The Advantages of Selling Appreciated Assets via a Structured Sale

A structured sale is a type of installment sale that provides the seller with a guaranteed payment stream from an assignment company. This article discusses how a structured sale works and its tax implications.

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Executive Summary

- **A structured sale is an obvious choice to consider to create a secure, fixed base of tax-deferred income.**
- **In a structured sale, the seller gets a guaranteed payment stream from an assignment company, without serious risk of either nonpayment or acceleration.**
- **A structured sale is eligible for installment sale reporting, and the assignment by the buyer is not a disposition.**

Today, many people are selling businesses, houses and commercial real estate at record levels and setting up retirement funds with the proceeds. Paying tax on the sale of appreciated property later is better than paying it today. How can one delay the tax bill?

Income averaging used to be one way to reduce and stretch out tax obligations, but it was eliminated many years ago. A better approach is an installment sale, which simply involves taking sale proceeds over a number of years, and allowing them to grow on a pre-tax, rather than a post-tax, basis. This article de-scribes the structured sale, which is a blend of an installment sale and a guaranteed payment stream.

Installment Sale Pitfalls

An installment sale appears straightforward. Indeed, it seems that little could go wrong from a tax standpoint. Yet, the history of installment sales discussed below suggests otherwise.[1] Understandably, installment sellers want to ensure that stretching out payments does not make ultimately being paid less likely. The foibles of traditional installment sales bring up an important point. Although installment sellers are concerned about being paid in general, what they really want is the security (and tax efficiency) of a payment stream over many years to secure retirement, achieve traditional tax deferral, serve asset protection goals, etc.

Security Interests

The installment seller can take back a security interest in sold property (such as a mortgage on real estate or a Form UCC-1, National UCC Financing Statement on inventory), but that often represents inadequate security. A security interest in real estate can be comforting when in first position, but in a business context it rarely gives much protection, because usually there are plenty of other creditors and it is not possible to jump ahead of them all. Besides, repossessing sold property is cumbersome and inconvenient, even if the seller can flip it.

Letter of credit: An installment sale note may be backed by a standby letter of credit that the seller can present for payment on a default. Although a letter of credit is far more efficient than collecting on a traditional security interest, most banks will issue one for only 12 months at a time. That means there are generally cumbersome renewal provisions in the note, purchase and/or security documents. A seller can be left with the choice whether to let a letter of credit lapse or to draw down on it, thus destroying the treatment of the transaction as an installment sale.

Deed of trust: A deed of trust on real estate, a security agreement or a pledge of stock in a closely held company can provide some security, but on default, they will compel the seller to foreclose and realize as much cash as possible, which would destroy installment sale treatment. Obviously, when the seller is faced with the possibility of not being paid, a desirable payment stream and tax deferral will pale in comparison.

Structuring an Installment Sale

Advisers are at their best when they can offer newer and better legal and financing techniques that do not cost the client more, and may actually save money. A structured sale is a blend of an installment sale and a guaranteed payment stream, and is a unique solution in the right circumstances.

The structured sale concept was introduced in mid-2005 to widespread interest among insurance industry specialists, business brokers and real estate professionals nationwide.[2] The idea is to capture the tried-and-true tax and financial benefits of an installment sale, but in a far more secure and certain environment, using the economic power of the life insurance industry.

Professionals can recommend the structured sale in real estate deals, business sales and in a wide variety of other transactions. It can diversify a client's financial holdings, secure the risky proposition of a traditional installment sale and lock in tremendous pre-tax investment returns.

This concept borrows from the structured settlement industry, in which brokers and life insurance companies have partnered for years in providing tax-efficient guaranteed annuities to successful plaintiffs in personal injury cases. In a structured sale, a seller bargains not merely for a security interest in property, a pledge of stock or a letter of credit (which mechanically never works). Instead, the seller gets a guaranteed payment stream without serious risk of either nonpayment or payment acceleration. The idea that the seller can dictate the terms of an installment sale and ensure the chosen payment stream is a powerful tool for the professional adviser.

Mechanics

A structured sale is simple. The buyer arranges to buy assets from the seller. The installment sale agreement obligates the buyer to make specified periodic payments for a stated number of years. The buyer may (or may not) make a down payment in the year of sale. The buyer's obligation and note are personal to the buyer. The note may (or may not) be secured by the purchased assets. So far, this is merely an installment sale under Sec. 453, entitling the seller to report the payments as he or she receives them.

After the sale, the buyer assigns his or her obligation to an assignment company. The buyer transfers a lump sum, representing the discounted value of the payment stream due under the installment sale agreement. In return, the assignment company agrees to assume the buyer's payment obligations. This assignment is between the buyer and the assignment company, and the installment seller is not a party. A top-rated life insurance company issues an annuity contract to the assignment company, which makes all periodic payments required by the original installment agreement.

All installment agreement terms continue to apply, including any pledges of collateral. Once the seller is in-formed of the assignment, he or she will look to the assignment company as the primary payment source. The life insurer guarantees that it will make all periodic payments due if it ever receives notice that the assignment company cannot make them.

Tax Basics

From a tax viewpoint, a structured sale accomplishes everything it sets out to do. Despite the impressive economic results, there is no tax avoidance, just tax deferral coupled with the advantages of compounding. It is an obvious choice to consider to create a secure, fixed base of tax-deferred income within any sound financial or estate plan.

Installment Reporting

Installment sale tax reporting is possible, because the buyer's periodic payment obligation to the seller is the buyer's debt, which is not payable on demand or readily tradable.[3]

Leaping another technical hurdle, the periodic payment obligation is not part of the "payment" received by the seller in the year of sale, so it qualifies for installment reporting.[4] That means an assignment by the *obligor*, which does not alter the original obligation, should not accelerate income. The buyer assigns its obligation to make the periodic payments, but the seller is not a party to the assignment, and the third party does not become directly liable to the seller. The third-party assignment company becomes the primary obligor and will purchase the annuity.

However, the seller technically has no rights in the annuity, even though, incredibly, the seller is the sole beneficiary. The IRS could conceivably argue that the value of the periodic payment obligation should be counted as a "payment" in the year of the sale, because the third party is not the purchaser of the property. In essence, the IRS could argue that the buyer purchased the property in exchange for the third-party debt obligation. However, such arguments probably are not persuasive, as they require integrating the transactions, something not supported by the facts. Indeed, like much of the tax law, there is a good deal of formalism here.

For example, in *Caldwell*,[5] the buyer formed a holding company to assume its obligations under the contract. The court held that the buyer, not the holding company, remained the purchaser, and that the seller was receiving the holding company's obligation, not the buyer's. In a structured sale, the installment seller is not a party to the assignment.

No Disposition

A "disposition" of an installment note is nearly always problematic. If an installment obligation is "disposed of," any gain or loss is recognized, and installment method benefits are lost. A disposition includes not only actual transfers of installment obligations to other parties, but also "deemed dispositions," in which the terms of the installment sale agreement are substantially altered.

Fortunately, the existing tax authorities make clear that there is no disposition when a buyer transfers the obligation to make periodic payments to an assignment company in a structured sale.[6] Generally, these precedents involve sellers who transfer the installment note. The question is whether such a transfer is a disposition. Less attention has been paid to the buyer, who may transfer the obligation to pay to a third party. Yet, it is hard to see how this could be abused. The seller is not disposing of anything, or even altering it.

Several leading cases show there is no disposition in a structured sale. In *Wynne*[7] and *Cunningham,*[8] the courts examined whether a new note was sufficiently different to cause a disposition. Like the IRS's own statement in Rev. Rul. 75-457,[9] these cases confirm that "the mere substitution and release of the original obligor on an installment obligation, and the assumption of the installment obligation by a new obligor, without any other changes, will not in itself constitute a satisfaction or disposition under section 453(d)." The Service issued another favorable ruling seven years later,[10] that there was no disposition.

Although structured sales are too new to be the subject of any authority, all these precedents seem applicable. Indeed, in a structured sale, the assignment merely follows the procedures laid out in Rev. Ruls. 75-457 and 82-122[11] for properly transferring an installment obligation.

Constructive Receipt

Another relevant tax doctrine is constructive receipt, and its relatives—the cash- equivalency and economic-benefit doctrines. The constructive-receipt doctrine prohibits taxpayers from deliberately turning their backs on income and selecting the year in which they want to receive (and report) it. Under Regs. Sec. 1.451-2(a), income is constructively received if it is credited to the taxpayer's account, set apart or otherwise made available to the taxpayer. There is no constructive receipt if the taxpayer's control is subject to substantial limits or restrictions.

Under traditional constructive-receipt principles, if payments are not credited to a claimant's account, set apart for him or her or otherwise made available to be drawn on at any time, there is no constructive receipt. Thus, constructive receipt has no application to structured sales. Security rights that protect installment sales do not trigger constructive receipt.[12] The buyer's assignment of its payment obligation to a third-party assignment company gives the seller no greater rights than the seller would have under a standby letter of credit.

The cash-equivalency doctrine (which is similar to constructive receipt) focuses primarily on deferred payment obligations that the taxpayer can readily discount. In a structured sale, the seller cannot convert the annuity into cash, and has no rights to it. The seller is not even a party to the transaction between the buyer and the assignment company. The documents forbid the seller from transferring, assigning, selling or encumbering rights to future payments.

In fact, any attempt by a seller to sell, transfer or assign the rights to future payments is void, thus precluding application of the cash-equivalency doctrine. A structured sale merely adds another obligor to the mix. Thus, the cash-equivalency doctrine should not apply.[13]

Economic Benefit

The economic-benefit doctrine is triggered when money or property has been transferred to an arrangement (such as a trust) for the taxpayer's sole economic benefit, even if the money is not necessarily available at any time. Fortunately, the authorities do not suggest that a structured sale would run afoul of the economic-benefit doctrine.[14] The seller is not a party to the transaction between a third party and the buyer, and the seller has no rights in the annuity.

Closing the Deal

There are some fundamental tax concepts that have not changed since the tax system started back in 1913. One of the central features of the system is that taxpayers do not pay tax until they have some accretion to wealth, and actually have a right to receive the income. Just as central to the notion is that there is nothing inappropriate about attempting to reduce tax exposure as much as lawfully possible.[15] One of these tried-and- true (and decidedly nonaggressive) techniques is installment sales.

The installment method of reporting has never been at odds with the constructive-receipt or economic-benefit doctrine. An installment sale merely stretches out payments. With all the talk today about the requisite "economic substance" for transactions to be respected for tax purposes, there is hardly anything with more economic substance than paying less tax because one receives less cash. As long as an installment seller conditions a sale on the execution of an installment note—establishing the amounts and number of years over which the sale price is payable—there simply should be no tax issue.

The structured sale takes this a step further, with an assignment by the buyer of the duty to make installment payments to the seller. The installment payments and interest rate remain the same. The only thing that has changed—and not through documents to which the seller is a party—is that the buyer's assignment produces an additional obligor and the backing of a guaranteed annuity from a top-rated life insurer. The third party makes a general promise to make any payments due after it receives notice of the assignment company's default, and the annuity payout provides certainty.

Yet, despite these items that are important to the tax treatment, there is a huge benefit. The seller ends up as the beneficiary of an iron-clad annuity guaranteed by a large and secure insurance company. That is a powerful way to structure the sale of appreciated assets.

Conclusion

As an unprecedented wave of baby boomers begins to reach retirement, there is even more concern about security, income streams and tax effects than at any time in our nation's history. The structured sale is a unique vehicle for satisfying multiple goals across a wide spectrum of personal and commercial sales.