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Guarantees: Are They Ever Income?

By Jonathan Van Loo • Wood LLP • San Francisco

While measuring the financial benefit of deferring tax payments may be complex, it is based on a simple principle: Taxpayers can earn an investment return on the amount of tax that is deferred during the deferral period. This simple principle is widely appreciated—employees participate in nonqualified deferred compensation plans; settlement recipients seek to structure their settlement payments; lawyers seek to structure their fees; and sellers of stock seek installment sale treatment. In each case, taxpayers are seeking deferral.

In these situations, there is a tension between the taxpayer's quest for greater security in the realization of future payments and the unpleasant reality of current taxation. The economic-benefit doctrine was originally based on what appeared to be the intuitive and simple concept that taxpayers should be taxed on the present value of the current economic benefit of a highly secure future payment. However, the economic-benefit doctrine has become highly driven by form rather than principle or common sense. As such, it requires tax lawyers to pay careful attention to the nuances of credit and security arrangements.

In fact, the taxpayer *may* receive the economic benefit of a credit support arrangement (in a real economic sense) without necessarily triggering current taxation (a condition based on "economic benefit" in a tax sense). A great deal depends not only on the details of the credit support arrangement but also on the context of the deferral arrangement. Under established case law and IRS rulings, stricter rules apply to nonqualified deferred compensation arrangements. In this article, I consider the impact on the economic-benefit doctrine of two common types of security arrangements: trust agreements and guarantees.

Economic Benefit of Security Arrangements

A transfer of assets to a trust is a common method to obtain greater security for future payments. In *E.T. Sproull,* 16 TC 244, Dec. 18,080 (1951), the employer established a trust and instructed the trustee

to pay half of the proceeds to the employee the following year and the remainder in the year after that. Under the constructive receipt doctrine, a taxpayer can be currently taxed on the *right* to receive money even if the money has not yet *actually* been received.

In *Sproull*, the court held that the constructive receipt doctrine did not apply because the taxpayer did not receive any money and had no right to receive any money in the year the trust was formed. However, the court ruled that the transfer of funds to the trust was taxable at that time because it conferred a present economic benefit on the employee. Crucially, the taxpayer in *Sproull* could freely assign or alienate his interest in the trust.

Under the cash-equivalency doctrine, a taxpayer is taxed on the receipt of a note or other negotiable or marketable financial instrument. The theory is that such an instrument can be easily converted to cash and thus represents taxable income with a definite value. Thus, the court in *Sproull* arguably could have reached the same result on the basis of the cash-equivalency doctrine. Not so in *T.B. Drescher,* CA-2, 50-1 USTC ¶9186, 179 F2d 863 (1950), where an employer purchased annuity contracts for the benefit of its employee.

The annuity contracts in *Drescher* provided the employee with the security of knowing that the employer had purchased assets to fund its future obligation. However, the employer kept possession of the annuity contracts. Moreover, the employee could not assign or otherwise alienate his interest in the annuity contracts.

Nevertheless, the court held that the employee was taxable in the year the annuity contracts were purchased. The court reasoned that the employee had received a *present* economic benefit from the right to receive payments in the *future*. The court struggled with how to *value* that present economic benefit, however, and suggested that the value of the benefit was less than the amount of the annuity premium paid by the employer.

Valuation Problems

The difficulty of valuing a promise to pay, even if it is secured by the transfer of assets to a trust or the purchase of annuity contracts, has led courts to conclude that the promise is *not* currently taxable. For example, in *Denver & R. G. W. R. Co.*, CtCls, 63-2 USTC ¶9524, 318 F2d 922 (1963), the taxpayer was a railroad company that purchased the Pullman sleeping car business as part of a consortium of railroad businesses. Following the acquisition of Pullman stock, the railroad company received a "car note" in 1947 as a taxable distribution.

According to the terms of this car note, the railroad company could elect either to use the face amount of the car note to purchase railroad cars immediately or to receive cash in the future. The railroad company elected to receive cash, which it received two years later in 1949. The court held that the promise to pay in the future did not confer an economic benefit that was currently taxable.

Yet the court still held that the dividend was properly received in the year of distribution of the car note. The court explained that the dividend was taxable because the railroad

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company had the immediate right to take possession of the sleep cars. By contrast, according to the court, a nonnegotiable, nonassignable and nontransferable promise to pay does *not* have any market value and therefore does *not* represent income.

While acknowledging contrary authority in *Drescher*, the court considered the valuation difficulty to be so great that the court held that the receipt of an unmarketable promise to pay did not represent taxable income. To hold otherwise, explained the court, "would thrust both taxpayers and the Internal Revenue Service into the briar patch of valuation-sans-market." [318 F2d, at 928, *supra*.] This decision thus appears to be a variant of the "open-transaction" doctrine.

In an open transaction, the taxpayer is permitted to defer the recognition of income as a concession to the difficulty of determining the actual amount realized. However, a promise to pay a stated amount in two years would not qualify for open-transaction treatment under the current rules. In general, open-transaction treatment is only permitted when the fair market value of a "contingent payment obligation" cannot reasonably be determined. [Reg. §15(a).453-1(d)(2)(iii).]

Would the outcome of the *Denver* case have been different if the government had presented evidence concerning the value of specific features of the promise to pay? For example, what if there were evidence concerning the creditworthiness of the Pullman business or the price of notes issued by corporations with similar credit ratings? Because these factors were not discussed, it appears that this type of evidence would not have influenced the court. Therefore, the court appeared to hold that a nonnegotiable, nonassignable and nontransferable promise to pay is not capable of valuation as a matter of law rather than as a matter of fact in this particular case.

Although they arrive at different conclusions, *Drescher* and *Denver* both identify the same problem: An economic benefit has arguably been conferred, but it is difficult to value. On the one hand, the court in *Denver* held that the valuation problem was so severe that a mere unsecured promise to pay that is not assignable or marketable does not result in taxable income to a cash basis taxpayer. On the other, the court in *Drescher* concluded that a promise to pay has *some* value. The court considered various factors—such as the ability of an annuitant to change the beneficiary—that might impact and influence that value. In the eyes of the *Denver* court, the *Drescher* court took the inadvisable step of leaping into the briar patch!

Securing a Promise to Pay: Rabbi Trusts

In Rev. Rul. 60-31, 1960-1 CB 174, the IRS did not even mention the difficulty of valuation. Instead, the IRS simply explained that a mere promise to pay, not secured by notes or other negotiable instruments, does not result in income to a cash basis taxpayer. Later, the same proposition was included in the Code Sec. 83 regulations, which state that for purposes of Code Sec. 83, property does not include an unfunded and unsecured promise to pay. [Reg. §1.83-3(e).] What began as a concession to the difficulty of valuing a nontransferable and unsecured promise to pay eventually became a matter of law.

Courts have sometimes alluded to the difficulty of valuation even after the rulings discussed above. For example, in *R.H. Minor,* CA-9, 85-2 USTC ¶9717, 772 F2d 1472, 1474 (1985), the Ninth Circuit explained that the economic-benefit doctrine only applies if the employer's promise can be valued. However, the Ninth Circuit explained that valuation is only possible when, among other requirements, the employer makes a contribution that is secured against the employer's creditors by a trust arrangement.

Interestingly, the Ninth Circuit phrases the issue as a valuation problem; yet in actuality, a broader principle is at stake. Even before the IRS blessed a "mere promise to pay" in its 1960 ruling, there was authority for the same proposition outside the deferred compensation area. For example, in *H.W. Johnston,* 14 TC 560, Dec. 17,578 (1950), the taxpayer sold stock in exchange for a payment of 50 percent of the purchase price up front.

The balance was to be received after providing a balance sheet of the target. The sellers were creditworthy and deposited the balance of the purchase price in escrow in the contract year. Nevertheless, the court held that the taxpayer only received the money in the following year when the balance was released from escrow.

It is difficult to reconcile *Johnston* with *Drescher*. Arguably the only difference is that *Johnston* dealt with the sale of stock rather than employee compensation. Concepts of receipt and benefit are inherently more sensitive with employees and service-related income—everyone has seen the "pay-me-next-year" predicament.

Be that as it may, the IRS's concession in the 1960 ruling proved to be a pivotal change in the economic-benefit doctrine. Taxpayers could now take advantage of the legal fiction that a mere promise to pay did not confer an economic benefit. Rabbi trusts arguably test the outer limits of what constitutes a "mere promise to pay."

In the rabbi trust ruling, a congregation created a trust to benefit a rabbi. [LTR 8113107 (Dec. 31, 1980).] Although the trust was irrevocable, the trust assets were subject to the claims of the congregation's creditors. Because the trust discharged the congregation's liability to the rabbi, it generally qualified as a grantor trust. [*See* Reg. §1.677(a)-1(d) (grantor treated as owner of trust whose assets are used to discharge liabilities of grantor).] Therefore the trust's assets were treated as owned by the congregation and the rabbi did not receive any economic benefit.

Defining "Defeasance"

The rabbi trust ruling provided a method for employees to obtain considerable security for future payment, but the trust assets in the ruling remained subject to the grantor's general creditors. Outside the context of compensation arrangements, this strict rule does not necessarily apply. For example, in Rev. Rul. 85-42, 1985-1 CB 36, a corporation established a trust as part of a defeasance.

In a defeasance, an issuer of a bond transfers assets sufficient to satisfy its obligations under the bond to a trust. The trust's assets consist of Treasury Bonds or other "risk-free" instruments such as agency bonds. The purpose of the trust is to assume the obligations of the issuer under the bond.

Why would an issuer want to defease its obligations under a bond? One common motivation is that the issuer wishes to be released from the covenants that it entered into with the bond holders at the time of issuing the debt. However, for reasons explained below, the bond documents will typically not permit the issuer to enter into a *legal* defeasance. Instead the issuer is normally limited to an "in-substance" defeasance.

As a practical matter, defeasance can be expensive for issuers because an issuer will typically pay a higher interest rate on the debt that it issues than it can earn on the government securities that it transfers to the trust. (To state it in a different way, a bond issued by the corporation with the same maturity and same interest rate will typically fetch a lower price than a Treasury Bond.) Therefore, it would normally be cheaper for the issuer to buy back its bonds than to create a defeasance trust.

While an early redemption of the bond might be a cheaper option, it is not always feasible. Early redemption requires a consent solicitation, which itself may be a difficult and expensive process. Thus, defeasance may be the only option for an issuer to free itself of its bond covenants.

In Rev. Rul. 85-42, the issuer transferred assets to an irrevocable trust whose assets were not subject to the claims of the issuer's creditors. Crucially, following the transfer of assets to the trust, the corporation remained legally liable for the bonds. Because the debt was treated as extinguished for financial accounting purposes, it was known as an "in-substance" defeasance.

Because the corporation had a reversionary interest in the trust, the trust appeared to qualify as a grantor trust. Critically, the IRS ruled that the corporation remained the owner of the trust assets. But what about the bond holders?

Under the *Cottage Savings* Regulations, what matters most is that the obligor must remain *legally* liable for the debt. If so, this type of defeasance will not result in a "significant modification" of a corporate bond, and thus will not be a taxable event for the bond holders. [*See* Reg. §1.1001-3(d), Example 5.] Following an "in-substance" defeasance, the issuer no longer has any *economic* liability for the bonds. However, to avoid triggering undesirable tax consequences, particularly to the bond holders, the issuer will typically agree to remain *legally* liable.

The IRS has approved of at least one structure involving in-substance defeasance of an annuity issuer's obligations under a qualified settlement structure. In LTR 200423024 (Nov.

26, 2003), a parent corporation ("Parent") was seeking to sell a subsidiary to a purchaser ("Buyer"). However, the subsidiary had entered into structured settlement transactions.

In these transactions, the subsidiary accepted qualified assignments of personal injury liabilities. To cover its liability under the qualified assignment agreements, the subsidiary purchased annuity contracts from an affiliate of the Parent ("Issuer"). The Buyer and the Parent agreed that, upon demand by the Buyer, the Issuer would establish a trust ("Trust") as security for its obligations under the annuities.

The subsidiary was the beneficiary of Trust and Issuer was the grantor. Issuer had the right to substitute, exchange and make all investment decisions for Trust assets. However, Issuer was required to maintain a required balance and only certain types of approved assets could be used.

The subsidiary only had the right to make a demand against Trust assets if there was a payment default on an annuity that related to a qualified assignment. By entering into this arrangement, Buyer was able to defease the subsidiary's qualified assignment obligations. Citing Rev. Rul. 85-42, the IRS concluded that Issuer would remain the owner of Trust assets.

In the deferred compensation area, tolerances are smaller. Indeed, the IRS will only rule on rabbi trusts that include a provision stating that the trust assets remain subject to the claims of the grantor's creditors. [*See* Rev. Proc. 92-64, §5.02(d), 1992-2 CB 422.] Moreover, even outside deferred compensation, the IRS has made it clear that the ruling is limited.

For example, in Rev. Rul. 99-14, 1999-1 CB 835, the IRS distinguished "in-substance defeasance" of a corporate bond from defeasance in the context of a LILO transaction. In the LILO transaction, a taxpayer "defeased" its obligations to make payments to a lender under a loan agreement by agreeing to receive an offsetting stream of rental payments that was highly secured. The IRS distinguished in-substance defeasance by explaining that, in the LILO transaction, the defeasance arrangement existed from the inception of the transaction. Therefore, the IRS did not respect the loan and lease as separate arrangements in the LILO transaction.

Guarantees

If an irrevocable trust does not confer an economic benefit, what about a guarantee? In the seminal case on structuring attorney's fees, a promise to pay did not result in an economic benefit even when it was backed up by a guarantee. [*R.A. Childs*, 103 TC 634, Dec. 50,239 (1994), *aff'd*, CA-11, 96-2 USTC ¶50,504, 89 F3d 856 (1996).] In *Childs*, the attorneys successfully structured their fees by assigning their right to the fees to an insurance company affiliate *before* the attorneys earned the fee. In exchange, the attorneys received a promise of future payments, but the attorneys did not have the right to assign, transfer, sell, accelerate or defer the future payments.

While the insurance company affiliate purchased annuity policies to fund its obligations, that affiliate remained the owner of the policies that were subject to the claims of its general creditors. The guarantee of the issuers effectively meant that the attorneys did not have to concern themselves with the creditworthiness of the affiliate. Nevertheless, the court in *Childs* dismissed the significance of the guarantee by explaining that the guarantee merely constituted a *second* promise to pay.

In *Childs*, the IRS argued that the attorney's rights went beyond a mere promise to pay. After all, the promise was backed by a guarantee. Moreover, the guarantors were subject to insurance regulations requiring them to maintain adequate reserves.

However, this argument failed in the face of the Treasury's own definition of property under Code Sec. 83, which excludes an unfunded and unsecured promise to pay. Thus, the guarantee was merely a second promise to pay. Furthermore, the regulatory requirement to maintain adequate reserves did not create a separate pool of funds that was remote from the claims of creditors of the guarantors.

The attorneys in *Childs* had structured the arrangement to virtually—but not quite—become the owners of the underlying annuity policies without triggering current income. Under the terms of the agreement with the payor of the future periodic payments, the attorneys could not assign or accelerate their right to future payments, bringing into question whether those rights were marketable and capable of valuation. However, the court did

not even attempt to justify its decision on the basis of the difficulty of valuing the attorneys' payment rights.

Surely the attorneys' payment rights had a value that was virtually the same as the underlying annuities. But perhaps an argument could be made that there would be a slight discount in the value of the annuities due to the attorneys' tax benefit from the transaction. The tax motivation behind the transaction may have allowed the issuers to charge a higher price for the annuity.

The limitations on transferability were critical to the court's holding in *Childs*. For example, if the contract right to payment is *assignable*, then the holder of the contract is taxable on the present value of the contract right in the year of receipt. [*Cf.* Rev. Rul. 68-606, 1968-2 CB 42.] However, these restrictions are not absolute. In one case a taxpayer successfully deferred payments under one deferred compensation arrangement by entering into a new deferred compensation arrangement. [*Olmstead Inc. Life Agency*, CA-8, 62-2 USTC ¶9511, 304 F2d 16 (1962).] Certainly he did so before he had any right to payment under the old contract.

Similarly, in LTR 200918001 (Nov. 3, 2008), a structured settlement recipient entered into a factoring transaction to receive the present value of part, but not all, of the future structured settlement payments. Even though the recipient would presumably have been able to accelerate all of her payments, the IRS ruled that the new factoring agreement was not readily saleable.

In spite of the IRS's position in *Childs*, Congress has permitted guarantees in the context of installment sale obligations. [Code Sec. 453(f)(3).] Moreover, Treasury Regulations extend this beneficial treatment to standby letters of credit. [Reg. §15(a).453-1(b)(3)(iii).] Therefore, sellers that benefit from installment sale treatment can obtain the security of a guarantee without triggering an economic benefit.

Guarantees and Deferred Compensation

It appears that the IRS has not yet considered the impact of a guarantee by a financial institution in the context of nonqualified deferred compensation arrangements. However, the IRS has ruled that the purchase of a surety bond to guarantee the future payment of lottery or gambling winnings does not result in an economic benefit. [*See* LTR 9241006 (June 30, 1992); LTR 8923020 (Mar. 10, 1989).] In both rulings, the IRS explicitly stated that the rulings were limited to a nonemployment context. The IRS warned that in the employment context, they might interpret a promise to pay secured by a surety bond to qualify as "property" under Code Sec. 83.

In LTR 9344038 (Aug. 2, 1993), the IRS blessed an arrangement in which the employee obtained insurance for future deferred compensation payments. The employer did not participate in the negotiations or provide any information to the insurer. The insurer only relied on public information about the employer. The employer did not transfer property to the employee that was set aside from the employer's creditors.

[A] different rule seems to apply to holders of corporate bonds when the corporation creates a defeasance trust.

Conclusion

Common sense suggests that an unfunded and unsecured promise to pay surely confers an economic benefit, and such an economic benefit arguably has a present value. Nevertheless, it has long been established that such a promise does not trigger the economic-benefit doctrine.

Moreover, this tax fiction has become extended to trusts and guarantees. What began as a concession to the difficulty of valuation has become a highly formalistic rule. Even if an unfunded and unsecured promise might be difficult to value, the IRS has not consistently allowed the valuation difficulties for guarantees to dictate the tax results.

For example, in LTR 9113009 (Dec. 21, 1990), a father provided a guarantee to corporations that were part-owned by his children. The IRS ruled that the guarantees constituted "valuable economic benefits" that would be subject to the gift tax. However, the ruling was silent on how the benefit would be valued.

The American Bar Association Section of Taxation recently provided comments to the IRS and recommendations that guidance be issued to taxpayers on the transfer pricing of related-party guarantees. They explained that the value of the benefit conferred by a guarantee might be determined through several different methods. The yield method (estimating the change in yield on a debt instrument as a result of a guarantee) appears to be the most prevalent of these valuation methodologies. [*See* American Bar Association Tax Section, "Practical Considerations for Dealing with the Pricing of Guarantee Arrangements," available at *www.meetings.abanet.org/webupload/commupload/TX357000/newsletterpubs/tp-guarantee-fedina-slides.pdf* (last checked September 30, 2012).]

There does not appear to be any consistent treatment of trust arrangements or guarantees in different contexts. The assets of a trust must remain subject to a grantor's creditors in the deferred compensation area. However, a different rule seems to apply to holders of corporate bonds when the corporation creates a defeasance trust.

In the deferred compensation context, guarantees from financial institutions do not appear to be permitted (unless the employee purchases the protection at his or her own expense). In contrast, guarantees are fully permissible in the installment sale context. Moreover, following *Childs*, they appear to be permissible in the structured settlement area as well.

These distinctions do not appear to be based on any general tax principle. In fact, they seem to have evolved into a series of highly formalistic rules that vary depending on the particular context. And unfortunately for the taxpayer, analogizing from one context to another can be hazardous.