The DST: An innovative and effective tool to Defer Capital Gains Taxes

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- Do you own a valuable business or highly appreciated real estate?
- Are you hesitant to sell your business or property because capital gains tax will take a big bite out of your sales proceeds?
- Are you thinking about an exit strategy to protect the equity that you have accumulated?
- Would you like to sell your business or real estate and receive a fixed income based on the pre-tax proceeds?
- Would you like to sell your property or your business and defer the capital gains taxes without doing a 1031 exchange?

If you answered "yes" to the questions above, the solution may be the Deferred Sales Trust™ (DST). Governed by Internal Revenue Code Section 453, the DST allows real estate and business owners to sell their assets in exchange for a secured installment note that allows for the deferral of capital gains taxes and provides income from the pre-tax assets inside the DST.

Many people have successfully built businesses or accumulated valuable real estate holdings over the years. In fact, business and real estate ownership have been among the most successful strategies for accumulating wealth, with many entrepreneurs having started their businesses or acquired their investment real estate 10 to 30 years ago, with the idea that these properties would one day leverage their retirement income. Now, as baby boomers begin to retire, they want to benefit from their investments and don't want to suffer a substantial drain of their accumulated equity as a result of capital gains taxes. Investors and business owners want to "sell" but they are wary of the considerably high capital gains taxes on such a sale.

A common strategy for tax deferral on the sale of commercial and investment real estate is the IRC Section 1031 exchange. However, a 1031 exchange requires the seller of real estate to reinvest in other "like-kind" real estate within a short period of time to achieve tax deferral. Moreover, due to the short time frame, the investor is forced to acquire replacement real estate in market conditions similar to those in which they sold their appreciated property in the first place. Often, this does not achieve the goal of the seller, and especially retirees, who would prefer to exit real estate ownership (with its associated headaches, risks and burdens) and invest their proceeds in a more diversified portfolio of income producing investments. Furthermore, a business is generally not an appropriate subject for 1031 exchange treatment. While the 1031 exchange may be a suitable strategy for certain real estate investors who want to continue owning real estate, the 1031 exchange is NOT an exit strategy from real estate and business ownership.

Another common tax deferral option is an IRC Section 453 installment sale (sometimes referred to as “seller financing”). This strategy can provide a designed income stream to the seller of a business or real estate for a period of years but will only achieve tax deferral for the seller on the portion of the principal that is not yet paid by the purchaser. Eventually, the payment of principal (such as with an amortized payment structure or a balloon payment) will result in the capital gains taxes being paid by the seller. Moreover, a traditional installment sale can have substantial risks associated with it, primarily because the installment note payments are secured by the same asset that you sold but which you no longer want or control. For example, when markets correct, the buyer of your asset could default on the payments leaving you to foreclose on the property. But what if the purchaser has mismanaged the asset or adverse market conditions have resulted in the value being substantially lower than when it was sold? Another concern with an installment note is that the buyer of your property can sell the property to a new buyer. In this situation, you could find yourself getting paid off too early, thereby triggering your capital gains tax liability and causing you to suffer a big equity drain.

The Estate Planning Team offers the Deferred Sales Trust™ as an attractive alternative to a 1031 exchange or a traditional installment sale. The DST offers powerful tax-deferral benefits but with significant advantages over a 1031 exchange or a conventional installment sale. With a DST, there is no requirement for acquisition of like-kind replacement property and the resulting installment note is not secured by the asset that you just sold but by a diversified portfolio of other assets. Installment notes are secured by assets inside the trust while using very experienced financial advisors to manage them. Unlike a 1031 exchange or a conventional installment sale, the DST offers an exit strategy with extraordinary flexibility, an income stream based on pre-tax proceeds and an opportunity for permanent tax deferral.

CONSIDER THE TAX IMPLICATIONS…

As of 2013, if you have income or capital gain over $400,000.00 as an individual, or $450,000.00 as a married couple, your federal capital gains rate is now 20% from 15% - a 5% increase.

If you have income or capital gain over $200,000.00 as an individual, or $250,000.00 as a married couple, you will now have to pay an additional tax of 3.8% for the Obama Health Care tax obligation.

The next page contains a sample illustration of the tax liability for a married couple living in California, selling an apartment building for $8,700,000.00, and the dramatic tax advantages that can be achieved by utilizing a DST.

Taxable Sale

$8,700,000 - Sale Price net of Commission
$2,200,000 - Loan on Property
$2,700,000 - Cost Basis
$6,000,000 - Taxable Gain
$1,200,000 - Federal Tax Obligation at 20%
$798,000 - State of CA Tax Obligation at 13.3%
$228,000 - Obama Health Care Tax Obligation at 3.8%
$2,226,000 - Total Tax Due
$4,274,000 - Net Investable Proceeds

VS.

A sale using a Deferred Sales Trust™

Find out what the Deferred Sales Trust can do for you, go to: www.mydstplan.com

$8,700,000 - Sale Price net of Commission
$2,200,000 - Loan on Property
$2,700,000 - Cost Basis
$6,000,000 - Taxable Gain
Deferred - Federal Tax Obligation at 20%
Deferred - State of CA tax Obligation at 13.3%
Deferred - Obama Health Care Tax Obligation at 3.8%
Deferred - Total Tax Due
$6,500,000 - Net Investable Proceeds*

* This net will be further reduced by DST fees.