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Deferred Sales Trusts

The tax landscape in the United States is ever-changing. In turn tax advisors, consultants, experts, etc., remain on a continued pursuit to mitigate their client's taxes from a business sale perspective. It is no secret, that the goal for all business owners who sell their company is to recoup as much value as possible by mitigating as much tax as possible. After all, business owners did not invest their lives into a company to give sales proceeds by way of tax to the government. There are many tax-saving structures and methodologies when selling a business and one structure, popularized over the last four to five years, is the Deferred Sales Trust. A Deferred Sales Trust or "DST," is an arrangement to defer capital gain on the sale of a business using the installment method under I.R.C. §453. However, a DST is not something embodied in the IRS Code or tax court case law.

Instead, the term "Deferred Sales Trust" is a trademarked term for a financial planning strategy. This article will set forth the structure of the DST, its origins, benefits, and drawbacks for those interested in utilizing a DST as a tax mitigating tool. To better illustrate the DST structure, steps 1-6 below provide how a DST is crafted to obtain the tax benefits proposed:

1. A third-party trust is formed that will be managed by a third party.
2. The Taxpayer/Seller assets are sold to the trust using an installment contract.
3. The trust then sells the assets to the Buyer and receives the funds.
4. The third-party trustee then invests the funds and/or distributes installment payments at the Taxpayer/Seller's direction.
5. Capital gains are only paid on the principal amounts the Taxpayer/Seller receives from the installment payments.
6. The Taxpayer/Seller can recoup the benefit of continued interest payments from the third-party trust based on the quality of investment while capital gains continue to defer.

But does a structure like this hold up under IRS scrutiny? The answer is yes. While DSTs are a semi-new concept, the nature of DSTs has been in existence since 1980. Before 1980, somewhat like the current DST structure, a Taxpayer/Seller would sell its property to a related person who would then sell the property to an outside buyer instead of using a trust managed by a third party. In 1976, the IRS took issue with the "related person" sale and challenged the structure in Wrenn v. Commissioner of Internal Revenue where the Tax Court held, "To receive installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom."

Wrenn v. Commissioner of Internal Revenue, 67 T.C. 576, 5821 (1976). Then, Congress passed the Installment Sale Revision Act of 1980, more specifically I.R.C. §453 which currently oversees the most integral part of DSTs, the installment method of payment, and related personal aspects. It is important to understand the history of DSTs as it has shaped the legality of how they operate today. Taxpayers/Sellers looking for a large lump sum of sale proceeds from selling their business are not prime candidates for a DST. DSTs pay out your proceeds over time, meaning you will have to wait until the term of the note to receive the full amount of the sales price, rather than getting a large sum of money right away. For those who can wait, you can reap the benefits of receiving interest payments on top of any principal due to you. While the financial return and tax mitigation of a DST can be very advantageous, it is vitally important the Taxpayer/Seller understand the creditor role of the creditor.

The creditor relationship between the Taxpayer/Seller and third-party trust is paramount to the investment protection and risk of the Taxpayer/Seller. Taxpayer/Seller financing is implemented using a Promissory Note, Security Agreement, and most important, a UCC Financing Statement securing the relevant collateral in case there is a default on the Promissory Note. When using a DST, it is paramount to understand the secured nature of your investment. An investment that lacks a Security Agreement and UCC1 Financing Statement increases the Taxpayer/Seller risk exponentially as the Taxpayer/Seller is left without collateral value in the scenario of a Buyer or third-party trust default.

However, confirmation of a Security Agreement and UCC1 Financing Statement is not the stopping point, it is equally important to understand the creditor position in which the Taxpayer/Seller will be placed as they want to be first in line to receive the collateral in the event of default. A second or third-place creditor position leaves the Taxpayer/Seller vulnerable and at risk of their investment. Finally, because DSTs are financial planning strategies rather than an intricate tax concept, there are usually other costs associated with the implementation. Moreover, in some DST the Taxpayer/Seller is subject to fees to the independent trustee and investment advisor as well. If you have any questions regarding Deferred Sales Trusts, please feel free to reach out at our website, www.taxplanning.com, or by phone at (618) 997-3436.

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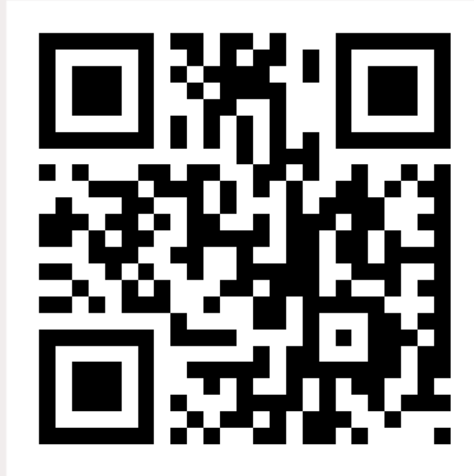

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