteed.

Should a fee be paid for the guarantee?

No clear consensus remains as to whether a fee has to be paid for a guarantee. Some commentators advocate that a fee be paid for the guarantee. These commentators generally recommend that the guarantee fee be set at a commercially reasonable rate (e.g., perhaps based on an independent appraisal, or what a financial institution might require in terms of a fee for a similar transaction). What is

[9] Redding, 630 F.2d 1169 (CA-7, 1980), *cert. den.* 450 U.S. 913.

[10] Penrod, 88 TC 1415 (1987).

interesting is that many of the practitioners who use guarantees with fees when structuring note sale transactions explain that they do not actually believe that guarantee fees are necessary, but they then use them in order to minimize the perceived tax risk of consummating the transaction without a fee being paid.

Some practitioners believe that while a guarantee fee generally should be paid, it is unnecessary when the guarantee is by a beneficiary of the trust. The argument is that a beneficiary will benefit from the trust and thus has an economic incentive to provide the guarantee that a third party does not. Therefore, the beneficiary does not need to be paid a guarantee fee.

The *Bradford*[11] court addressed a beneficiary protecting his or her interest in the trust, and, therefore, held that a guarantee fee is not necessary. Many trusts involved in note sale transactions, however, include a class of beneficiaries rather than a single beneficiary. In addition, many trusts vest powers in an independent institutional trustee, or give an independent distribution committee the right to determine distributions. Thus, often no particular beneficiary has any expectancy in the trust. Trusts are frequently intentionally structured in this manner to enhance the asset protection benefits for the beneficiaries. In such instances, does the beneficiary-guarantor really have a defined interest in the trust to protect him or her under a *Bradford* test? If not, would a fee—in contrast to *Bradford*—be required? At what point is the demarcation drawn? What if the beneficiaries can replace the trustee permitted to make distributions?

The above can be viewed as a sequence of three gradations:

1. A beneficiary with a discernable interest (perhaps similar to *Bradford*) may not require a fee to provide a guarantee (e.g., a sole current beneficiary receiving a mandatory income or unitrust payment).
2. A discretionary beneficiary might arguably be able to provide a guarantee to protect a discernable interest in the trust.
3. A sprinkle trust with multiple discretionary beneficiaries might increase the argument that a fee is necessary.

Some practitioners adhere to an arbitrary 10%-of-equity benchmark.

Yet, even with discretionary beneficiaries, the concept of "discretionary" may be more than merely a potential or hypothetical interest in some views. Certain payments might be supported by a parameter of reasonableness so that it may not be solely within the trustees' absolute discretion not to pay it. Thus, it might be arguable that even a beneficiary who is not a sole current mandatory beneficiary has a sufficient interest to provide a noncompensatory guarantee without raising a gift issue.

While paying a supposed arm's-length fee for a guarantee might seem a logical step, is it realistic? Is it necessary?

- Would any third-party financial backer actually guarantee a debt on a sale of a closely held family business transaction? If the family business value is discounted by say 35% to reflect lack of marketability and lack of control, would many of the factors supporting these discounts also support a substantial premium for a third party to provide a guarantee?
- What is a commercially reasonable fee? If a beneficiary is providing a guarantee for a loan that supports an asset acquisition that is intended to benefit that same beneficiary, does that potential benefit obviate the need for any guarantee fee? How can the potential benefits to be derived by a beneficiary be weighed against the need for a guarantee fee?
- The estate tax treatment of a guarantee might offer some insight into the appropriate fee to be charged for a guarantee. In *Estate of Lay*,[12] where the decedent was liable on a note only as a surety, no deduction was permitted because the borrower had ample assets to repay the loan. In *Estate of Cafaro*,[13] no deduction was permitted because the loans were not in default, and no payment was made on the guarantee. Applying this reasoning, if the trust has ample assets to repay the loan, then what quantum of a fee is really necessary or appropriate? If the trust has modest equity initially, but it grows over time, does the appropriate fee, if any, decline over time, or is it established only at inception? If the guarantee as contingent debt is too uncertain to warrant a deduction for estate tax purposes, how much compensation should be paid for incurring it?
- Some practitioners have advocated using the fees a bank would typically charge for a letter of credit to establish the fee to be paid for a guarantee. It is not clear, however, that this analogy is appropriate. Banks issuing letters of credit are likely to have ongoing

[11] 34 TC 1059 (1960).

commercial relationships with the customer for whom a letter of credit is issued, ample security supporting it, etc.

The specific nature of the guarantee involved may be relevant to the determination of the guarantee fee to be charged:

- Is the guarantee unconditional?
- Does the guarantee apply to all of the principal and interest due under the note? Only a portion? What portion? If a particular tier of the note is guaranteed, how is that factored into the analysis?
- Can the due dates for the guarantee payments be accelerated according to the terms of the note if the note is accelerated in default?
- Is the guarantor guaranteeing the actual payment and not the mere collection of the amounts due under the note?
- Is the liability of the guarantor under the guarantee primary, direct, and immediate—rather than conditional or contingent on the lender pursuing any remedies he or she may have against the borrower, or the borrower's successors and assigns, with respect to the note?

What is a guarantee?

While this article could have been introduced with a discussion of exactly what is a guarantee, the discussion has been deferred to this point to focus on the more specific issue to practitioners as to how a fee should be set for a particular guarantee. Discussions of determining an appropriate fee tend to presume that guarantee provisions are relatively generic, but this may not in fact be the situation. Therefore, prior to analyzing how much of a fee, if any, should be paid for a guarantee, some consideration of the nature of guarantees should be explored.

A guarantee is the promise to answer for the payment of a debt of another person who is liable in the first instance. The promise is in the form of a contract in which the guarantor (promissor) commits to make the payments exactly as they were agreed to be made by that other person, in the instrument (the note) creating the payment obligation in the first instance. Guarantees can be structured in many different ways, including the following:

- An "absolute guarantee" is a guarantee that is an unconditional undertaking by the guarantor. Many guarantees are conditional in that they require notice to the guarantor, reasonable exhaustion of some or all of the remedies against the principal borrower, the IDGT, etc.
- A guarantee can be of the timely payment of interest, or of the ultimate repayment of principal, or both.
- A guarantee can be for any payment shortfall, or only a shortfall up to a specified amount (cap).
- The guarantee could be structured as a payment advance agreement in which the guarantor commits to paying certain periodic payments on time regardless of the acts of the borrower. These commitments may be limited to a specified number of defaults or payments. Each of these factors should be evaluated in how the guarantee is structured and the impact it might have on the guarantee fee.

The guarantor can generally look to the borrower, the IDGT, for reimbursement if it is required to make a payment under the guarantee. Thus, the value of the underlying assets or business interests held by the IDGT should determine the risk really assumed by the guarantor. If the guarantor has the right to receive reimbursement from the borrower/IDGT, and if the value of the underlying assets is secure even if illiquid, then this should be factored into the analysis of the risk assumed by the guarantor.

If the guarantee is of only the principal repayment, due on maturity of the loan as a balloon payment, no payments may be due from the guarantor for decades. This too should be factored into the security it affords the seller, as well as the quantum of risk assumed by the guarantor. Such a balloon structure was, for example, respected by the Service in Ltr. Rul. 9535026.

A recent article in the New York Law Journal is instructive in evaluating the formalities of guarantees in the estate planning context:

> ... there is an enhanced need for attorneys representing commercial property owners to be aware of ... the nature of any guarantee.... While guarantees were often glossed over by borrowers entering into commercial real estate loan agreements ... now ... the type of guarantee that was negotiated ... has taken on great importance and has been the focus of a great deal of recent litigation.... There is a broad spectrum of types of guarantees. On one end of the spectrum there are 'non-recourse loans' without any type of personal guarantee...On the other end of the spectrum are loans that are unequivocally personally guaranteed... "Carve-outs" are similar to springing guarantees in that they are usually directed at "bad acts" by the borrower to trigger recourse liability ... a lender's recovery under a "carve-out" is normally limited to actual damages..."[14]

The above excerpt has two implications that are relevant to the discussion at hand:

[12] 40 BTA 522 (1939).

[13] TCM 1989-348.

[14] "Loan Guarantees: Broad Scope May Trigger Catastrophe for the Unwary," NYLJ, 5/12/2010, page 5.

Planning Tips

Some advisors recommend that a guarantee fee be paid annually. Other advisors have structured transactions with a one-time fee. An annual fee, if paid timely and appropriately, might lend more credibility to the transaction. Providing for an annual payment that is either not made on a timely basis or not adjusted as the outstanding note balance declines, however, may be worse than charging no fee at all, as it will demonstrate noncompliance with the structure. Then again, even in the commercial context, a guarantee agreement might simply provide for a penalty if the fee is paid late. Little authority exists for any position.

The guarantor should provide financial data to corroborate his, her, or its financial wherewithal to pay the amount guaranteed. If the guarantor's assets are inadequate, the guarantee will prove transparent and of little import to supporting the larger transaction.

Many of the notes are structured with balloon payments at maturity and have only interest paid in the intervening years. If a guarantee supports such a note, periodic reevaluations of the trust's property, and the need for the note guarantee, might be advisable. If instead principal on the note is being amortized, as the principal balance declines, so might the guarantee fee. Principal amortization will help demonstrate the economics of the transaction as well as facilitate reduction in the guarantee fee over time.

On the other hand, consider the specter of Section 2036 estate tax inclusion risks. The amortization of principal on the note out of cash flow might bolster an argument by the Service that the client/seller has made a transfer with a retained interest. This is a concern especially if the facts demonstrate that all or a substantial portion of the income and cash flow from the property is being used to make payments. In contrast, a balloon payment of all principal at maturity might counter the Section 2036 argument.

Whatever approach is used, the guarantor should consider engaging independent counsel. This not only lends credibility to the transaction, but is an important safeguard for counsel in the event that the guarantor is called on to make payment under the guarantee.

These myriad of approaches all raise a more fundamental issue: Will the transaction be able to support the economic burden of the guarantee fee? Yet, the logic and analysis becomes circular. If the valuation of the property is understated, or a significant discount is claimed compared to the value of the underlying assets, the cash flow relative to the debt service will likely support a larger guarantee fee.

- Does the ability of a transaction to shoulder a substantial guarantee fee suggest that the valuations or discounts are askew?
- Does the ability to support a substantial guarantee fee suggest that the cash flow from the transaction is strong so that the risk of the guarantee being called is less and, therefore, the fee should be lower?

If congressional action restricts or eliminates discounts, the cash flow generated by a transaction will be substantially different without the discount leverage and may not be able to support both the interest cost on the undiscounted value and the guarantee fee.

1. In true unrelated third-party commercial contexts, the care and attention paid to guarantees was questionable. Thus, in evaluating a taxpayer's adherence to the formalities of a guarantee, should a higher standard be demanded to be "arm's-length"?
2. Guarantee arrangements in transactions among unrelated parties have complex and varied provisions, so finding variability among guarantee arrangements in the estate arena should not be surprising.

Determining an appropriate fee for providing a guarantee

The factors that should be evaluated in determining how to price a guarantee might include:

- Each of the relevant factors as to the structure of the guarantee agreement (e.g., see discussion above of many of the options as to how a guarantee can be structured).
- The obligation amount; how much is being guaranteed.
- Repayment time frame.
- Anticipated cash flow from the business interests or assets held by the buyer/borrower trust. While this is a commonly cited factor, the actual determination of cash flow will depend not only on historical payment patterns, current status of the assets (e.g., whether a lease on an underlying property is up for renewal), but perhaps more significantly, what assurance there is that the cash flow historically generated by the underlying assets or business interests will in fact continue to be paid. For example, the governing documents might mandate cash distributions equal to 40% of income to enable passive owners to cover their tax cost. Other governing documents may make distributions discretionary to the manager or general partner. In such event, how can the cash flow to meet debt service really be evaluated? What if the governing documents (e.g., a limited partnership agreement) include future capital calls? Bear in mind that this analysis is still one layer removed from the analysis of the risk of the guarantee.

- Creditworthiness of the business that is in whole or part owned by the buyer/borrower trust.
- The remedies and rights available to the guarantor in the case of a default by the borrower. This will depend on the particular terms of the guarantee, but the terms of the note and other ancillary documentation may be relevant as well.
- Current circumstances. The fee may change from time to time as economic and other factors evolve.

In addition to the many factors to consider in pricing a guarantee fee, there appear to be rather wide-ranging opinions as to how those factors should be evaluated in establishing an appropriate guarantee fee:

- Some experts maintain that the value of the guarantee should be expressed as a percentage of the debt obligation. This approach might begin with a 2% fee as a base point, to be adjusted for the many other factors noted above. The percentage may be regional, depending for instance on what banks in the area typically charge for a guarantee. This concept is similar to the build-up approach used in determining discount rates for discounting future cash flows. Start with a base rate and adjust upward or downward for other relevant factors. Yet, with intra-family transactions that are so unique, how "solid" can the figures be calculated for base rates or the adjustments?
- Another approach is more akin to a decision tree with weighted present values: Estimate the probabilities of different outcomes (e.g., a 20% chance of the guarantee being called in full). Then discount the expected values of each branch of the decision tree to a single net present value. The discount rate used may depend on the type of investment.
- Yet another approach might be to consider the typical cost of stand-by letters of credit used as a proxy for guaranteeing the debt (a service fee). Such fees might range from 0.2% to 0.5%.
- Some appraisers suggest guarantee fees in the range of 5% to 6%+, because of the "nature" of the underlying assets supporting the guarantee. For instance, a fractional interest in raw land may be considered an undesirable asset to support a guarantee and thus it should require a higher guarantee fee. This conclusion, however, depends on the nature of the underlying guarantee. If the guarantee is for a note that accrues both interest and principal, or it is a guarantee for principal that is due only on maturity, then perhaps the illiquid nature of the underlying asset is less of a detriment if appreciation is significant. If the transaction is unable to tolerate the economic stress of the guarantee fee easily, however, it could be argued that it should not be done. Such a conclusion does not address the underlying economics, but rather only the current cash flow.
- A more sophisticated mathematical approach uses a Black-Scholes put-options model to determine the minimum fee for a guarantee.
- An insurance paradigm would measure the fee akin to a premium paid to insure against the default.
- Another approach is to evaluate the creditworthiness or status of the transaction. Perhaps without the guarantee the note might be analogous to a BBB or other credit rating. Then consider the impact of a guarantee on how that credit rating would improve. Finally, evaluate the spread in the commercial market for the change in credit rating. Make any adjustments that might be warranted to reflect unique transaction circumstances. The net result is the rate to apply to the amount guaranteed to determine the appropriate fee.

Is a no-fee guarantee a gift?

Is the provision of a gratuitous guarantee (i.e., when no fee is paid) a gift? Some practitioners and articles have implied or even concluded that it is not. However, that reasoning may be flawed. To address this issue properly requires several factual determinations for which there are no easy answers:

- What is the value of the guarantee provided? If there is no determinable value, no current gift can be found. But a guarantee can be valued even if the value is uncertain.
- Does the guarantor have a relationship or benefit from the borrower who benefits from the guarantee such that either no fee has to be charged to avoid a gift, or the value of the benefit offsets the value of the guarantee? (See the discussion of *Bradford*, above.) This and similar cases have been cited by some to conclude that no fee is necessary when a beneficiary provides a guarantee.

The Service has held that the provision of a guarantee of a note is a gift because it confers an economic benefit. In this letter ruling, the father guaranteed notes of his children's corporation. The Service

found a gift, citing Reg. 25.2511-1(h)(1)—which provides examples of transactions constituting a taxable gift. The Regulation provides:

> The following are examples of transactions resulting in taxable gifts and in each case it is assumed that the transfers were not made for an adequate and full consideration in money or money's worth: A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation.

The Service viewed the provision of a guarantee as a transfer of property. This view, however, leaves in all events a determination as to the value of that property and the value of any consideration received by the party providing the guarantee.

In contrast, however, some cases and rulings have concluded otherwise. For example, in Ltr. Rul. 8316092, the payments of term life insurance policy premiums by beneficiaries of an irrevocable trust that bought and owned a policy on the insured's life were held by the Service not to be taxable gifts by beneficiaries. The Service reasoned that they were merely payments for their own benefit. Yet, the reasoning in this ruling left open the issue of how the provision of economic benefit by a beneficiary would be treated if there were multiple beneficiaries and not all provided comparable benefits. It is instructive to consider the actual discussion and reasoning in the ruling, which many articles and practitioners appear to have overlooked. This overlooked language has clear implications to the proper conclusion concerning a guarantee constituting a gift. The ruling stated:

> The tax court in SELIGMANN V COMMISSIONER, 9 T.C. 191 (1947), held that when a beneficiary of a trust pays the premiums on the policies which are a part of that trust, such payments are not taxable gifts because they are made to protect the beneficiaries [sic] own interest. Similarly, in BURGER V COMMISSIONER, 10 T.C.M. (CCH) 1255 (1951), the court held that an insurance trust beneficiary's payment of insurance premiums on her husband's life was not a taxable gift because it lacked the requisite donative intent. The court stated that "her beneficial interest was at all times substantial, subject only to the death of the insured, her husband".
>
> The provisions of the insurance trust in the present case provide for the beneficiaries to pay the premiums in proportion to their share of the proceeds of the face value of the policy. Accordingly, these payments are being made for their own beneficial interest.

In the context of many IDGT agreements, distributions are in the discretion of an independent trustee or trust distribution committee. IDGTs typically include many individual beneficiaries, often at different generational levels. Some trust documents grant persons the right to add charitable or other individual beneficiaries, or to remove beneficiaries. Typically, the assets of an IDGT are intended to grow within an asset and transfer tax protected envelope of the trust for as long as feasible. These circumstances appear to be considerably different from those cited in the above ruling. It may not be appropriate to conclude that the beneficiary of a particular IDGT has a beneficial interest that is at all times substantial. The interests of the beneficiaries are likely to be unspecified, so how can the beneficiaries provide guarantees in proportion to their share of the proceeds or assets of the trust?

In Ltr. Rul. 9113009, the Service held that the husband/father's agreements to guarantee the loans on behalf of his children were transfers subject to the gift tax based on the economic benefit conferred on the children as shareholders.[15] Further, if the primary obligors default on the loans and the husband/father pays the outstanding obligations, amounts paid less reimbursements will be taxable gifts. Although the ruling was withdrawn by Ltr. Rul. 9409018, the language actually used in the initially ruling may be instructive:

> .... The agreements by T to guarantee payment of debts are valuable economic benefits conferred upon the shareholders of the acquiring companies and entities. You state that, without those guarantees, those shareholders (T's children) may not have obtained the loans or, in the very least, would have had to pay a higher interest rate to obtain the loans....
>
> Accordingly, the enforceable agreements by T to guarantee the loans on behalf of the shareholders are transfers (subject to gift tax) of the economic benefit conferred upon the shareholders on the dates they are entered into by T.
>
> Likewise, in the event that the primary obligors subsequently default on the loans and T pays any outstanding obligation under the terms of the agreements, any amounts paid by T, less any reimbursement from the primary obligors, will be gifts subject to the gift tax...."

Even if the initial ruling were not withdrawn, the Service would have to demonstrate that the loan would not be obtainable without the guarantee, or a higher rate would have been incurred. The notes in IDGT transactions, however, are related-party loans, and the interest rate is set generally based on tax criteria. Thus, under the Service's analysis, arguably the loans would have been obtained—and at the same rates—regardless of the guarantee.

For many IDGT transactions where a guarantee is provided, it might be prudent to charge a fee in order to avoid the imputation of a gift.

Tax law changes may increase the need for guarantees

There is increasing likelihood of legislative attack on certain valuation discounts. For example, H.R. 436 (the Pomeroy Bill) includes

[15] Section 2511.

such changes. The indirect impact of restrictions or eliminations of discounts on seed gifts and guarantees will be significant, and has not been addressed in the professional literature. The real economic basis for supporting notes used in a sale to a grantor trust is the cash flow from the assets sold to the trust (i.e., the underlying economics). Lower discounts means less cash flow leveraged into the trust. Less cash flow to support note payments increases the importance of seed money or guarantees to assure that the transaction is viable.

Example. Rental real estate is valued at $10 million. Thus, 40% of the LLC owning that real estate would be valued at $4 million gross. If a 30% discount applied, 40% of the LLC would be valued at $2.8 million. Assume the property generates a 5% cash return, or $500,000. The 40% interest would receive $200,000.

- If the 40% interest is valued at $2.8 million, this cash flow is a 7.1% return.
- If the 40% interest is valued at $4 million, that is a 5% return, or about 40% less than with the valuation discount.

If the Pomeroy bill is enacted and passive real estate interests no longer qualify for a discount, the need for a guarantee to support the same transaction is arguably greater.

All the variables of the note sale transaction are interconnected. If the cash flow is lower, the ability to repay the notes becomes an issue. So, even if guarantees are perhaps not as important today and people may take the position that seed money is not needed today, changes in the economics of the transaction due to the elimination of discounts may make the characterization of those notes more questionable.

Guarantee fees as an affirmative tax planning device

Guarantees, and the fees paid for them, can themselves provide advantageous tax planning opportunities. For example, having a well-funded family trust, instead of beneficiaries of the IDGT, provide the guarantee in exchange for a fee will infuse cash into that trust. An irrevocable life insurance trust (ILIT) funded years earlier with permanent life insurance policies may have sufficient net worth (or perhaps a bid can be obtained from third parties as to the sale value of the policies) to provide for a tier of guarantee. Perhaps a GRAT that is struggling to make payments might have net worth that could support the provision of some guarantee in exchange for a fee. In these instances, the incentive might even be to use a higher fee in order to shift value into other tax-advantaged trusts. This might enable an older ILIT to eliminate the need for annual gifts; an especially attractive approach if congressional action restricts or eliminates "Crummey" powers.

In fact, guarantees may represent a flexible tool for clients with existing estate planning documents to shift value among family trusts, especially where existing irrevocable trusts have need for cash and assets sufficient to support the provision of a guarantee. Because commercial guarantees can be for fixed terms and easily renegotiated, short-term guarantees might permit a taxpayer to reexamine periodically which trusts are in need of funds and shift value through guarantees, as needed.

If a family irrevocable life insurance trust has entered into a split-dollar agreement, and if that trust has sufficient assets to support a guarantee of a portion of the guarantee deemed advisable in the particular transaction, use of a guarantee and payment of an appropriate fee, may provide a gift-tax-free mechanism to shift cash into the insurance trust as part of the split-dollar exit strategy. The fee might be enhanced if instead of the insurance trust and beneficiaries all guaranteeing a given amount of the note, tiers of guarantees are used—thereby increasing the risk faced by the insurance trust relative to other guarantors, and thus increasing the fee to be paid to the insurance trust.

Subordinated loan as alternative or supplement to a guarantee

Another approach to the seed money and guarantee issue might warrant consideration. A guarantee provides assurance that the note will be paid, thereby supporting the transaction. A somewhat similar result may be achievable if a loan is made to the IDGT, which is then subordinated to the note used to consummate the IDGT's purchase. The subordination would effectively make the funds so loaned a further support for the primary loan transaction. The circular analysis noted above, however, might affect this approach as well. If a client will sell a $9 million asset to a trust and wishes $1 million in seed gifts and guarantees to support it, consider a $1 million subordinated loan—but will that loan then require under the same analysis a $100,000 seed gift, and so on?

Conclusion

Guarantees and seed money relating to IDGT note sales continue to present a host of unresolved issues for practitioners. This article has explored some of the more significant issues and endeavored to raise several new issues that have not been addressed to a significant degree in other literature. Certain important guarantee issues, however, were not addressed in significant depth—including the gift and estate tax issues of the guarantee itself. ■