Gift Tax Exposure from a Personal Guarantee

Take-Away: When an individual guarantees a loan to a related party, the loan might be characterized by the IRS as a loan from the lender to the guarantor, followed by a second loan on the same terms from the guarantor to the ultimate borrower. The second deemed loan would then be recharacterized as a taxable gift to the ultimate borrower rather than as a loan.

Background: A subtle way for parents and grandparents to increase the assets of their children and grandchildren, without incurring a gift tax, is to encourage the child or grandchild to borrow funds needed to make investments. The parent or grandparent (with their own substantial wealth) offer personal guarantees to the third-party lender, which then allows the child or grandchild to borrow and invest the loan proceeds in amounts far greater than the child or grandchild could borrow on their own.

This wealth building strategy has been overlooked by the IRS for a considerable period, but those days may be coming to an end.

Indirect Gifts: Under IRC 2501, imposing the gift tax applies whether the transfer is in trust or otherwise, *whether the gift is direct or indirect,* and whether the property is real or personal, tangible or intangible. These terms are used in the broadest and most comprehensive sense, and per the Supreme Court, they will be broadly defined *"to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, [such that] the gift tax statute is broad enough to include property, however conceptual or contingent." Dickman v. Commissioner, 465 U.S. 330 (1984.)*

IRC 7872: The Supreme Court in *Dickman* held that a no-interest loan between family members, or their companies, would be treated as a gift of the foregone interest. Thus, a taxable gift includes the gratuitous use of money. This position was later codified in the Tax Code in IRC 7872. This Tax Code section calculates the amount of the gift by comparing the interest (if any) charged by the lending family member to a specified (floating) interest rate that is identified in IRC 7872(a). However, this Tax Code section does not address the circumstance where the borrower could not have obtained a loan from a disinterested lender at any interest rate (e.g., due to a lack of the borrower's own financial resources

sufficient to justify the extension of credit.) If the loan is guaranteed by another, is that guarantee a taxable gift?

IRS: The IRS has come up with a 'doctrine' to recharacterize *impossible* loans as either equity or some other interest, but not *debt*. The IRS believes that a personal guarantee should be treated as a gift, but it has been reluctant to officially pursue that assertion because it has no plausible theory for how these indirect gifts/personal guarantees should be valued, and no administrative solution for how to tax the deemed gift (via a personal guarantee for a family member's loan.) For example, in *Private Letter Ruling 9113009, March 29, 1991,* the IRS concluded that an individual's guarantees of the debts of his children's company "are transfers subject to gift tax of the economic benefit conferred." Yet in *Private Letter Ruling 9409018, March 4, 1994,* the IRS withdrew PRL 9113009 stating "we express no opinion at this time about the tax treatment of the guarantees." To date, the IRS is **still reconsidering** its position on the gift tax implications of a personal guarantee.

The Future: The IRS has tolerated no-fee family guarantees for multiple decades without imposing a gift tax on these arrangements. But the winds may be changing in the continuing search for more tax revenues. Going back to *Dickman,* the Supreme Court recognized that a gift may arise when an individual makes property available for another's use. Later the IRs had some court success when it had an appellate court recharacterize a guaranteed loan as a loan from the lender to the guarantor, followed by a transfer from the guarantor to the borrower. *Plantation Patterns v. Commissioner, 462 F.2d 712 (5th Circuit, 1972.)* This decades-old decision might be revisited by the IRS to recast a personal guarantee furnished to a loan to a family member as a taxable gift, even when the determination of the amount of the gift is difficult to calculate, and even if the personal guarantee is never called upon for payment.

Thoughts: The implications of the *Dickman* decision are interesting. The Court held that an individual is free to waste the value of his/her money by not taking advantage of that value themselves., which does not cause a taxable gift to be made. However, *"if the taxpayer chooses to not waste the use value of money…but instead transfers the use to someone else, a taxable event has occurred."* The Court essentially said, applying this principle to a loan guarantee situation, that an individual is free not to use his/her borrowing capacity to make investments themselves, but if they choose to transfer that borrowing capacity to their family members, that becomes a taxable gift.

Conclusion: If a parent/grandparent is asked to personally guarantee a loan to a family member, it would be wise to report that personal guarantee on a Form 709 Gift Tax Return each year that the guarantee is outstanding.

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