Economic Substance and the "10%" Funding "Myth" for Trusts

A rule of thumb has taken on excessive importance to some practitioners who recommend a trust that will purchase assets with an installment note.

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An installment note sale to a grantor trust is a popular and powerful wealth-shifting strategy. The most typical transaction involves an estate owner creating an intentionally defective grantor trust (IDGT) and funding the trust with "seed" money. After a reasonable waiting period in order to avoid step-transaction status, the donor would sell assets to the trust for an installment note. According to Rev. Rul. 85-13,[1] the sale would be income tax-free. The expectation is that the deferred payment obligation will be satisfied out of the future cash flow from the acquired asset.

A variation of the IDGT note sale is a sale to a trust created by a third party where the seed money is subject to a lapsing power of withdrawal so that the trust is taxed 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). Typically, the funding is as an accommodation to the beneficiary and is limited to $5,000, although a larger amount is permissible.

The "10%" myth

A popular "rule of thumb" provides that in order to be respected, the trust must receive a minimum funding of 10% to support the creditworthiness of the transaction. The general supposition is that in order to provide adequate "economic substance" for the sales transaction, the trust must be "seeded" with at least $1 to legitimize the sale of every $9 to the trust. Many advisors will not proceed unless that artificial test is met.

This article generally discusses the economic substance issue in terms of deferred sales to IDGTs. However, the analysis is equally applicable to deferred sales to BDITs. Because most BDITs are funded with $5,000, an installment note sale ordinarily will not satisfy the arbitrary 10% rule of thumb. The proper process is to comply with the "reality of sale" concept discussed at length below. Although technically not required, additional safety is obtained by supplementing that analysis with legitimate guarantees.

The authors believe that the theoretical 10% safety net is a "myth" and unsupportable. Nowhere in any

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case law, published ruling, or administrative pronouncement is the 10% funding required. However, that "rule of thumb" has been cited so often that it appears to have taken on an assumed authority of its own. Many advisors view the 10% threshold as a requirement and will not proceed unless the arbitrary test is met.

Probability of repayment. The populist viewpoint follows a 10% narrative based on using similar, but different analogies to alternative estate planning strategies. Contrarily, the authors believe that the more supportable approach is to follow the judicial analysis used in countless decisions—including four in the Supreme Court[2]—on precisely the same question in the income tax area. The issue is "under what circumstances will a deferred payment sale be respected?" The "key" to the proper evaluation should be that a seller will want to know that he or she will be paid and that the analysis of whether to proceed will be controlled by that factor. In the real world, an astute seller will look at the probability of the financed amount being paid in accordance with its terms rather than using an artificial sum in determining whether to consummate the transaction.

The courts follow a "reality of sale" approach. Accordingly, the proper test in determining if a sale should be respected is: "Based on all of the facts, can the purchaser reasonably be expected to meet its financial obligations on the promissory note as they become due?"

Supreme Court's reasoning. Professor Charles Kingson in his excellent article on the topic reaches this conclusion: With respect to the issue of economic substance, 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 motive, no nontax economic effect, and no nontax profit."[3]

These cases, as well as a significant number of other well-reasoned decisions in the lower courts test the issue of "economic viability" by analyzing "whether or not it is reasonable to assume that the note will be paid in accordance with its terms." They conclude that if the taxpayer can demonstrate that the purchaser is expected to have the necessary funds to timely meet its obligations, the "economic substance" test is met. Furthermore, there is no need for a nontax motive or an anticipated pre-tax profit.

Of the four cases cited by Prof. Kingson, the most recognizable one is *Clay Brown*,[4] which was a bootstrap sale to a charitable buyer with 100% nonrecourse financing. The Supreme Court stated that—

1. A sale for a promissory note payable solely out of earnings will be respected.
2. Risk-shifting is not an essential component of legitimizing a sale for tax purposes.
3. Tax consequences matter. The tax impact is a meaningful element of the decision-making process. It will be factored into the buying and selling equation by the parties in a real transaction. Tax dollars saved are the functional equivalent of dollars derived from other sources.

With regard to the "tax consequences matter" evaluation, it is self-evident that if there are two identical purchasers, with the only distinction being that one was a person or entity that pays taxes and the other does not, a sale to the tax-exempt entity would be the preferable transaction to the seller. The tax preferenced buyer would provide greater safety and could pay off the debt more rapidly than a buyer who pays the purchase price with after-tax dollars.

To illustrate, assume a business is sold for $6 million. A buyer in the 40% income tax bracket would have to earn $10 million to pay the debt. Conversely, a buyer with an identical profile who is not required to pay income tax on earnings needs to earn only $6 million to honor the obligation. In effect, the seller is receiving two items of considerable value, the secured note and the favorable "tax consequences" of the buyer. Therefore, the tax-advantaged buyer is a more desirable purchaser to the seller. The transaction is safer and the debt can be paid more quickly.

Expanding on the importance and impact of beneficial tax consequences, it would be reasonable to conclude that in most instances, favorable tax consequences are more economically advantageous to the seller than the seed money. In transacting with a grantor trust, the tax consequence of eliminating income tax for the buyer in earning the money to pay the note, and for the seller in avoiding gain on the sale, presumptively exceeds the virtues of transacting with a tax-exempt organization such as a charitable entity in most instances.

The dilemma for advisors

Obviously, it would be best to comply with both (1) the reality-of-sale ideology and (2) the predominant customary approach of using 10% seed money. However, given an option of which one should prevail

[1] 1985-1 CB 184.

[2] Brown, 380 U.S. 563, 15 AFTR2d 790 (1965); Consumer Life Ins. Co., 430 U.S. 725, 39 AFTR2d 77-1261 (1977); Frank Lyon Co., 435 U.S. 561, 41 AFTR2d 78-1142 (1978); Cottage Savings Assn., 499 U.S. 554, 67 AFTR2d 91-808 (1991).

[3] Kingson, "Risk, Ownership, Equity: 2011 Erwin N. Griswold Lecture," 64 Tax Lawyer 635 (Spring 2011); for case citations, see note 2, *supra*.

[4] Note 2, *supra*.

if only one path is available, the authors believe that the former is much more supportable. That approach is consistent with:

1. The judicially adopted analysis on the exact question in the income tax context, including the Supreme Court.
2. What occurs in real world transactions.
3. Academia.
4. Economic sense.
5. Common sense.

Based on all of the facts, can the purchaser reasonably be expected to meet its financial obligations on the promissory note as they become due?

The aggregate of the five foregoing factors is to be compared to 10% seed money approach which is based on analogous, but different strategies. Even if one is dismissive of other factors, the Supreme Court has concluded in four well-reasoned decisions that a favorable economic forecast is determinative of whether the transaction will be upheld on the exact same question. It appears odd that the general consensus concludes otherwise and uses a different approach.

Planning tips

The first step is to comply with the reality-of-sale test and structure the note so that the obligation will be projected to be paid in accordance with its terms. That path should be undertaken even if the trust is funded with 10% seed money. The advisor should make sure that financial projections support that conclusion. Often, either a CPA or the appraiser will do the financial analysis. There is no proscription, however, to having it done internally in the entity or using a reasonably similar alternative. The evidence to support the economic viability should be retained.

The second recommendation is to comply with the prevailing community standards. With an IDGT, in a large sales transaction, the initial financial commitment would be substantial.

Many practitioners use "guarantees" to support the economic vitality of the transaction. It is rational to conclude that a legitimate guarantee is at least as protective as seed money. Because the goal of the "seed" money theory is to make the transaction economically viable, the availability of outside financing (as distinguished from seeding the trust) should sanitize the transaction and support the economic decision. A guarantee of a similar amount by a person or entity with the economic wherewithal to pay the guarantee, if it is called, should satisfy proponents of the theoretical 10% substance test.

Guarantees are more consistent with typical behavioral patterns in the real world than checking the buyer's balance sheet to see if it supports a 9:1 debt/equity ratio. Indeed, it is more reasonable to conclude that the income statement is far more important than the balance sheet. In essence, that conclusion is apparent in the approach recommended. Consistent with the structuring of the seed gift, the guarantee does not have to be for the full amount of the note. A guarantee of 10% should be at least the equal of 10% seed money.

Contrary to the traditional analysis, the authors believe that various ancillary factors should also be part of the equation. For example, the nature of the seed gift should be considered. A stock/bond portfolio is more comforting than a non-controlling interest in an entity of comparable value that owns raw land. Furthermore, the profile of the asset sold should also receive very strong consideration. An asset with cash flow sufficient to satisfy the note would satisfy the judicial test. Alternatively, an equivalent valued asset with low cash flow would have a much higher risk.

Third, the arbitrary 10% rule of thumb appears to have taken on a life of its own, and the authors suspect it will be followed by many practitioners irrespective of the flawed analysis. Those practitioners who elect use to the 10% seeding approach are strongly advised also to perform a financial analysis and comply with the reality-of-sale thesis.

Fourth, often planners are faced with situations where the ability to honor the note in accordance with its terms is questionable because of the lack of sufficient cash flow. Some advisors recommend that the note be structured as a nine-year note in order to access the mid-term rate table rather than the long-term rates. The expectation is that the note will be renegotiated before the balloon payment is due. That approach does not conform to case law, and its success is highly problematic.

That is to be contrasted with circumstances where the performance analysis is properly performed although the actual results are disappointing. Certainly, in situations where the supportable projected success does not occur, it is reasonable to renegotiate a note. However, it would be unusual for a seller to enter into a transaction where at the inception the buyer's ability to perform is highly questionable. In addition, because the current interest rates are abnormally low, and the expectation is that they will rise, electing the mid-term rates rather than locking in the low long-term rates is probably imprudent anyway. ■