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Jeffrey, Below is an excerpt from a 50 page Virginia Tax Review article on gifting of intra family transfers:

### 3. Loan Guarantees

The most far-reaching extension of Dickman has occurred in the context of loan guarantees. Nearly twenty years ago, George Cooper reported the "very popular" practice of parents guaranteeing commercial loans to their children, and stated that it was "clear that such a gift of credit is not subject to transfer taxation." n254 In Private Letter Ruling 91-13-009, n255 however, the Service relied on Dickman to take a contrary position.

In that ruling, Parent guaranteed commercial loans obtained by his five adult Children to finance their acquisition of target companies. The lenders required Parent to guarantee the loans; n256 absent such guarantees, Children either would not have been able to secure the financing or would have had to pay a higher interest rate. n257 The guarantees were unsecured, would remain outstanding until repayment of the loans, and would survive Parent's death as claims against his estate. n258 The Service ruled that under Dickman the loan guarantees constituted transfers of valuable economic benefits from Parent to Children on the date the agreements were executed. In addition, if any of the Children ever defaulted on

[\*398] their obligations and Parent had to honor his guarantee, there would be an additional gift at that later time. n259

Commentators widely criticized the Service's application of Dickman to loan guarantees. n260 In their criticism, they emphasized (i) the difficulty in valuing the guarantee; (ii) the lack of support for the result under the estate depletion purpose for the gift tax; (iii) the possibility of double taxation if Parent were forced to honor the guarantee; and (iv) the administrative problems spawned by the ruling. Several of these commentators also placed the loan guarantee ruling in the context of the Service's prior use of Dickman to attack estate freezes and GRITs, and speculated

[\*399] about the effect of Snyder on the Service's position. n261

In applying the first Snyder prong of an ascertainable and objective measuring rod to value the gift, the loan guarantee may be harder to value than the foregone interest on the loan in Dickman but easier to value than the foregone return on the preferred stock investments in Snyder and Hutchens. For example, the guarantee could be valued by reference to the cost of a comparable guarantee by a surety company or by the reduction in the interest rate on the underlying loan made possible by the guarantee. Under the second Snyder prong, the availability of assets to fund the payment of the foregone guarantee fee would depend on further analysis of the Children's other assets and the performance of the acquired businesses. Moreover, although a loan guarantor may be more analogous to the lender in Dickman than the preferred stock holder in Snyder and Hutchens, the Service's position in extending Dickman to loan guarantees would confront the Tax Court's reluctance to extend Dickman beyond the interest-free loan context.

Numerous letters were sent to the Treasury Department protesting the result in the ruling, n262 and one commentator advocated change through the promulgation of regulations, enactment of remedial legislation, or issuance of a revised ruling. n263 Each of these avenues was pursued with varying degrees of success.

The Office of Chief Counsel opened a regulation project on the "gift tax treatment of loan guarantees" in October 1992, n264 but over two years later, the Service has not yet issued any guidance. n265

[\*400] Bills have been introduced to add new section 2503(h) to explicitly exempt loan guarantees by parents from the gift tax, n266 but they have not been enacted. In any event, after many public statements that it would revise the ruling, n267 the Service recently withdrew the ruling and "expressed no opinion at this time" about the gift tax treatment of the loan guarantee. n268 As a result, "taxpayers are left to speculate on the IRS's current thinking" on the gift tax treatment of loan guarantees. n269

n254 Cooper, Voluntary Tax, *supra* note 56, at 33; *Cooper, New Perspectives, supra* note 56, at 186.

n255 1990 PRL LEXIS 3431 (Dec. 21, 1990).

n256 *Id.* at \*1-2 Parent also guaranteed obligations of corporations in which he owned an equity interest. *Id.* These guarantees did not present a gift tax issue but were relevant to the marital deduction issue raised in the ruling. See *infra* note 259.

n257 1990 PRL LEXIS 3431, at \*8.

n258 *Id.* at \*2-3.

n259 *Id.* at \*8-9. The ruling also raised a controversial estate tax marital deduction issue. As noted above, if Parent died before all of the loans subject to guarantees were repaid, Parent's estate would become liable for the outstanding guarantees. As a result, property that passed to two marital trusts that otherwise would qualify for the marital deduction could become subject to the payment of the guarantees. Specifically, property equal to two times the "Net Value Cost" of making payments on the outstanding guaranteed loans (twice the present value cost of satisfying the guarantees) would be allocated to the Estate Trust. The residue of the estate would be allocated to the QTIP Marital Trust. *Id.* at \*3-4. The Service ruled that the marital deduction for property passing to the Estate Trust had to be reduced by the face amount (not the "Net Value Cost") of the outstanding guarantees that could be satisfied out of such property because the guarantees could be triggered at any time. Moreover, the entire Marital Trust (not just the face amount) would not qualify as a QTIP trust for marital deduction purposes because someone other than the surviving spouse (the lender) could have an interest in the property during her lifetime. *Id.* at \*12-19.

n260 See Jerald D. August, Ltr 9113009: An Ailing Ruling in Need of a Cure (What Is the Proper Diagnosis for Guarantees?), *54 Tax Notes* 215 (1992); Jerald D. August & Joseph J. Kulunas, Guarantees Have Unexpected Gift Tax and Marital Deduction Consequences in IRS Ruling, *74 J. [REDACTED] 346* (1991); Reed W. Easton, The IRS's General Aversion to Loan Guarantees on QTIP Trust Planning, *24 Tax Adviser* 447 (1993); Nicholas J. Fiore, Parent's Guarantee of Children's Business Loans Results in Taxable Gift, *22 Tax Adviser* 543 (1991); Waller H. Horsely, Guarantees Without Consideration, *42 Tul. Inst. on Fed. [REDACTED] 15-1* (1992); Burton W. Kanter & Sheldon I. Banoff, IRS Inaction on Loan Guarantee Ruling Is Perplexing, *77 J. [REDACTED] 190* (1992); Burton W. Kanter & Sheldon I. Banoff, IRS Seems Unsure of the Estate Planning Consequences of Loan Guarantees, *76 J. [REDACTED] 130* (1992); Anne J. Palmer O'Brien, Loan Guarantees and the Estate Tax Marital Deduction, *32 Tax Mgmt. Mem.* 359 (1991); Jacques T. Schlenger et al., Despite Prior Ruling, Service States That Loan Guarantee Was Not Taxable Gift, *19 Est. Plan.* 173 (1992); Jacques T. Schlenger et al., Guarantee of Loan is Taxable Gift and Also Limits Marital Deduction, *IRS Rules*, *18 Est. Plan.* 300 (1991); Michael Schwartz, *PLR 9113009* and the Gift Tax Consequences of Loan Guarantees, *92 Tax Notes Today* 254-97 (Dec. 21, 1992); Lee A. Sheppard, Estate Planning for the Middle Class, *52 Tax Notes* 749 (1991); Dale L. Sorden, *PLR 9113009*: The Chaos Continues, *58 Tax Notes* 982 (1993); A.L. Suwalsky, Jr., The Camel's Nose in the Tent: Private Ruling Holds Guarantee is Taxable Gift, and More, *7 Tax Mgmt. Real Est. J.* 120 (1991); Wolff, *supra* note 82, at 542, 553-53; Private Ruling Suggests Large Potential Problems for Individuals Who Guarantee Loans, *16 Est., Gifts & Tr. J.* 148 (1991).

n261 See August, *supra* note 260, at 218-19; August & Kulunas, *supra* note 260, at 350; Easton, *supra* note 260, at 450; Horsely, *supra* note 260, at 15-4 to 15-5; Wolff, *supra* note 82, at 553-54.

n262 See, e.g., Letter from Jerald D. August to James Miller, Tax Legislative Counsel (Aug. 8, 1991), *91 Tax Notes Today* 167-32 (Aug. 9, 1991); Letter from Judi McCormick & Henry Ruempler, American Bankers Association, to Internal Revenue Service (Feb. 18, 1993), *93 Tax Notes Today* 66-38 (Mar. 24, 1993); Letter from Thomas P. Sweeney, American College of Trust and Estate Counsel, to Shirley D. Peterson, Commissioner of Internal Revenue Service (Nov. 16, 1992), *92 Tax Notes Today* 237-25 (Nov. 27, 1992); Letter from Philip J. Wiesner, KPMG Peat Marwick, to Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy) (Aug. 12, 1992), *92 Tax Notes Today* 170-44 (Aug. 20, 1992).

n263 August, *supra* note 260, at 221.

n264 Chief Counsel's Office Opened Nine Rules Projects in October, *IRS Says, BNA Daily Tax Rep.*, Dec. 4, 1992, at G-2.

n265 Although an internal draft of the regulation has been circulated (Special Supplement, Report by Office of Chief Counsel, Internal Revenue Service, On Regulations Projects Status and Dispositions as of Feb. 28, 1994, BNA Daily Tax Rep., Apr. 15, 1994, at 38), there has been no public disclosure of the contents of the draft.

n266 Proposed section 2503(h)(1) provides that "the mere making of a 'qualified guarantee' shall not be treated as a transfer of property by gift." A "qualified guarantee" is defined as any guarantee by an individual of a loan to a lineal descendant (or their spouses), or to a business entirely owned by such descendants. H.R. 504, 103d Cong., 1st Sess. section 3 (1993); H.R. 4166, 102d Cong., 2d Sess. section 3 (1992). The sponsor stated that the intention of the bill is to reverse Priv. Ltr. Rul. 91-13-009 because the ruling "jeopardizes the financial security of parents who guarantee loans to children hoping to start their own business, buy their own house, or finance a college education." 138 Cong. Rec. H291 (daily ed. Feb. 5, 1992) (statement of Rep. Darden).

n267 See, e.g., Juliann Avakian-Martin, Service Plans To Revise Loan Guarantee Ruling, Says Grosgebauer, 92 Tax Notes Today 53-28 (Mar. 9, 1992); Juliann Avakian-Martin & Kathleen Matthews, FBA Tax Section Conference: IRS Asks Help on Partnership Regs; Loan Guarantee Ruling To Be Revised, 54 Tax Notes 1316 (1992); Schwartz, supra note 260, at 2-3 n.13; Sheppard, supra note 260, at 750; Estate and Gift Tax Consequences of Guarantees: Status of *PLR 9113009* Remains Uncertain, 33 Tax Mgmt. Mem. 202 (1992); In Brief, 11 Tax Mgmt. Weekly Rep. 373 (1992); Loan Guarantee Inquiry Elicits Surprise Response, 33 Tax Mgmt. Mem. 92 (1992).

n268 *Priv. Ltr. Rul. 94-09-018*, 1993 PRL LEXIS 2516, at \*9 (Dec. 1, 1993). The ruling also modified the position in the prior ruling on the availability of the estate tax marital deduction. See supra note 259. The Service stated in the revised ruling that the marital deduction for property passing to the Estate Trust would not be reduced by the face amount of the outstanding guarantees unless, at the time of Parent's death, a default was likely, the trust assets would be used to pay the entire unpaid balance of the loans, and the subrogation rights were worthless. 1993 PRL LEXIS 2516, at \*1. The Service stated that, for marital deduction purposes, a loan guarantee is indistinguishable from a note; in both cases, there is a risk of loss if the borrower defaults and is incapable of repaying the loan. Just as the presence of a note does not disallow a marital deduction for assets passing to a QTIP trust, the presence of a loan guarantee as an encumbrance on assets passing from Parent to his spouse would not completely disallow the marital deduction otherwise available. Id. at \*6-9.

n269 IRS Finally Modifies Its Position Regarding Loan Guarantees and the Marital Deduction, 80 J. [REDACTED] 258, 258 (1994); see also IRS Withdraws Controversial Ruling on Effect of Loan Guarantees on Marital Deduction, RIA Est. & Financial Planner's Alert, Apr. 1994, at 4, 5 (Service "does not now have a position on the gift tax consequences of the transactions described in the ruling," and matter is "under study"); Loan Guarantee Ruling Requiring Reduction and/or Disallowance of Marital Deduction Withdrawn, 35 Tax Mgmt. Mem. 133 (1994) (Service did not address gift tax consequences); Sec. 2056 -- Bequests to Surviving Spouse, 13 Tax Mgmt. Weekly Rep. 357 (1994) (Service did not comment in ruling on gift tax consequences of loan guarantee but is expected to address issue in forthcoming regulations); Service Modifies "Guarantee Ruling," 19 Est., Gifts & Tr. J. 111 (1994) (Service did not address gift tax consequences).

In any event, the question of the proper gift tax treatment of loan guarantees may be largely a theoretical one. As noted above, the Service's concern is that the parent's guarantee may permit her children to borrow money at rates lower than the children otherwise would be able to secure. In most if not all cases, even this lower interest rate would equal or exceed the applicable federal rate under *I.R.C. section 7872*. Thus, to avoid any potential gift tax exposure, parent instead could borrow the money and relend it to the children at the applicable federal rate. This transaction highlights the weakness of the safe harbor interest rates created under section 7872 regardless of the actual credit worthiness of the borrower. See supra note 148.

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