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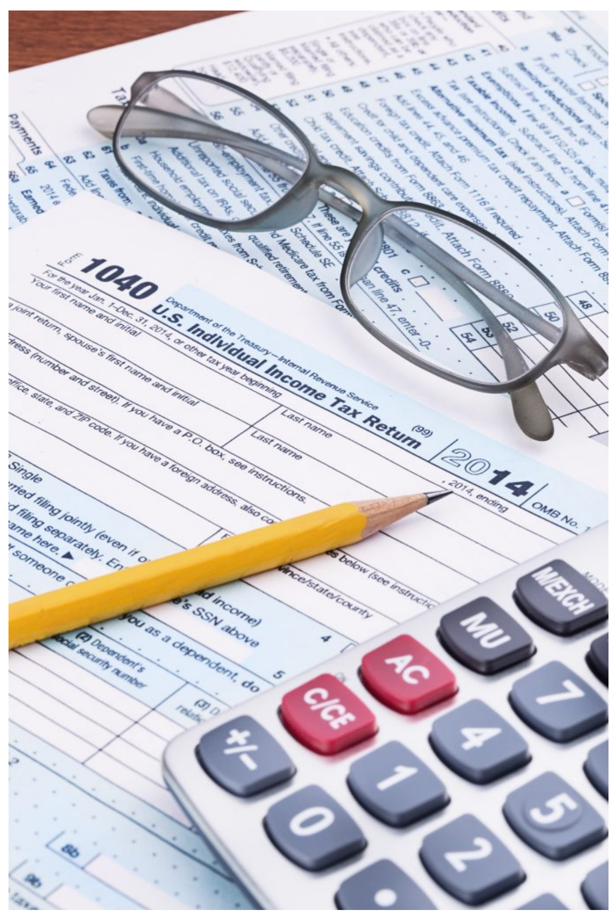
Deferred Sales Trust - What's All the Hype?

By Dawn D. Hallman

An emerging alternative to the §1031 exchange,[1] wherein the taxpayer has the opportunity to defer the gain on a sale, is a deferred sales trust (DST). Unlike a §1031 exchange, a DST does not require the taxpayer to reinvest in like-kind replacement property and is not subject to the timeline restrictions of a §1031 exchange.[2] In short, a DST is an irrevocable trust that utilizes the installment sale treatment under the Internal Revenue Code (IRC) §453 in order to defer the taxes due on the sale of a business, real estate or other taxable assets. The grantor sells the asset to the DST in exchange for a promissory note or deferred installment contract. The DST then owns and controls the asset until it is sold to another third-party for the full sales price. Then, the proceeds of the sale are used to pay the grantor under the promissory note or deferred installment contract.



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The DST can, but is not required to, reinvest the sale proceeds into other investments; there is no timeline or like-kind reinvestment requirement. The grantor only pays capital gains tax on the principal payments received from the DST, thus deferring the taxes due by virtue of the installment sale.[3] Some of the main issues to be addressed in a DST are the use of an independent trustee, transfer of the asset ownership without retained interest, constructive receipt of the sale proceeds, trust distributions, trust restrictions and trust legitimacy. Before exploring the mechanics of how the DST works, it is important to understand why it works.

IRC §453 is used to afford deferred tax treatment on installment sales. Historically, this was designed to eliminate the hardship of immediately paying the tax due on a transaction since the sale did not produce immediate cash. Furthermore, if the purchaser defaulted on the installment note, the seller may have paid tax on money he never actually received. The Installment Sale Revision Act of 1980 (1980 act)[4] restructured the installment sales provisions of section 453 and attempted to simplify the provisions and increase the availability of installment reporting. The 1980 act also changed the definition of "related persons."[5] Congress has since made many changes in order to restrict

the availability of installment sale reporting and deter abuse, most notably was
the Tax Reform Act of 1986 (1986 act)6 dealing with installment sale of marketable securities.

In summary, a taxpayer who does not receive all of the proceeds from a sale of property at once may pay tax only on the gain realized on the sale and only in proportion to the amount of installment payments received in such year.7 The current law installment method applies only to sales of real estate, except sales in the ordinary course of business, and sales of personal property, which is not inventory property.8 There are some other specific rules for the sale of farm property, residential lots and timeshare rights.9 The eligibility rules come down to this: is the deferred payment on the sale of property that was held as a capital asset or as a §1231 asset? If yes, the sale can qualify for installment sale reporting.10 Under IRC §453(i), the portion of the gain realized upon the sale of an asset that would be characterized as ordinary income under the depreciation recapture rules is not eligible for deferral under the installment method.11 Installment sale reporting is mandatory unless the taxpayer elects not to use the installment method under section 453(d), and thus reports the entire gain in the year of the sale.12

THE NECESSITY OF AN INDEPENDENT TRUSTEE

The IRS successfully challenged installment sale treatment in *Lustgarten v. Comm'r*.13 In Lustgarten, a father/taxpayer entered into the following agreements with family members for a stock sale in 1971:

- Installment sales contract – father sells stock to son
- Installment note – father paid in installments
- Escrow agreement – monthly payments made to father out of escrow fund, and escrow fund could be terminated if father and son jointly agreed
- Irrevocable trust – father as grantor, daughter as beneficiary, son and his uncle as co-trustees
- Joint venture agreement – between son and his uncle as trustees for irrevocable trust

The court held that the taxpayer did not qualify for installment sale treatment because he had "constructive receipt" of the entire proceeds immediately.14 The court reasoned that the son was a little more than an agent for the father, the father retained control over decisions to reinvest escrowed funds and the son could not independently order the sale.15 Section 453 does not apply if a taxpayer has entered into an arrangement which is in form but not in substance a true installment sale.16

This case provides the foundation for why an unrelated third-party trustee is necessary, and a true transfer of ownership and control of the asset is required when using a DST. A taxpayer is entitled to installment sale treatment, but only if she does not directly or indirectly have control over the proceeds from the sale or possess economic benefits therefrom.17

The definition of "related persons" is in IRC §1239(b). With respect to installment sales to related parties, IRC §453(e) provides:

1. any person disposes of property to a related person (hereinafter in this subsection referred to as the "first disposition"), and
2. before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the "second disposition"), then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.18

It is imperative to understand the importance of "related parties" within the meaning of the IRC. IRC §267 (b)(2) provides that related persons include an individual and corporation, where more than 50 percent of the value of the outstanding stock is owned directly, or indirectly, by or for such individual. IRC §267(c)(1) states that for the purposes of determining ownership of stock, in applying subsection (b), the ownership of stock owned directly or indirectly, by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by or for its shareholders, partners or beneficiaries.

Roberts v. Comm'r, even though it was decided before the 1980 act, is still used as precedent today and identifies the importance of an independent trustee.19 In *Roberts*, the court held that an irrevocable trust established by the taxpayer for the benefit of his children was, in fact, an independent entity of real substance.20 The court reasoned that the taxpayer's stock sale to an irrevocable trust in exchange for a promissory note was an actual sale, and thus entitled to installment sale reporting for the realized gain.21 In *Roberts*, the taxpayer had no control over the trust or the trustees. Once the sale of stock was made to the trust, the taxpayer no longer had any personal interest or control regarding the sale; the sale by the trustee was not for the taxpayer's benefit, but for diversification of the trust corpus.22

A direct sale to a third party under section 453 possesses the inherent risk of the taxpayer/seller carrying the note for an unrelated third party. The seller is essentially assuming the traditional risk that a financial institution (bank) would incur when lending money to buyer for the purchase. While the deferred tax treatment of an installment sale may be preferred, the escalated risk to the seller of collecting the note may not. The seller/noteholder runs the risk of buyer default, reduction in value of the collateral, future delays due to litigation, bankruptcy, probate, etc. The DST is designed to utilize the tax benefits of the installment sale under IRC 453, without the risk of carrying the note, or essentially lending directly to the unknown buyer.

The DST is an irrevocable trust and, like all irrevocable trusts, the grantor (in this case, the taxpayer) cannot be the trustee. However, to maintain independence, the DST must go one step further and have an independent, unrelated third party serve as trustee. It is imperative for capital gains tax deferral that the DST must be considered a bona fide, third-party trust with an independent trustee.

ONCE THE DST IS ESTABLISHED

Once the DST is established, the next step is to transfer the asset into the DST, which must be done before the sale. The taxpayer must relinquish full ownership and control of the asset to the DST. If the DST does not actually own and control the asset, the taxpayer will be viewed as owning the asset at the time of the sale, and thus the IRS will disallow the installment sale treatment.

With respect to control and distributions from the DST, the IRS has been very clear that the taxpayer cannot have constructive receipt of the proceeds when disposing of the asset. Lustagarten is a perfect example of such constructive receipt, which disqualified the installment sale treatment.23The independent trustee should have full control over the asset sale and distributions, as seen in *Roberts*.24

DSTs have also been used to rescue a taxpayer from a failed IRC §1031 or IRC §721 exchange. When an asset is sold under a §1031 or §721 exchange, the sale proceeds are required to be held by a qualified intermediary on behalf of the taxpayer in order to close on the replacement property within the requirements of the IRC. If this type of exchange fails, the taxpayer must pay depreciation recapture and capital gains taxes on the sale. The DST may provide an alternative solution, whereby the proceeds of the sale are paid directly from the qualified intermediary to the DST. It remains important that the taxpayer does not have constructive receipt of the proceeds; otherwise, the beneficial tax treatment is lost.

CONCERNS AND CONSIDERATIONS

One of the primary concerns is that the DST is viewed as a legitimate trust and not a "sham trust." An entity without economic substance is considered a "sham" by the IRS, and hence is not recognized for federal tax law purposes.25 In *Markosian v. Comm'r*, the tax court developed a four-factor test:

> 1) is the taxpayer's relationship to the transferred property differed materially before and after the trust's creation; 2) does the trust have an independent trustee; 3) is an economic interest passed to other trust beneficiaries; and 4) is the taxpayer respecting the restrictions placed on the trust'soperation as set forth in the trust documents.28

The Sparkman court applied this "sham trust" test and held that the trust organization lacked economic substance, and thus had to be disregarded for income tax purposes.27 The court reasoned that the taxpayer was still empowered to "operate the company to the same extent as if he were the owner"; thus, installment treatment was not allowed.28 The court further reasoned that the trustee was not independent because she "had no meaningful role," the trust did little to change the taxpayer's relationship to underlying business, and the taxpayer did not respect trust form.29 Essentially, the *Markosian* test was not met, it was considered a "sham trust" and the installment treatment was disallowed.

Another consideration of the DST is that not all depreciation recapture taxes are deferred. There are two situations where the gain, all or part, cannot be deferred: 1) if the character of the gain realized from the sale is treated as ordinary income because of the depreciation recapture rules30 and 2) if the seller pledges the installment obligation as collateral for a loan.31 If the recapture of depreciation is not eligible for deferral under the installment sale, then the recapture portion of the gain must be reported at the time of the sale; however, the remaining portion of the gain (the §1231 portion of the gain) can be deferred.32

Of course, the DST is not without some disadvantages. Like most tax planning strategies, it is expensive and complex to set up, as there are many rules and regulations. However, the income that can be generated from investing the full sale proceeds, due to the tax deferred treatment of the capital gain, may far outweigh the administrative and legal costs of setting up the DST. The DST can be difficult to launch and manage, as compared to a Delaware Statutory Trust or a §1031 exchange.

Remember, tax deferral does not mean the tax is eliminated. Under a DST, the capital gains tax exposure occurs when the taxpayer receives principal payments from the trust. Depending on the timing of the corpus payments, the tax deferral could potentially outlast the taxpayer.

THE DST AT WORK

While the concept seems simple, the application is not. This is a very useful tool to share with clients; notwithstanding, careful selection of the drafting attorney and the third-party trustee is paramount to the success of the DST. Having a working knowledge of the DST allows you to identify potential users. There are many intricacies to make a DST work as planned. This is not a mere form that an attorney can "fill in the blank." An error or omission in creation of the DST, transfer of the asset, operation or management of the DST or the asset could ultimately be very costly to the taxpayer, especially if the installment sale treatment is successfully challenged.

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Dawn Hallman is the principal attorney and founder of Hallman & Associates and focuses on estate and tax planning for millionaires and billionaires. Ms. Hallman is the past chairman of the OBA Estate Planning, Probate and Trust Section, chartered Legacy Rotary Club and serves as vice chairman for both Washita State Bank and Frontier State Bank.

1. *See* IRC §1031.
2. *Id.*
3. *See* IRC §453.
4. *See* Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247.
5. *See* IRC §1239 (b).
6. Pub. L. No. 99-514, 100 Stat. 2085, 2365-2372 (1986).
7. *Lustgarten v. Comm'r*, 639 F.2d 1208 (5th Cir. 1981).
8. David F. Shores, "Closing the Open Transaction Loophole: Mandatory Installment Reporting," 10 *Va. Tax Rev.* 311, 320 (1990).
9. *See* IRC §453 (a).
10. Planning for the Principal Owner, SL054 ALI-ABA 633, 640-641.
11. *Id.* at 641.
12. *See* IRC §453 (d).
13. *Lustgarten v. Comm'r*, 639 F.2d 1208 (5th Cir. 1981).
14. *Id.* at 1211.
15. *Id.* at 1210.
16. *Id.*

17. *Id.* at 1211.
18. *See* IRC §453 (e).
19. *Roberts v. Comm'r*, 643 F.2d 654 (9th Cir. 1981).
20. *Id.* at 657.
21. *Id.* at 656.
22. *Id.* at 657.
23. *Lustgarten v. Comm'r*, 639 F.2d 1208 (5th Cir. 1981).
24. *Roberts v. Comm'r*, 643 F.2d 654 (9th Cir. 1981).
25. *Sparkman v. Comm'r*, 509 F.3d 1149 (9th Cir. 2007).
26. *Markosian v. Comm'r*, 73 T.C. 1235, 1243-44, 1980 WL 4562 (1980).
27. *Sparkman v. Comm'r*, 509 F.3d 1149 (9th Cir. 2007).
28. *Id.* at 1155.
29. *Id.*
30. IRC §453 (i).
31. IRC §453 (a) (1).
32. David F. Shores, "Closing the Open Transaction Loophole: Mandatory Installment Reporting," 10 *Va. Tax Rev.* 311, 320 (1990).

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