Guarantee Fee Analyses Gaining Momentum

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Financial institutions commonly require personal guarantees in connection with business loans, especially when there is any uncertainty regarding the collateral and risk inherent in the arrangement. It is also simply a method for the banks to reduce risk and ensure compliance with internal guidelines or standards imposed by regulatory authorities. When wealth transfer strategies involve loans with personal guarantees, practitioners must be aware of potential gift tax consequences.

The following is an example with facts similar to that of a recent case. Let us assume that the majority shareholder of a privately held operating company ("ABC") previously transferred stock of ABC into a trust and wants to move additional shares into that same trust. The shareholder and his advisors determine that they would like the trust to purchase the shares using borrowed funds. Representatives of the trust engage a financial institution and arrange for the financing, but the financial institution requires that the majority shareholder provide a personal guarantee. The majority shareholder has significant other assets, so this guarantee meaningfully de-risks the loan and provides a safety net should the ABC stock decline in value.

We must now deal with the gift tax ramifications of the guarantee. There are two basic approaches, the first being to establish a guarantee fee that is to be paid by the trust to the guarantor either in one lump sum or periodically over time. This is akin to an insurance premium and the level of fee should be commensurate with the risk taken by the guarantor. A business valuation firm can be engaged to determine the appropriate fee. In the alternative, if there is no desire for the fee to be paid, a gift has been made by the guarantor to the trust, and the business valuation firm can be engaged to value the gift. This valuation is generally made by computing the present value of the guarantee fee that would have been charged.

A second illustration is reflective of situations common in the private equity space. Imagine an individual ("Mr. Smith") has committed $5.0 million to a newly formed private equity fund ("PEF"), and wishes to transfer 20% of his limited partnership interest in PEF to a trust for the benefit of his descendants. The valuation of Mr. Smith's interest is based in large part on the capital account balance on the date of transfer. However, the transfer includes the obligation to fund the remaining commitment. The transferee, in this case a trust, does not have the funds sufficient to make those capital contributions. The trust obtains funding from a financial institution, but that institution requires a personal guarantee from Mr. Smith in order to make the loan. Mr. Smith and the trust should enter into a guarantee fee arrangement to avoid a gift, or should report a gift having been made if there is no desire to install such a fee. A business valuation firm would be needed in either case to determine the appropriate guarantee fee.

Guarantee fees are typically due and payable on an annual basis from the initial date of the arrangement until the date of its termination. A guarantee can be likened to a standby letter of credit ("SLOC"). *Barron's Dictionary of Banking Terms* defines a SLOC as "a contingent (future) obligation of the issuing bank to make payment to the designated beneficiary if the bank's customer fails to perform as called for under the terms of a contract."

SLOC Cost + Guaranteed Fee Factors

The cost to obtain a SLOC from a financial intermediary is typically a percentage of the face amount on an annual basis. Similarly, this provides the business valuation firm with a starting point in determining the market rate for the guarantee. Certain factors that impact the concluded guarantee fee include, but are not limited to, the following:

- Collateral underlying the note
- Nature of payments (interest only versus equal payments, etc.)
- Prepayment plan (if any)
- Maturity of note
- Amount of principal subject to the guarantee
- Credit analysis of the borrower (including other underlying assets)
- Capital market rate evidence/interest rate environment

Once all factors are considered, the business valuation firm is able to determine the market rate of the guarantee fee. This market rate represents the rate that the Trust would pay to Mr. Smith for the Guarantee of the Note as if the two parties were negotiating at arm's length.

If your client or a trust is involved in a loan arrangement similar to those described herein, have you provided for the appropriate guarantee fee to your Mr. Smith or have you contemplated the potential gift that was made?

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