SPI

Settlement Professionals, Incorporated

PLAINTIFF-LOYAL SETTLEMENT PLANNERS

The Ensured Installment Sale:

(Structured Sale)

The New Secret Tax and Financial Weapon for the Sale of Appreciated Assets



This manual is meant to educate you on the Ensured Installment Sale™ (Structured Sale) and help you understand when and for whom it is best used. After reading the manual, please give us a call if you have any questions or would like to discuss the sale of an appreciated asset.

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Tough Decisions – Making sense of things

Traditionally, sellers have had to make a tough decision when selling appreciated assets such as real estate or a business. Deciding on what sales method to use that enables them to best reach their goals is difficult because choosing the wrong one could cost **big bucks**.

On one hand, do you sell with an **all cash sale** and take the heavy capital gains tax right away; or do you defer taxes using techniques such as the **1031 exchange, installment sale, or the Ensured Installment Sale (Structured Sale)**? **Note: the popular PAT (Private Annuity Trust) is no longer a viable tax deferment tool according to the IRS.* The 1031 exchange, installment sale, and all cash sale are excellent tools, but they sure do leave a lot to be desired for sellers who:

a) want maximum **capital gains deferral**.
b) want **safety** from the creditworthiness of the buyer.
c) want a safe **stream of guaranteed income**.
d) want to rid themselves of the **headaches of managing a property or business**.
e) want to invest their money pretax to **leverage Uncle Sam's cash**.

Retirees, baby boomers, and investors are just three groups of sellers who typically look for the benefits mentioned above. Not one of the techniques (all cash, 1031 exchange, or installment sale) will help a seller achieve **all** of the above benefits.

In order to choose the best method, a seller should understand the different sales methods and how they work. Below, **Table 1** reviews the three current popular sales methods with benefits and drawbacks of each, as well as the new Ensured Installment Sale (Structured Sale).

Table 1: Popular Sales Method Choices

Structured Sale (Ensured Installment Sale)	**1031 Exchange**
- Considered an installment sale by IRS for tax purposes. Is like a cash sale from buyers perspective. Seller enjoys all of the benefits with few drawbacks. **Benefits** – • Defer capital gains to time payments are received • Safety from buyers creditworthiness • Payments guaranteed by Fortune 100 company • Can be leveraged to purchase other properties • Earn pre-tax return on the principal • No requirement to acquire new property • No additional cost to seller, buyer, agent. Etc. **Good for:** Sellers who want tax deferment and are looking to retire, exit the market, or leverage their equity to obtain financing for new projects.	- 1031 exchange is an exchange for a "like kind" property within a specific time period with certain restrictions. **Benefits** – • Defer capital gains to the time you actualize equity as profit. • Buyer gets full title at close **Drawbacks** – • Must continue to own/manage property or business • Strict time frame restrictions on transaction • Sometimes a cost if using a 1031 broker **Good for**: **Sellers looking to "trade up" properties/businesses and continue to own investment properties and businesses.**
Installment Sale	**All Cash Sale**
- An installment sale is a sale when the seller receives at least 1 payment after the year of the sale. **Benefits** – • Defer capital gains to time payments are received **Drawbacks** – • Seller is at risk of buyer default and/or asset devaluation • Seller must foreclose on buyer upon default • No additional cost to seller, buyer, agent. Etc. **Good for**: Sellers wanting tax deferment who can't find a buyer who can either pay cash or obtain financing for the purchase. Seller also must be confident that the buyer will pay each and every payment.	-A cash sale is just as it sounds; the buyer purchases the property by paying all cash to the seller at the time of close. **Benefits** – • Seller receives all of his equity at close • Buyer gets full title at close **Drawbacks** – • Hit with capital full capital gains in year of sale • No chance of tax deferral strategies **Good for: Sellers who don't want to defer taxes and/or those who want to immediately roll the proceeds into another investment. *(*note: the Ensured Installment Sale allows sellers to use the annuity as collateral for financing new projects)***

As you can see, each sales method has its benefits and drawbacks and each has specific niches that it caters to.

The Ensured Installment Sale (Structured Sale)

Responding to the needs that sellers of appreciated assets were voicing, Allstate Insurance developed what they call the Structured Sale in 2004 and released it in late 2005. The new Structured Sale (or Ensured Installment Sale as we call it) truly solves the problem that sellers of appreciated assets face when trying to achieve all of the benefits mentioned in **Table 1**.

The Structured Sale allows the seller to spread capital gains tax liability over a span of years, enabling the seller to gain a return on Uncle Sam's money or leverage it free of charge. In addition to the tax benefits, the Structured Sale offers the seller enhanced safety and leverage that other sales options fail to provide. Rather than being at the mercy of the buyer's creditworthiness, the Structured Sale is guaranteed by a Fortune 100 company such as Allstate Insurance.

What is the Ensured Installment Sale (Structured Sale)?

In layman terms, the Ensured Installment Sale (Structured Sale) is a new twist on the traditional installment sale that enables both the seller and buyer of appreciated assets to take advantage of tax, safety, and/or financial benefits that traditional sales methods don't offer.

An Installment Sale is basically the sale of an appreciated asset where at least 1 payment is to be received in the year(s) after the year that the sale occurs. Installment Sales allow the seller to defer gain to the year that payment is received. This is a powerful tool that helps sellers to defer capital gains tax rather than having to pay the entire tax in the year of sale. One huge drawback to the traditional Installment Sale is that the seller takes on the risk that the buyer will not fulfill the payment agreement or the property value will decrease.

Further problems arise, however, with sellers who are reluctant to accept the buyer's promise to pay future installment payments because a default could mean that seller receives back his property or business after either has depreciated significantly due to market conditions, mismanagement, or both, along with the legal expenses involved in foreclosure.

The Ensured Installment Sale, however, transfers the buyer's obligation to pay to a third party assignment company who in turn purchases an annuity from a Fortune 100 U.S. insurance company such as Allstate. The seller is the sole beneficiary of the Fortune 100 guaranteed annuity, which can be passed on to heirs should the seller die before all payments are received. This gives the seller the peace of mind that the payments will be made each and every time no matter what the buyer does. Please note that there is still a very small degree of risk when using the Ensured Installment Sale. Should the Fortune 100 life insurance company such as Allstate become insolvent and go out of business, the seller may be at risk of not receiving payments. However, the chances of this event happening are little to none.

Now that you know the basics of the Ensured Installment Sale, let's take it a little deeper.

If you are the analytical type, the following eight pages describes the Structured Sale more in-depth and is written by one of the top tax attorneys in the nation, Robert Wood. He is a huge proponent of the Structured Sale and states his opinion on the subject.

Structured Sales: Breathing Life Into Installment Sales

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By Robert W. Wood

Since the beginning of time — or the beginning of the income tax at least — taxpayers have wanted to defer their tax obligations. Deferral is practically a hallowed concept. Much of the lore of tax planning is based on it. Given the desire taxpayers have to postpone their tax obligations, there is a natural tension between that mantra and several fundamental tax concepts, including the annual accounting requirement, the constructive receipt doctrine, and the economic benefit doctrine.

Installment sales hardly represent a new concept. A taxpayer is permitted to arrange a sale of property so the proceeds are taxable as received across several years, without fear that the stream of payments will be accelerated and taxed in the year of sale. That seems unextraordinary. And there seems little that can go wrong from a tax standpoint.

Yet the history of installment sale transactions suggests that was not always so. Before 1980, installment sales were subject to more complicated rules, including a limitation on the consideration (30 percent or less) that could be received in the year of the transaction. That percentage threshold was abrogated by the Installment Sales Revision Act of 1980.[1] For the last 25 years, there has been no percentage restriction and a vastly more liberal installment sale regime.

Cash Is King

Understandably, installment sellers want to be certain that stretching out payments does not make it less likely they will be paid. The Installment Sales Revision Act of 1980 also addressed that issue, making clear that a standby letter of credit can be issued in the name of the installment seller to provide security. The installment seller can always take back a security interest in the property sold, but that often represents inadequate security. A security interest in real estate can be comforting if you're in first position, but a security interest in a business rarely gives full protection. Besides, repossessing the sold property is cumbersome and inconvenient, even if the seller is able to turn around and sell it again. Congress's blessing of standby letters of credit in the Installment Sales Revision Act was viewed as a boon to installment sellers.

Today a typical installment sale entails a promissory note and security. The note may be backed by a standby letter of credit. If there is a default on the note, the taxpayer/seller can go to the bank and present the letter of credit for payment. That is fast, easy, and far more efficient than realizing on traditional security. There is a fair amount of variation in how those standby letters of credit are written. Having fiddled with this a lot over the last 25 years, I don't think there's a universally accepted way of tidying all loose ends.

For example, the seller who sells his business for a 20-year stream of payments may request a standby letter of credit. If there is a default on the installment note in year three, the seller can go to the bank and request payment, assuming the letter of credit is still in effect. In all likelihood, though, the letter of credit will pay the *full* amount on any default, not just the then-due installment. One default typically accelerates all extant payments.

Clearly, the installment seller wants to get paid, but what he *really* bargained for was the *stream* of payments over 20 years. The seller bargained for that stream of payments, perhaps both for retirement income reasons as well as to achieve traditional tax deferral goals. So the seller really doesn't want to accelerate all the payments. Of course, even if the seller can draw down only the then-due installment under the terms of the letter of credit, there's the problem of the continuing mechanics of the standby letter of credit. If there is a default in year three, will the letter of credit still be outstanding?

Most banks will issue a letter of credit only for 12 months at a time. That means there are generally cumbersome renewal provisions in the note, purchase, or security documents. Not infrequently a seller is left with the Hobson's choice of whether to let a letter of credit lapse or to draw down on it, thus destroying the installment treatment for which he bargained.

I am mindful that some reader may tell me I have been dealing with the wrong banks all these years, and that *if* you have the right bank, and *if* you have the right customer relationship with the bank,

[1] *See* Installment Sales Revision Act of 1980, Pub. L. 96-471, 94 Stat. 2247.

you can get a standby letter of credit that is payable over a long term (say 20 years); is irrevocable; and permits the installment seller and beneficiary to draw down on it annually only on that then-due installment if there is a default on the underlying note. I have never seen such an animal, nor do I expect to.

In a quest for alternate security, the installment seller may look for security in the assets sold. Thus, a deed of trust on real estate, or a pledge of stock in a closely held company that is the subject of the installment transaction, can provide some solace to the seller. Here again, though, the seller is really banking against the dreaded possibility that there will be a default under the note. If there is, the deed of trust, security agreement, or pledge agreement will nearly always compel the installment seller to foreclose and to realize as much cash as possible.

Again, with a security interest or pledge, a foreclosure will destroy the installment treatment. Obviously, when the seller is faced with the specter of not being paid, the initially desirable stream of payments and corollary tax deferral will pale compared with the prospect of not being paid at all. Cash, after all, is king. Nevertheless, that is a choice the seller ought not to have to make.

Structuring an Installment Sale

There is a better way. Borrowing from the structured settlement industry, the structuring of an installment sale (a structured sale), involves a seller bargaining not for a security interest in property or a pledge of stock but for the certainty of a stream of payments without serious risk of nonpayment or acceleration.

The structured sale involves a simple installment transaction in which 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 is personal to the buyer. It may (or may not) be secured by the purchased assets.

So far there is nothing extraordinary here. It is merely an installment sale under section 453, entitling the seller to report the payments as he receives them. In the structured sale, however, after the sale occurs, the buyer will assign its obligations under the installment sale agreement to an assignment company. The buyer will transfer a lump sum to the assignment company, which in effect represents the discounted value of the stream of payments the buyer is obligated to make under the installment sale agreement. In return, the assignment company agrees to assume the buyer's payment obligations.

Note that the transaction is between the buyer and the assignment company, a third party, which was not a party to the underlying installment sale. The installment seller is not a party to the arrangement between the buyer and the assignment company. The buyer and the assignment company negotiate the amount of the lump sum payment based on prevailing discount rates and other factors. The life insurance company will issue an annuity contract to the assignment company.

After that assignment transaction, the assignment company will make all periodic payments required under the original installment agreement. All terms of the installment agreement continue to apply, including any pledges of collateral or any other arrangements contained in the original installment agreement. Notably, that assignment arrangement does not release the buyer from any of its obligations under the installment agreement. Of course, once the seller is informed of the assignment, the seller will look to the assignment company as the primary source of payments. If the assignment company fails to perform, the life insurance company agrees to send directly to the seller those periodic payments that come due after the life insurance company receives notice that the assignment company is not making the payments. Of course, the buyer still remains liable under the original installment agreement.

Tax Doctrines

A structured sale is simple and clean. The buyer of the installment property enters into the transaction with the assignment company because it is in the buyer's financial interest to do so. The discount is presumably deep enough that the fact that the buyer remains obligated on the underlying installment note does not make the buyer uncomfortable. Of course, as a practical matter, the buyer looks to potentially paying the note payments only in the event that the assignment company, as the obligor of the structured installment note, and the life insurance company, under its agreement to pay, should *both* default. That is presumably not a serious risk.

Given that there is nothing about that kind of transaction in section 453 or the accompanying regulations, does it work from a tax standpoint? I believe it does, and that there is little reason the IRS should even want to attack it. However, I've tried to outline below the various tax doctrines that seem pertinent, with some analysis of why they should not be problematic here. Those include the statutory concept of dispositions of installment obligations, the constructive receipt doctrine, and the economic benefit doctrine.

Installment Sale Basics

The buyer's periodic payment obligations to the seller constitute indebtedness of the buyer, which is not payable on demand or readily tradable.[2] Therefore, the periodic payment obligation is not part of the payment received by the seller in the year of sale.[3] Consequently, an assignment of that obligation by the *obligor*, which does not alter the original obligation, should not accelerate income (nor result in a disposition of the installment obligation) to the seller.

The periodic payment obligation is an obligation of the buyer and at all times remains an obligation of the buyer. Even after the buyer assigns its obligation to make the periodic payments to the seller, the seller is not a party to that assignment and the third party does not become directly liable to the seller. Also, the buyer is not released from liability.[4]

That means that if the third party should fail to make the periodic payments, the buyer would still remain liable. Thus, the periodic payment obligation received by the seller remains indebtedness of the buyer. Of course, the buyer will assign its periodic payment liability to a third party, and that third party will be a primary obligor (and will purchase an annuity to fund the liability). However, the seller will have no rights in the annuity.

Traditional timing of income concepts [5] suggest that the seller's lack of interest in the annuity should remove any constructive receipt or economic benefit concerns (topics considered below). Still, it is conceivable that the IRS could argue that the periodic payment obligation received by the seller should be viewed as an obligation of the third party. The IRS might argue that the value of the periodic payment obligation should be included in the amount of the payment the seller received in the year of the sale, because the third party is not the purchaser of the property. To take that position, I think the IRS would in essence be arguing that the buyer purchased the property in exchange for the debt obligation issued by the third party.

Although there is no authority directly on point, I don't find those arguments persuasive. Those arguments would seem to require an integration of the transactions, which is not supported by the facts. Indeed, in *Caldwell v. U.S.*,[6] the buyer formed a holding company to assume the buyer's 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, and the buyer remains contingently liable to the seller (the buyer is not released from liability).

The Buyer's Assignment Is Not a Disposition

Section 453B(a) states that if an installment obligation is disposed of, any gain or loss will immediately be recognized. In that case, the benefits of the installment method are lost and immediate recognition of income results. When an installment obligation is disposed of at other than its face value, any gain or loss is measured by the difference between the basis of the obligation and the amount realized. In all other dispositions, gain or loss is measured on the difference between the basis of the obligation and its fair market value.[7]

Just what is a disposition? A disposition includes not only actual transfers of installment obligations to other parties, but also deemed dispositions. A deemed disposition occurs when the terms of the installment sale agreement are substantially altered.

In effect, the installment obligation is considered to have been exchanged for a new obligation. In

[2] Section 453; reg. section 15A.453-1(b)(3)(i).

[3] *See* section 453(c)(3) and *Caldwell v. United States*, 114 F.2d995, (3d Cir. 1990).

[4] 4*Id.*

[5] *See* Wood, *Taxation of Damage Awards and Settlement Payments*, Chapter 7 (3d Ed. 2005).

[6] 6114 F.2d 995 (3d Cir. 1990).

[7] 7*See* section 453(B)(a)(1) and (2).

Rev. Rul. 75-457,[8] the IRS concluded that a disposition occurs when the seller's rights are materially disposed of or altered. A large body of law addresses modifications to installment obligations, the question being whether a modification is significant enough to create a disposition.[9] Generally, those authorities involve *sellers* who transfer their installment notes, and the question is whether that transfer should be considered a disposition. Less attention has been paid to the *buyer* in the installment sale, who may transfer its obligations to pay under the note to a third party.

Existing authorities do not specifically address whether *buyers* can assign their obligations to a third party under an agreement under which the third party will make the same periodic payments as the buyer, allowing the seller to continue with installment reporting. Of course, it is hard to see how that could be abused. The seller isn't disposing of anything or even altering it. At no time does the holder of the installment obligation dispose of it. It seems difficult to argue that it is a disposition when the seller does not take any action. The issuer of the obligation — the buyer — undertakes a transaction with an assignment company paying a discounted amount rather than being on the hook for the entire stream of installment payments.

The code and regulations provide only limited guidance on whether an assignment of an installment obligation constitutes a disposition, and really no guidance at all when the assignment is by the obligor rather than the obligee. A body of cases address whether the *substitution* of obligors under an installment obligation results in a disposition for purposes of the installment sale rules. Those authorities are not directly on point, because the assignment contemplated here does not involve a substitution of obligors.

In fact, in a structured sale, the third party's payment obligation under the assignment is in addition to, not in substitution of, the buyer's original obligation to the seller. The buyer's liability to the seller is not extinguished. Clearly, if a complete substitution of obligors (the old obligor being completely discharged and a new one in its place) would not trigger a disposition, neither should an assignment.

Case Law and Rulings on Dispositions

A leading case on this topic is *Wynne v. Commissioner*.[10] In *Wynne* a corporation, whose stock was owned by a partnership, owed remaining payments to a former shareholder under an installment obligation. The corporation was liquidated and the partnership assumed liability to make the remaining payments in accordance with the terms of the original obligation. Thus, the only change that occurred as a result of the liquidation was the substitution of a new obligor in place of the former obligor. The Board of Tax Appeals rejected the IRS's contention that a disposition of the installment obligation occurred.

Another leading case is *Cunningham v. Commissioner*,[11] in which a corporation bought the stock of another corporation for cash and promissory notes. The stock was then pledged as collateral for repayment of the promissory notes and the original buyer released from any further liability.

Soon after that sale, the new buyer and seller agreed to change the terms of the promissory note. The changes related to the amount and due dates for payments and a waiver of interest. The court rejected the IRS's contention that the second sale resulted in a disposition of the promissory notes for purposes of the installment sale rules, reasoning that the sellers had no more or less than they had in the beginning. They were creditors of the same installment obligations. There was a different obligor, but in both instances the essential underlying security for the obligations was the stock and its earning potentials.[12]

In Rev. Rul. 75-457,[13] the taxpayer sold real estate to a buyer for cash and a promissory note. One year later, the buyer sold the property to a new buyer and the taxpayer agreed to release the first buyer from further liability and to substitute the new buyer as the obligor under the promissory note. The other terms of the note were not changed. The IRS held

[8] 8Rev. Rul. 75-457, 1975-2 C.B. 196, *amplified by* Rev. Rul. 82-122, 1982-1 C.B. 80.

[9] 9*See* Walter C. Cliff and Phillip J. Levine, ''Reflections on Ownership — Sales and Pledges of Installment Obligations,'' 39 *Tax Law*. 37 (1985).

[10] 1047 B.T.A. 731 (1942).

[11] 1144 T.C. 103 (1965).

[12] 1244 T.C. at 108.

[13] 131975-2 C.B. 196, 1982-1 C.B. 80.

that the substitution of a new obligor did not trigger a disposition under the installment sale rules. The IRS stated 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).’’[14]

Rev. Rul. 75-457 contains a discussion of GCM 36299,[15] which focused on the rights of the seller. A disposition should not occur ‘‘as long as [the seller] possesses substantially the same rights he received in the original transaction.’’ Based on that standard, the GCM concluded that a disposition does not occur merely on account of ‘‘a change in the identity of the obligor when the seller's rights under the installment sale otherwise were not altered.’’

The rationale of GCM 36299 and Rev. Rul. 75-457 differ somewhat from the reasoning suggested by Rev. Rul. 61-215.[16] In that earlier ruling, two corporations merged and the surviving corporation assumed a liability under an installment agreement. The IRS concluded that the substitution of obligors that occurred as a result of the merger did not trigger a disposition of the note. The IRS reasoned that ‘‘there was, in essence, not a substitution of a new or materially different obligor or obligation.’’

That suggests that a disposition could be triggered if the new obligor is ‘‘materially different’’ in some sense from the original obligor. However, the IRS has not chosen to follow that aspect of Rev. Rul. 61-215. Rev. Ruls. 75-457 and 82-122 both focus solely on changes in the rights of the seller and ignore entirely the identity of the obligor.

In Rev. Rul. 82-122,[17] the IRS amplified its holding in Rev. Rul. 75-457.[18] The two rulings involved similar facts, except that in Rev. Rul. 82-122, in exchange for releasing the original buyer from further liability, the seller and the new buyer agreed to increase the interest rate and monthly payments under the assumed mortgage. The IRS concluded that the changes in the obligor and interest rate did not eliminate or materially alter the rights of the seller. Accordingly, the IRS held that the transaction did not result in a disposition.

The IRS and courts continue to adhere to the holding in Rev. Rul. 75-457 and the *Cunningham* case. The structured sale should therefore fare well.

In a structured sale, the sole effect of the assignment is to impose a payment obligation on the third party that is in addition to, not in substitution for, the original payment obligation of the buyer under the agreement. The buyer is not released from liability. Apart from creating an additional obligation on the part of the third party, the assignment does not otherwise alter or affect the terms of the buyer's original obligation.

Constructive Receipt

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) the income. Income is constructively received if it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer can draw on it. [19] There is no constructive receipt if the taxpayer's control is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available until some future date, the mere crediting on the corporate books does not constitute receipt.[20]

General constructive receipt rules seem to have no application to the structured sale. If a *buyer* assigns an obligation to pay periodic payments to a third party in an independent transaction, the *seller* should not have to accelerate its gain. The regulations define when income is constructively received by a taxpayer, but they do not suggest that rights under security instruments that protect installment sales trigger constructive receipt.[21] Indeed, the Installment Sales Revision Act of 1980 allowed for security instruments (such as standby letters of credit) to be specifically exempt from any constructive receipt issues. A security instrument merely ensures the seller of funds if the buyer or third party defaults.

[14] 14*Id.*

[15] 15GCM 36299, I-106-75 (June 5, 1975); *see also* GCM 39225. I-288-83 (April 25, 1984).

[16] 161961-2 C.B. 110.

[17] 17Rev. Rul. 82-127, 1982-1 C.B. 80.

[18] 18*See also* TAM 9238005 (June 8, 1992) and FSA 200125073, *Doc 2001-17353, 2001 TNT 122-24* (Feb. 21, 2001).

[19] 19Treas. reg. section 1.451-2(a).

[20] 20*See* LTR 7927001; *Commissioner v. Tyler*, 28 BTA 367 (1933).

[21] Treas. reg. section 1.451-2(a).

Under traditional constructive receipt principles, if payments are not credited to a claimant's account, set apart for him or otherwise made available so he may draw on the settlement at any time, there's no constructive receipt. Therefore, if a buyer assigns obligations to pay periodic payments to a seller, the seller should not experience any acceleration of gain. 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.

Cash Equivalency

The cash equivalency doctrine essentially states that if a promise to pay a benefit to an individual is unconditional and exchangeable for cash, then the promise is the same as cash and will be currently taxable, even if that promise is unfunded. In *Cowden v. Commissioner,*[22] the court held that a contract right to deferred bonus payment under an oil and gas lease was the equivalent of cash. Thus, the court found that the right was currently taxable just as if cash had been received by the taxpayer.

The *Cowden* court based its conclusion on three factors: The obligation of the payer was an unconditional and assignable promise to pay by a solvent obligor; it was of a kind that was frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money; and the obligation was readily convertible to cash.[23]

There are strong arguments why the cash equivalency doctrine should not be applied to structured sales. The case law exploring the cash equivalency doctrine focuses on deferred payment obligations that the taxpayer can readily discount. That makes sense. Conversely, when a payee's rights cannot be assigned, transferred, pledged, or encumbered, the cash equivalency doctrine has not been applied.[24]

In a properly structured sale, the documents will forbid the seller from transferring, assigning, selling, or encumbering their rights to receive future payments. Any attempt by a seller to sell, transfer, or assign their rights to future payments is void, thus precluding application of the cash equivalency doctrine. Again, it is the *buyer* who may choose to assign its obligations to a third party. That gives no extra rights to the stream of payments.

In a structured sale, the seller cannot convert the annuity into cash. The seller has no rights to the annuity. The seller is not even a party to the transaction between the buyer and the assignment company. Several cases support the fundamental principle that if the taxpayer cannot assign, transfer, pledge, or encumber the asset or payment right, the cash equivalency doctrine does not apply.[25]

A structured sale merely adds another obligor to the mix. It doesn't release the original obligor, and it doesn't change *any* of the terms of the original note. The terms of the contract between the buyer/third party forbid the seller from transferring, assigning, selling, or encumbering any of its rights to receive future payments. Any attempt by a seller to sell, transfer, or assign their rights to future payments is void, therefore precluding application of the cash equivalency doctrine.

Economic Benefit

The economic benefit doctrine is another bogeyman that should have no application here. Economic benefit occurs when money or property is not necessarily available so that the taxpayer may obtain it at any time, but has been transferred to an arrangement (such as a trust) for the sole economic benefit of the taxpayer. Rev. Rul. 60-31[26] considers the economic benefit doctrine across an array of examples. Those examples discuss situations in which there is more than a mere promise to pay and the obligations are secured in some way.

The authorities contain no suggestion that the structured sale would run afoul of the economic benefit doctrine. For example, in *Sproull v. Commissioner*27 an employer established an irrevocable trust for the benefit of the employee. The court held that the employee had received an economic benefit and thus the value of the trust was taxable. However, in *Sproull* the taxpayer's rights in the trust were vested and secured, and the taxpayer was free to assign or alienate the trust proceeds. The ability to assign or alienate value is a key right.

[22] 289 F.2d 20 (5th Cir. 1961).
[23] *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), *rev'g and remanding* 32 T.C. 853 (1959), *opinion on remand* T.C. Memo. 1961-229.

[24] *See Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983).

[25] *See id.*; *Johnston v. Commissioner*, 14 T.C. 560 (1950).
[26] 1960-1 C.B. 174.

In a structured sale, the seller is not a party to the transaction between the third party and the buyer. The seller has no rights in the annuity. Plus, *Sproull* involved personal services, not a sale of property. In *Sproull*, the taxpayer's employer set up the trust in connection with the taxpayer's services.

Special scrutiny is appropriate with personal services. Indeed, section 83 was enacted in 1969 to address property transferred in connection with the performance of services. While section 83 may not have entirely preempted constructive receipt and economic benefit issues in the context of personal services, it does suggest that there are special concerns present in the personal service context.

Personal services were also involved in *Childs v. Commissioner*,[27] though there the taxpayers were found not to have an economic benefit. *Childs* addressed whether attorneys had the economic benefit of annuity policies purchased to fund periodic payments of their fees. The opinion states that the annuity policies were not secured, because the policies were subject to claims of general creditors of the insurance companies (who sold the annuities). Therefore, the annuity was not taxable income to the attorney when the annuity was purchased.

Childs is the seminal case on structuring attorney fees. The IRS has not acquiesced in *Childs*, although interestingly enough, the IRS has cited *Childs* and relied on it in several private letter rulings.[28] Whether the IRS is comfortable approving structures of personal service payments, the road map drawn by the *Childs* court seems (to me at least) to be a clearly marked one that taxpayers can follow.

Of course, *Childs* involved personal services. In any personal service context, there is greater potential for constructive receipt concerns, because there could conceivably be arguments about the specific point in time at which the service provider becomes entitled to payment. After all, when do attorney fees accrue? In the context of a property sale, it is axiomatic that a taxpayer can refuse to sell except for installments over time, and that the refusal plainly does not invoke constructive receipt. A subsequent transaction between the *buyer* and a third party that does not give the installment seller different terms but merely adds an obligor should not invoke constructive receipt or economic benefit.

In a structured sale (which takes place after the conclusion of a sale of property transaction, not the performance of services), the third party's payments are not secured and do not replace the liability of the buyer to make the periodic payments. If the buyer was already bound by an installment agreement under which the payments are taxable only in the year received, the buyer's receipt of payments from a third party (whose ability to make those payments are not secured) should not change the tax position of the seller.

The examples and discussions in Rev. Rul. 60-31[29]apply the economic benefit doctrine when there is considerably more than a mere promise to pay, when the obligations are secured. In a structured sale, the obligation to pay is not secured; the annuity and third-party guaranty are merely in addition to the buyer's obligation to pay. The buyer remains personally liable to the seller for all payments. While the presence of a third-party obligor may provide additional peace of mind for the seller, there is no guarantee the third party will remain solvent. There is no alteration of the seller's rights.

Conclusion

Timing of income issues is central to our tax system. Just as central is the notion that there is nothing inappropriate about attempting to reduce one's tax exposure as much as lawfully possible.[30] The installment method of reporting has never been at odds with the constructive receipt and economic benefit doctrines, precisely because one is fully entitled to arrange one's affairs so as to pay a reduced amount of tax. There is hardly anything with more economic substance than paying less tax because one receives less cash. As long as the installment seller conditions the sale on the execution of the installment note, thus firmly establishing the amounts and number of years over which the sale price is payable, there simply should be no tax issue.

The structured sale involves an assignment by the obligor under the installment note of its duties to a third party who will then make payments to the

[27] 103 T.C. 634, *Doc 94-10228, 94 TNT 223-15* (1994), *aff'd* 89 F.3d 856, *Doc 96-19540, 96 TNT 133-7* (11th Cir. 1996).

[28] *See* FSA 200151003, *Doc 2001-31373, 2001 TNT 247-70*.

[29] 1960-1 C.B. 174.

[30] Judge Learned Hand said this in *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935).

seller. That does nothing to alter the series of events first set in place when the seller negotiated for installment payments. The installment payments remain the same, the interest rate remains the same, and the original obligor is still obligated under the note. The only thing that has changed — and changed not through documents to which the seller is a party — is that the buyer's assignment of its obligations produces an additional obligor and a third party makes a general promise to pay any payments coming due after it receives notice of the assignment company's default.

To Wrap It Up

As you can now see, the Ensured Installment Sale (Structured Sale) is a very powerful tool for sellers who want to defer their capital gains taxes. However, like other methods, this sales method is not a one size fits all solution.

For instance:

- Sellers who want to use the proceeds of the sale to immediately acquire another property should probably use the **1031 exchange**.
- Sellers who need all of their equity in cash at the closing table should go with an **all cash sale**.
- Sellers who want to defer capital gains taxes but absolutely cannot find a buyer who can either pay with cash or obtain financing may want to go with a **traditional installment sale**. (remember the seller takes on the risk of the buyers creditworthiness)

In virtually every other situation, the **Ensured Installment Sale (Structured Sale)** is perhaps the best solution for the seller.

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