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From: Steve Leimberg's Estate Planning Newsletter
Subject: **Jerry Hesch, Dick Oshins & Jim Magner: Note Sales, Economic Substance and "The 10% Myth"**

"An installment sale to grantor trust in exchange for a note is a well-accepted and powerful wealth shifting strategy often recommended by estate planners. In the typical transaction, the trust is 'seeded' with a taxable gift and then a sale is made to the trust in return for a note. Under the 'Intentionally Defective Grantor Trust' (IDGT) version of a note sale, a senior family member creates a trust that is disregarded for income tax purposes but is a separate trust for gift and estate tax purposes. Therefore, the sale is disregarded for income tax purposes. Often in practice, the initial funding is designed to establish the creditworthiness of the IDGT. An alternative strategy is for a third party to 'seed' the trust, whereby a beneficiary is given a lapsing power of withdrawal which results in income tax grantor status to the beneficiary-powerholder under Section 678. This variation has been referred to as a 'Beneficiary Defective Inheritor's Trust' (BDIT) or 'Beneficiary Grantor Trust' (BGT). Ordinarily, the third party limits the gift to the trust to $5,000.

There is a popular myth or 'rule of thumb' that the initial funding of an IDGT should be 10% (a ratio of 9:1) in order to give the sale transaction 'economic substance.' Thus, $1 million will support a sale of $9 million to the trust because that theoretically will provide economic validity to the transaction. Many advisors view the 10% figure as a funding test and will not proceed without satisfying that amount of 'seeding.' In other words, subscribers to the 10% test contend that a rational seller in the 'real world' would not sell assets to a buyer who does not own the 10% minimal amount to protect against the downside risks of the sale.

But is that arbitrary test correct? Although addressed primarily with respect to sales to grantor trusts for transfer tax purposes, the issue is one of 'reality of the sale' for both income and transfer tax. The same issues arise for related party sales in the income tax. That said, nowhere in any published ruling, case or other unofficial pronouncement of the Internal Revenue Service can this

theoretical 10% rule be found. The 10% rule of thumb is based on several analogies and has unfortunately developed a life of its own. In so doing, it has become the ultimate 'urban legend' in the estate planning space.

It is our belief that practitioners have been using analogies which are not reflective of how transactions are consummated in the real world. Rather than deriving analogies from similar, but very different, estate planning arrangements, we believe that the income tax cases dealing with the identical reality-of-the-sale issue are much more indicative of the proper approach. Indeed, the United States Supreme Court, in several cases analyzing the 'reality of the sale' issue, never mentioned this conjectural, assumed test. We feel that the 10% minimum funding myth is inapplicable and not indicative of real world behavioral patterns in engaging in similar transactions.

The Reality of the Sale concept approaches the Economic Substance theory and instead uses a more realistic approach that is consistent with the realities of life. The 'key' is that sellers expect to be paid, and that their analysis will be generally be controlled by that factor. Therefore, the better test, and the one consistent with the Supreme Court in analyzing the economic approach of sellers is: 'Based on all of the facts, can it be reasonably expected that the purchaser will be able to meet its financial obligations on the promissory note in a timely manner as they come due.' In the real world, a savvy seller would not look at an artificial number in determining whether to sell. Rather, the crucial question involves the seller desiring to know if the note will be paid in accordance with its terms. Many factors are taken into account in the decision making process to determine if the transaction makes economic sense. Generally, considerations as to the cash flow from the source of payments are much more impactful than a 10% cushion would be. In addition, tax consequences matter and are generally given higher consideration than the 10% negligible protection.

Irrespective of our philosophy, we generally recommend that the Reality of the Sale approach always be complied with even if the advisor subscribes to the 10% seed concept. In addition, if the Reality of the Sale approach is used, additional safety is obtained by also having a legitimate guarantee of 10% as an alternative to 10%. This financial analysis, coupled with a 10% seeding gift or a legitimate 10% guarantee should meet the standards of the estate planning community.

We conclude that the correct test is whether the scheduled note payments can

be projected to be satisfied. That standard should always be met. In addition, either a 10% cushion in the trust, through a legitimate guarantee, or a combination of both is recommended."

Jerry Hesch, **Dick Oshins** and **Jim Magner** provide members with their commentary on what they refer to as "The 10% Myth."

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Richard A. Oshins is a member of the Las Vegas law firm of **Oshins & Associates, LLC** where he concentrates in tax and estate planning with a substantial emphasis on multi-generational wealth planning particularly with regard to closely held businesses. Mr. Oshins advises clients throughout the United States and has been an advisor and consultant to many of the largest financial institutions in the United States. He has been listed in both *The Best Lawyers in America* and *Martindale-Hubbell's list of Preeminent Lawyers* from their inception, and is a member of the Estate Planning Hall of Fame by the National Association of Estate Planners & Councils. Dick was also selected by *Worth* magazine as one of the Top 100 Attorneys in the United States and has been named one of the 24 "Elite Estate Planning Attorneys" by the Trust Advisor. Prior to coming to entering the private practice of law, Mr. Oshins served as a law clerk for the United States Court of Claims in Washington, D.C. and as an Attorney-Advisor in the Office of the Tax Legislative Counsel, U.S. Treasury Department, in Washington, D.C. Mr. Oshins lectures extensively on innovative tax and estate planning strategies and is the author or co-author of numerous articles.

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Here is their commentary:

EXECUTIVE SUMMARY:

An installment sale to a grantor trust in exchange for a note is a popular and powerful wealth shifting strategy often recommended by estate planners. In the typical transaction, the trust is "seeded" and then a sale is made to the trust in return for a note. Under the "Intentionally Defective Grantor Trust" (IDGT) version of note sale, the client ordinarily transfers assets to a trust that is defective for income tax purposes and subsequently sells assets to the trust. Often in practice, the initial funding is designed to establish the "creditworthiness" of the IDGT. A newer strategy is for a third party to "seed" the trust, whereby a beneficiary is given a lapsing power of withdrawal which results in income tax grantor status to the power-holder under Section 678. This variation has been referred to as a "Beneficiary Defective Inheritor's Trust" (BDIT) or "Beneficiary Grantor Trust" (BGT), which is ordinarily the recipient of an initial capitalization of $5,000.

There is a popular belief or "rule of thumb" that the initial funding of an IDGT should be 10% (a ratio of 9:1) in order to give the sales transaction "economic substance." Thus, $1 million will support a sale of $9 million to the trust because that theoretically will provide economic validity to the transaction. In other words, subscribers to the 10% test contend that a rational seller in the "real world" would not sell his/her assets to a buyer who does not own the 10% minimal amount to protect against the downside risks of the sale.

But is that arbitrary test correct? Must there be "risk shifting?" Although

addressed primarily with respect to sales to grantor trusts, since the issue is one of “reality of the sale” for income and transfer tax purposes, the same issues arise for non-grantor trusts. There also appears no reason that it should not apply to other intra-family transfers not otherwise legitimized by statute, judicial decisions or administrative pronouncements.

Nowhere in any published ruling, case or other unofficial administrative pronouncement of the Internal Revenue Service can this theoretical 10% rule be found. The 10% rule of thumb is based on several analogies and has unfortunately developed a life of its own. In so doing, it has become the ultimate “urban legend” in the estate planning space.

Indeed, many commentators and practitioners misapply the hypothetical safe harbor and use a debt-to-equity ratio of 10:1. In such instance, assuming that 10% was the minimal permissible equity, the test would not be met. It is our belief that practitioners have been using the wrong analogies which are not reflective of how transactions are consummated in the real world. Rather than deriving analogies from similar, but very different, estate planning arrangements, we believe that the income tax cases dealing with the identical reality-of-sale issue are much more indicative of the proper approach. Indeed, the Supreme Court in several cases analyzing the “reality of the sale” issue decided in well-reasoned decisions that this conjectural assumed test is inapplicable and not indicative of real world behavioral patterns.

COMMENT:

The Reality of the Sale Conundrum

The recent commentary on installment sales to grantor trusts has naively established a guideline that the grantor trust should have independent funding in an amount equal to 11.1% of the value of the property it purchases from the grantor.[ii] However, nowhere in any published ruling, case or unofficial administrative pronouncement of the Internal Revenue Service is there a 10% rule,[iii] although some have suggested[iv] that it is based on an analogy to the requirement of § 2701 that the junior equity interest have a value of at least 10% of the value of the enterprise.[v]

Commenting on the various risks associated with the lack of substance, a noted authority has stated that:

> The risk created by ‘thin capitalization’ is includability in the gross estate under Section 2036, a gift upon the cessation of Section 2036 exposure, applicability of Section 2702 to such a gift, the creation of a second class of equity in the underlying property with possible consequences under Section 2701 and possible loss of eligibility of the trust to be a shareholder of an S corporation, continued estate tax exposure under Section 2035 for three years after cessation of Section 2036 exposure, and inability to allocate the GST exemption during the ensuing ETIP. The Section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain.[vi]

The minimum 10% funding guideline is easy to understand and has clearly assumed an authority of its own. Often advisors forget that this is theoretical and not a rule. For example, the court in *Baker Commodities, Inc. v. Commissioner* concluded that a 700:1 Debt/Equity ratio was legitimate.[vii] In order to comply with the 10% gauge, the grantor of the trust may have to make a taxable gift of a substantial amount in order to provide such funding unless there is an existing grantor trust with existing assets or arrange for a similar alternative. In addition to the gift tax, providing the minimum funding becomes doubly expensive if the available GST tax exemption has already been used.[viii]

In the income tax cases that have dealt the issue of whether related party installment sales will be recognized, the prevailing law is that the sale will be respected if (i) the amount of the seller-provided financing does not exceed the value of the asset purchased,[ix] and (ii) it is reasonably expected that the purchaser will be able to meet the financial obligations on the note in a timely manner as they become due. It is difficult to conclude that the same analysis should not be applied to related party sales under the transfer tax system.

Analytically, we are not dealing with a specific Internal Revenue Code section. Rather, the task is to consider what test should be applied to obtain legitimacy of a transaction for all tax purposes. We find it difficult to conclude that the courts, including the Supreme Court, in several cases, would apply different criteria to a similar transaction for transfer tax and income tax purposes. Accordingly, the crucial question to ask is:

> Based on all of the facts and circumstances can it reasonably be expected that the purchaser will be able to meet its financial obligations on the

promissory note in a timely manner as they become due?

In this regard, the key fact is that taxpayer must be able to demonstrate that there is a reasonable probably that the purchaser will have access to the necessary funds to meet its obligations as they become due.

Planning Note: For an exceptional analysis of the "Reality of the Sale" approach of the Supreme Court and other courts, **LISI** members should review the article by **Charles I. Kingson** titled "*Risk, Ownership, Equity: 2011 Erwin N, Griswold Lecture*," *Tax Lawyer*, Vol. 64, No. 3, Spring 2011.

Fundamental Questions in Resolving the "Reality of the Sale" Conundrum

Given this background, a number of fundamental questions are presented when an attempt is made to deal with the "reality of the sale" conundrum, including the following:

- What is the proper test to determine whether an "intra-family" transfer cast in the form of a sale to trust should be respected?
- What is "economic reality?"
- Is there a "business purpose" test that must be met?
- Is "risk shifting" an essential element intra-family sales?
- To what extent do the tax consequences to the buyer and to the seller factor into the transaction?
- What safety precautions should the advisor consider in structuring a sale to a trust or directly to junior family members?

The Concept of Fair Market Value ("FMV") For Lifetime Transfers

The general definition of FMV for lifetime transfers of property is found in Treasury Regulation Section 25.2512-1:

> The value of property is the price that property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of

relevant facts.

The Regulations in effect look at: (i) hypothetical parties who wish to engage in a transaction ("willing") and (ii) the price that will be arrived at is what the asset being sold would generate in a retail market place for the asset in question.[x] Although the Regulations use a market price that would be arrived at by knowledgeable parties, they assume imaginary parties and do not look at other factors, such as the wealth of the buyer. Although the identity of the buyer is not relevant in deciding "fair market value," it is often an essential ingredient in determining if the sale should be respected by the IRS and the courts. We will demonstrate that transactions often contemplated in sales to grantor trusts which meet the 10% assumed safety threshold are economically inferior to certain transactions structured differently. In those circumstances, the seller's choice in the real world would not be the theoretical 10% option. That conclusion is supported by case law, including several opinions by the Supreme Court.

Economic Substance/Economic Reality/Business Purpose

The necessity for a business purpose should be satisfied if the exchange is for equal value. In order for assets to have equal value, if one of the assets has shortcomings, the other asset must have offsetting characteristics, or the assets exchanged will not be of equivalent value. Reasonable people would disagree which attributes are preferable. The parenthetical languages in Sections 2036 – 2038 dealing with "adequate and full consideration" support this notion, as does the case law.

The equality of valuation issue has been successfully approached by using a Defined Value Sale safety net. Otherwise, if a Defined Value Sale is not used, any gratuitous element would be a gift. A gift is often tolerable in the sale to an IDGT because of the large exemption that may be available, but not in the sale to a BDIT. A well-structured Defined Value Sale should be sufficient to prevent a gift from the seller to the trust.

Assuming that the asset sold is equivalent in value to the note, the next hurdle that must be met for the transaction to be honored is the theoretical economic reality.

With regard to the issue of economic reality, any IRS attack would have "… to deal with the four Supreme Court cases … *Clay Brown, Frank Lyon,*

Consumer Life, and Cottage Savings. Each upholds a transaction with no nontax economic effect and no nontax profit."[xi]

There are two hurdles that must be satisfied: 1) the values are not equal and 2) the sale will not be respected:

1. Any disparity in value in value can be eliminated by using the Defined Value Sale formula, and

2. The cases decided by the Supreme Court that will disregard the sale and treat the transaction as something else.

The same principles should be applicable in both the transfer tax and the income tax context. In effect, does the transaction have economic substance? Perhaps, a good place to start the analysis is to look at the codification of the economic substance doctrine, for income tax purposes, first realizing that if Congress desired to include the transfer tax system, it would have enacted a similar law in the both gift tax and the generation-skipping transfer tax.[xii] For *income tax purposes* there is a two prong test that the taxpayer must comply with: (i) the transaction must change in a meaningful way (apart from federal income tax effects) the taxpayer's economic position and (ii) the taxpayer must have a substantial purpose (apart from federal income tax effects) for entering into the transaction.[xiii]

The answer to the two tests if they were applicable to a sale transaction is that there is a very substantial difference in the seller's economic position which is not dissimilar to an owner of a preferred interest in an entity and a common interest. The cases dealing with the conversion of equity to debt recognize that the two interests have very different attributes. Debt is safer than equity, however, it does not share in the upside rewards of success. Essentially, in a note sale, the seller is exchanging "… a claim to the property (equity) for a claim *against* the property (debt)…"[xiv] (Emphasis added).

In addition to the unique characteristics of debt and equity, the seller is able to liquidate his/her asset presently with a preferred buyer who is sheltered with favorable income tax consequences. Based upon supportable evidence, there is a larger range of reasonably acceptable value based on earnings and net worth for a buyer who is acquiring an asset with after-tax dollars in a sale that is income tax-free.[xv] The existence of favorable tax consequences transforms many transactions into making "economic sense" and are a

meaningful component of the decision making process.

Since an equity interest bears the risk of declines in value as well as the benefit of increases in value, in effect a seller is exchanging an "equity" interest in the asset (principally, the post transfer appreciation after the note is paid in full), for the secured debt that can be paid by the buyer with pre-tax dollars. The favorable tax component increases both the safety of the transaction compared to an individual or a taxable entity and the buyer's ability to pay off the debt faster. Because the buyer is not paying income taxes, this increases the safety of the payment to the seller as well, as the ability of the buyer to accelerate the payment of the note.

Moreover, because the sale is not an income tax realization event, the favorable income tax attributes can be factored into the transaction and can be shared by the parties during the negotiation process. Surely, the buyer that is paying a debt with untaxed cash flow is a preferable buyer than an otherwise identical buyer who is paying a debt with the impediment of after tax cash flow.

Real World Economic Analysis

Perhaps the way to determine what is an economically viable transaction is to look at what would be the expected behavioral reactions in the real world. In other words, what would rational parties do given alternatives reflective of the approaches being discussed? Would they elect the 10% "seed" money option, or would they choose a viable alternative?

Initially, we need to recognize that 10% "seed" money of the same value is not always equal. To illustrate, assume that Trust A is funded with $5 million of cash/bonds/marketable securities and Trust B is funded with a non-controlling interest in an LLC that owned raw land that after applicable valuation adjustments was worth $5 million. It is easy to predict that Trust A would be the preferable buyer in the eyes of an astute seller.

Example: The following example illustrates why the artificial 10% rule of thumb is not economically reasonable.[xvi] Assume that a client owns two LLCs, LLC #1 has a value of $15 million; LLC #2 has a value of $225 million. The client owns 100% of both LLCs and they each have 1% voting interests and 99% non-voting interests. For income tax purposes, both entities are treated as "disregarded entities." The client funds an IDGT with $1

million. For the sake of simplicity we will assume a discount of 40% is permissible:

- Step #1 - The client sells the 99% non-voting interest in LLC #1 to the IDGT for just under $9 million which meets the 10% theoretical test. Proponents of the concept would feel very comfortable with the 9:1 ratio.

- Step #2 – Subsequently after the transaction is old and cold, the client sells the 99% interest in LLC #2 to LLC #1 for $135 million. Because LLC #1 is worth $15 million it is within the 10% rule of thumb.

- Both LLCs are disregarded entities. Since the trust is a grantor trust, both sales are income tax-free.

- The theoretical 10% test would have been met in both transactions, however, the $1 million has been leveraged so that it owns the two 99% interests. We meet the "10% test." However, is there reasonable economic substance in the "Double LLC" transactions that the real world would recognize?

Planning Note – Although there is no support for the proposition that "seed" money is essential, and indeed, our position is the opposite, many careful planners substitute "legitimate" guarantees to meet the economic protection thesis of those who advocate the 10% "seed" philosophy. A legitimate guarantee made by someone who has the wherewithal to pay the guarantee should it be called should be essentially the functional equivalent of "seed" money. The guarantor should generally be represented by separate counsel and reflect the guarantee on his or her balance sheet.

Planners should note that two significant companion cases recently before the Tax Court (*Estate of Donald Woebling v. Commissioner*, Docket No.30261-13, and *Estate of Marion Woebling v. Commissioner*, Docket No. 30260-13), involved a 10% personal guarantee by two Woebling sons. Both cases have apparently been settled. [xvii]

In the real world, banks and other lenders often look to guarantees, and the following fact pattern is not uncommon. The child of a wealthy family goes to a bank to finance the purchase of a shopping center. The child is a recent college graduate with minimal assets of his/her own.[xviii] The excess cash

flow from the shopping center can easily support the mortgage payment if there is an 80% loan-to-value ratio. The child wants the bank to lend only 75%. Although the child will personally guarantee the mortgage loan, the bank will refuse to make the loan unless the child's wealthy parent guarantees the loan. That is true even if the child has his/her own funds, unless those funds are substantial. In effect, the only reason the bank made the loan is because a person with the financial ability to satisfy the loan made a personal guarantee!

The foregoing leads to the conclusion that both supportable cash flow and legitimate guarantees would prevail over a nominal 10% equity cushion a buyer might have.

Tax Consequences Are a Meaningful Ingredient of the Business Decision Making Process

The *Clay Brown* line of cases illustrate another impediment of 10% providing the economic incentive for the transaction. As noted below, tax consequences are a meaningful ingredient in the business decision making process. The fact that business people take the tax consequences into account in structuring, or even proceeding with, a transaction is indisputable, a point that featured prominently in the *Clay Brown* opinion:

> However, the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source. The Code gives the (charitable entity buyer) a tax (benefit) which makes it capable of taking a greater after-tax return from a business than could a non-tax-exempt individual or corporation."[xix] (Emphasis added)

In effect, because the buyer (here a charity) does not pay income taxes, both the buyer and seller can structure the transaction where the tax treatment could enable both to improve their economic positions. Because of the lack of income tax consequences to the buyer, it would have a larger after tax profit than a taxable buyer and could pay the seller either more for the asset, pay the seller faster, or both. That result could not occur if the transaction was with a buyer who did not have the favorable "tax attributes."[xx]

In *Clay Brown*, the seller (the Brown family) exchanged a remainder interest

in the entity "…for two tax benefits: exemption from tax at the corporate level and capital gain rather than dividend treatment at the shareholder level."[xxi] If we extend the Supreme Court's analysis to a sale to a grantor trust, the after-tax economic analysis generally will lead to the general conclusion that the 10% cushion is fundamentally irrelevant. The seller to a more nominally funded IDGT or BDIT receives two items of substantial value, in addition to the relatively minimal amount of any initial "seed" money: i) the note and ii) the "tax attributes."

The tax attributes of grantor trust status are significant. In essence, the seller transfers the upside appreciation in exchange for the superior after-tax result. If the sale were made to an individual, or taxable entity, the proceeds would be: (i) taxable to the seller and (ii) the earnings of the entity would be taxable to the entity and the seller would net an inferior after tax return – less security, slower payout and a reduced ability to negotiate the price because of favorable tax consequences. Although the buyer and seller are considered the same if there is income tax grantor trust status, they are not the same person for state law property right purposes and transfer tax purposes.[xxii] Therefore, the financial impact on the buyer becomes significant.

Although the "willing buyer/willing seller" test presumes that the parties are hypothetically strangers in arriving at the value of the asset being transferred, the fact that the buyer has a larger cash flow as a result of not being subject to income taxes should be taken into account in determining the viability of the transaction from a net transfer tax standpoint as well as the ability to accelerate payment. The income tax feature of the IDGT and BDIT would permit the those trusts to pay off the debt considerably faster than a taxable buyer, which is a factor that would be a very desirable attribute to a seller who wants to receive payment as quickly as possible. If the buyer did not accelerate payments and retained the tax savings, it could accumulate a wonderful safety net for the seller's security. Because a buyer that does not pay income tax must earn less to pay the debt than a taxable counterpart, the income tax favored buyer provides more security to the seller (and should be able to pay the debt faster) than a buyer who is paying the obligation with after tax dollars, particularly if the buyer is paying the debt solely from cash flow.

To illustrate the proper analysis of the transaction, if an asset were sold to a person other than a spouse,[xxiii] or a taxable entity in the 40% income tax bracket for $9 million, a taxable buyer would have to earn $15 million to pay off the debt, ignoring the interest component. Alternatively, if the sale were

made to a buyer that does not pay tax, such as an IDGT or BDIT, the buyer would have to earn only $9 million to pay the debt. Even if you factor into the decision making equation that the taxable buyer had 10% seed money (11.1% of the $9 million - $1 million) the buyer who is not subject to income taxes is the safer option for the seller to transact with than the non-sheltered buyer with 10% funding.

It is conceded that the ability to receive "some" of the money back is more apparent where the assets are used as a down payment or retained as a cushion, although 10% is a relatively minimal amount. The reality of the transaction is that the seller is looking to the "net" cash flow for payment. The untaxed cash flow is 167% of the after tax cash flow. Certainly, in most instances, it will more than offset the nominal 10% "seed" money.

Generally, the asset sold to the IDGT or BDIT is a hard to value asset which has a reduced market. For many clients, owning illiquid assets is disconcerting, particularly as they get older. The ability to freely liquidate the asset and exchange it for cash flow is desirable. The transferor is exchanging "…a claim *to* the property (equity) for a claim *against* the property (debt) … Equity is riskier because it is subordinate to debt…"[xxiv] Because the buyer is tax-sheltered, there is a larger marginal disparity in determining a sales price that is economically beneficial to both parties. Since the IRS does not participate in the transaction: (i) the sales price can be increased by the parties and still have economic viability; (ii) there is an increased number of "willing buyers," and thus a larger market of potential buyers; and (iii) the purchase can be paid faster from cash flow.

From the buyer's perspective, similar to the charity in *Clay Brown* or the entity in *Frank Lyon,* a grantor trust will have a far greater after-tax return than an unsheltered buyer. As a result, it can pay the debt faster than an alternative buyer, therefore eliminating the debt and becoming an equity owner. Further, the income tax exempt nature of the buyer will result in a greater profit to the buyer as the equity owner. In this instance, for the buyer, the BDIT is presumptively superior to the IDGT because the seller is a beneficiary of the grantor trust.

In addition, the ability of the BDIT to eliminate grantor trust status during lifetime is problematic. Thus, the buyer trust is assured of having someone else absorb the income tax bite until the death of the income tax owner of the trust. The assurance of grantor trust status is a very valuable asset to the

BDIT. That can be simply visualized by computing the power of tax-free compounding over a time. Note that the risk of the BDIT's income tax owner dying too early can be hedged by the BDIT acquiring a life insurance policy on the life of the income taxpayer.

Planning Note: Acquiring the life insurance in the grantor trust offers many substantial benefits. First, it would not be estate taxed. Second, cash flow in excess of the money to pay the note is an excellent source of premium money. Third, if the grantor trust is a BDIT, the client can be a beneficiary and have indirect access to the internal cash value build-up.

The foregoing analysis can be examined by comparing expected buyer behavioral patterns where a hypothetical seller has an asset worth $9 million. In ranking the potential buyers, it is reasonable to assume that the most desirable deals be ranked in reverse chronological order:

1. A sale to a buyer which has a balance sheet of $1 million equity, but the projected cash flow from the purchased asset is negligible;
2. A sale to an IDGT that had $1 million equity and had cash flow from the purchased asset that is sufficient to pay the installment note in accordance to its terms if the trust remained a grantor trust, but insufficient to pay the note if it did not;
3. A sale to a BDIT that had $5,000 equity and had cash flow from the purchased asset that is sufficient to pay the installment note in according to its terms if it remained a grantor trust, but insufficient to pay the note if it did not.

Option #1 is least desirable because under present facts, the note would not be able to be paid in accordance with its terms. Under option #2, the grantor may turn off the spigot and eliminate grantor trust status, which would eliminate the ability to pay off the note in accordance with its terms. Turning off grantor trust status is a common election for grantors who find that grantor trust status is undesirable. Under option #3, we do not know of a safe method for turning off grantor trust status other than death of the owner of the income. Thus, the probability that grantor trust status continues is far greater than in option #1. Further, a life insurance policy on the life of the income tax owner is an option to hedge the concern.

Planning Note: Because the essential ingredient of the *Clay Brown* line of cases is "Will the note be paid off in accordance with its terms?" it is

important to obtain supportive evidence that meets that test. Accordingly, it is crucial to obtain a high quality appraisal. We generally advise that with sales of hard to value assets that an independent trustee negotiate the transaction on behalf of the trust and that both parties be represented by separate counsel. The desire to use separate counsel is to comply with the decisions in the family limited partnership area where taxpayers have failed because they did not use separate counsel and the courts concluded that the taxpayer "stood on both sides of the transaction."[xxv] In the context of gratuitous transfers of FLP interests, it is difficult to concur with the philosophy that donor/donees would require, or have, separate representation for giving and receiving of gifts. On the other hand, as a general proposition, both parties in a large sale typically have separate representation.

Planning Note: The importance of reputable written financial projections cannot be overstated because of the key component that the note is expected to be paid in accordance with its terms. Generally, either the CPA or the appraiser will provide this support. When structuring transactions, some advisors assume that the note can be renegotiated in the future (often after 9 years) if the cash flow is inadequate to pay the note in accordance with its terms. We believe that the protections of analogous case law are substantially compromised where legitimate projections do not illustrate that at the time of the transaction the buyer can meet its obligations under the note. Re-negotiation of a note where projections are not made should not adversely impact the sanctity of the transaction so long as there was a legitimate expectation at the time of the sale. Therefore, in any related party sale, even where the buyer has sufficient equity, a financial projection should be prepared showing that the asset purchased can provide the necessary cash flow to pay the interest, and even the principal, on the note without regard to the purchaser's other assets.

Supreme Court Analysis of Reality of Sale and Intra-Family Sale Transactions

A major (even the sole) source of funds for the trust to meet its financial obligations on the promissory note as they become due can always be the cash flow expected to be generated by the asset purchased from the grantor. Bootstrap sales, even with 100% non-recourse financing, have long been accepted as sufficient to support sales for federal income tax purposes.[xxvi]

In *Commissioner v. Clay Brown*, the Supreme Court held that the taxpayer's

"bootstrap" sale of stock to a charity in exchange for a note as part of a three party sale and leaseback did not preclude the seller of capital gain treatment. The note was non-recourse and payable solely from the earnings of the business. The Supreme Court "…used the criterion of state law to determine tax ownership, explicitly stated that the economic risk did not determine ownership, and upheld a transaction with no nontax motive and certain economic loss."[xxvii] Although there are two attributes of ownership (economic benefit of gain and risk of loss), the Supreme Court in *Clay Brown* held that the sale will be respected even though risk of loss was retained by the seller.

Proponents of the position that there must be 10% at risk in order to provide sufficient protection to the seller to legitimize the transaction overlook the realities of what occurs in real life. *Clay Brown* concluded that risk shifting is not an essential element of a valid sale and that often in commercial practice, transactions are often structured so that solely the cash flow is responsible to pay the purchase price.[xxviii] In *Clay Brown*, the Supreme Court said:

> To say that there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income produced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term "sale," is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it.
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> *******
>
> Furthermore, risk-shifting of the kind insisted on by the Commissioner has not heretofore been considered an essential ingredient of a sale for tax purposes…. To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale. The term "sale" is used a great many times in the Internal Revenue Code and a wide variety of tax results hinge on the occurrence of a "sale." To accept the Commissioner's definition of sale would have wide ramifications which we are not

> prepared to visit upon taxpayers, absent congressional guidance in this direction.[xxix]

In effect, only benefit of gain to the buyer is needed!

Conclusion

A basic business transaction – the sale of an equity interest in exchange for legitimate debt – which has meaningful alternative economic consequences, should be respected for tax purposes. Simply because the selection of an alternative is largely or entirely based on comparative tax advantages should not adversely impact that result. To conclude otherwise is irrational and is not consistent with normal behavioral patterns. The often cited landmark decision of *Gregory v. Helvering* provided that: "… the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[xxx] In situations, such as a note sale to a grantor trust where it improves the pure economics of the transaction, the conclusion should be respected.

In the real world, given a choice between equity ownership of an asset (including the remainder interest), or a claim against the asset equal to the value of the asset (the note), reasonable people may disagree as to which option is best. Because the buyer's income tax shelter results in the asset being liquidated income tax-free, that alternative will often prevail. Although economic substance is not essential, at least in a vacuum, if the term "economic substance" is given its ordinary meaning, enhanced benefits should triumph. The tax-free payment of the current fair market value of an asset should be very appealing to both the buyer and seller and prevail.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jerry Hesch

Dick Oshins

Jim Magner

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[i] Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation. 2016-22785 exp 12.2017.

[ii] See e.g., Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14*?, 32nd U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶ 1505.2 (1998); Oshins, *Sales to Grantor Trusts*, 13 Prob. & Prop. 46, 48 (1999).

[iii] It has been suggested that PLR 95-35-026 (05-31-1995) required a contribution of 10 percent of the installment purchase price as a condition of the issuance of a favorable ruling, but the facts of the ruling do not reference a 10 percent contribution; see Poker, *A Primer On Sales To Intentionally Defective Grantor Trusts*, ALI-ABA Estate Planning Course Materials Journal, October, 2008 at p. 40; also see Zaritsky, "Tax Planning for Family Wealth Transfers: Analysis With Forms," ¶ 12.07[3][d][i], Thomson Reuters/WG&L, 5th Ed., Apr. 2014, ("In, [PLR 9535026] the IRS is reported to have demanded that the parties agree to commit at least 10 percent of the purchase price to trust equity.").

[iv] See, e.g., Hatcher and Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. Tax'n 152, 159 (2000). As the authors correctly note, if this is the basis for the 10%, gross up principles require that the funding be 11% of the note.

[v] 2701(a)(4); Reg. 25.2701-3(c), determined by including indebtedness to family members in enterprise value, §2701(a)(4)(A)(ii); Reg. § 25.2701-3(c).

[vi] Aucutt, *Installment Sales to Grantor Trusts*, 4 Bus. Ent. 28 (Mar./Apr. 2002).

[vii] 48 TC 374 (1969), aff'd. 415 F 2d 519, cert. den.

[viii] The GST tax exemption is indexed for inflation and is $5,450,000 for 2016.

[ix] In Lebowitz v. Commissioner, 917 F.2d 1314 (2d Cir. 1990), the court stated that "the proper question concerning the genuineness of the debt turns on whether the value of the acquired property . . . approximated the principal amount of the . . . note."

[x] Treas. Reg. Sec 25.2512-1.

[xi] Kingson, *Risk, Ownership, Equity: 2011 Erwin N, Griswold Lecture*, *Tax Lawyer*, Volume 64, No. 3, Spring 2011, p. 642.

[xii] LMSB-20-0910-024.

[xiii] Sec. 7701(o).

[xiv] Kingson, Id. at p. 638.

[xv] Commissioner v. Clay Brown, 380 U.S. 563. Both Justice White writing for the majority and Justice Harlan in the concurring opinion, address the factor that tax consequences matter and should be taken into account in determining the economic reality of a transaction.

[xvi] Oshins and Handler "Estate Planning with Disregarded Entities" Estate Planning Newsletter #2367, December 14, 2015.

[xvii] See Steve Akers, "Pending Settlement of *Woebling* Cases (Involving

Sale to Grantor Trust with Defined Value Feature)," Bessemer Trust, April 4, 2016; Ron Aucutt, McGuireWoods Legal Alert, "Parties Settle Closely Watched Tax Court Cases Involving Defined Value Clause".

[xviii] Hesch & Manning, *Coordinating Income Tax Planning with Estate Planning: Uses of Installment Sales, Private Annuities and Self-Canceling Installment Notes*, 36th Annual Phillip E. Heckerling Institute On Estate Planning, Chapter 10, at 17; see Mulligan, supra note 1, at ¶ 1507.1; Nicholson, *Sale to a Grantor Trust: Better Than a GRAT?*, 37 Tax Mgmt. Mem. 99 (1996); see also Hatcher and Manigault, supra note 2 at 158 (suggests trust with no resources other than property purchased is difficult to distinguish from a GRAT); Hesch & Manning, *Coordinating Income Tax Planning with Estate Planning*: 36th Annual University of Miami Phillip E. Heckerling Institute on Estate Planning, Chapter 10; Hesch & Manning "*Deferred Payment Sales to Grantor Trust*" 24 Tax Management Estate, Gifts and Trust Journal 3 (1999).

[xix] Commissioner v. Clay Brown, 380 U.S. 563 (1965), Justice Harlan concurrence p. 580.

[xx] Kingson, Id. at page 638.

[xxi] Kingson, Id. At page 644.

[xxii] See IRC Subtitle A, Ch. 1J, Part E and Rev. Rul. 85-13.

[xxiii] Sec. 1041.

[xxiv] Kingson, Id. at page 638.

[xxv] Estate of Bongard v. Commissioner, 124 T.C. at 118; Estate of Jorgensen v. Commissioner, T.C. Memo. 2009-66, aff'd, 431 F. App'x 544 (9th Cir. 2011); Estate of Hurford v. Commissioner, T.C. Memo. 2008- 278; Mirowski v. Commissioner, T.C. Memo. 2008-74.

[xxvi] See *Commissioner v. Clay Brown*, 380 U.S. 563 (1965); *Mayerson v. Commissioner*, 47 T.C. 340 (1966), acq. in result only Rev. Rul. 69-77, 1969-1 C.B. 59. Although there are few, if any "reality of sale" decisions in the transfer tax area, there is a well-documented history of case law dealing with intra-family sales in the income tax area. For example, consider all of the sale-leaseback cases that the IRS challenged in the era when the intra-family sale

was designed to generate depreciation deductions or convert the cost of non-depreciable land into deductible rental payments. All of these income tax cases dealt with the reality of sale issue and discussed the factors that the courts would consider in deciding upon the reality of the intra-family sale. And, all of the tax shelter cases from a prior era also support the reality of sale analysis. See the Supreme Court's opinion in *Frank Lyon Company v. U.S.*, 435 U.S. 561 (1978). In the income tax area the IRS has provided guidelines on how to structure intra-family transactions that will be respected. See Rev. Rul. 55-540, 1955-1 C.B. 39 and Rev. Proc. 75-21, 1975-1 C.B. 715, modified by Rev. Proc 76-30, 1976-2 C.B. 647. The IRS guidance evaluated these factors as guidance in determining whether the intra-family transaction was a sale or a lease.

[xxvii] Kingson, Id. at page 637.

[xxviii] The result of the *Clay Brown* strategy of using tax-exempt entities in a boot-strap sale was eliminated by Congress in 1969 with the addition of IRC 514(a). Professor Kingson explains that the statutory change - "…implicitly accepts the *reasoning* of *Clay Brown* - that you can transfer ownership without transferring risk. * * * * * In both *Clay Brown* and *Frank Lyon*, the issue was whether a sale had taken place. * * * * *Who has the claim *to* property (equity) and who has a claim *against* the property (debt)." Kingson supra at p. 638 (Emphasis the authors) "… the sellers retained the same risk of loss in the business after the transaction but gave up some future earnings. Kingson supra at p. 643.

[xxix] *Commissioner v. Clay Brown*, 380 U.S. 563 (1965) at p. 570 and 574.

[xxx] *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

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