



WHAT SHOULD YOU KNOW ABOUT DEFERRING CAPITAL GAINS

A DST 1031 property is a type of replacement property used for an IRC 1031 exchange as well as for direct cash investors.

The Rules

Advantages

Process

Disadvantages

Comparison between a Delaware Statutory Trust and a Deferred Sales Trust falls between two different tax regulations.



Cash Sale or 1031 Exchange?

CONSIDER THESE ISSUES BEFORE CLOSING ON PROPERTY HELD FOR INVESTMENT

Assume a California taxpayer has held an investment property for many years and will have \$500,000 in net proceeds after closing. Also assume this property has \$500,000 of capital gain and \$200,000 of this gain is due to depreciation recapture.

As you can see in the comparison below, the taxpayer who performs a 1031 exchange can obtain considerably higher investment returns from deferring the payment of capital gain taxes and other taxes. The potential to obtain a low rate for financing can provide a unique opportunity for taxpayers to lock-in excellent loan terms. Taxpayers should explore the possibility of exchanging before closing on the sale of investment property and review with their tax advisor.

	SALE (CASH OUT)	1031 EXCHANGE (REINVEST)
Capital Gain Taxes Owed	\$141,500 *	\$0 (no taxes owed in the current tax year)
Net Income to Invest	\$358,500 (proceeds less taxes owed) 1-5% possible cash flow (assume 3%)	\$500,000 (entire amount of proceeds received). Many real estate investments provide 6-10% cash flow (assume 8%)
Possible Income	Bank CD, Bond Fund, Money Market. Assuming a 3% ** return on \$358,500 \$10,755/annual income \$896/monthly income	Residential Rental, Commercial, Agricultural Land, etc. Assuming a 8% return on \$500,000 \$40,000/annual income \$3,333/monthly income
Preferential Tax Treatment	Income is not tax-favored if earnings are in a non tax-qualified account. May be fully taxable.	Income generated is tax-favored. Income can be partially sheltered with write-offs. Depreciation tax benefits are also available.
Liquidity	Very liquid if 100% cash	Real estate is generally not very liquid.
Diversification	Yes	Yes, but must reinvest in real property. May diversify by asset class and/or geography.
Time Restrictions	None	Yes, 45 days to identify replacement property. Maximum of 180 days to close on replacement property.
Replacement Asset Basics	Basis equals purchase price	Only partial basis for new depreciation. Basis equals purchase price minus deferred gain.

FOOTNOTES:

* Depreciation Recapture: $\$200,000 \times 25\% = \$50,000$; Remaining Federal Capital Gain: $\$300,000 \times 15\% = \$45,000$; State Taxes: $\$500,000 \times 9.3\% = \$46,500$
Total Capital Gain Taxes = \$141,500; After-Tax Proceeds Available: $\$500,000 - \$141,500 = \$358,500$

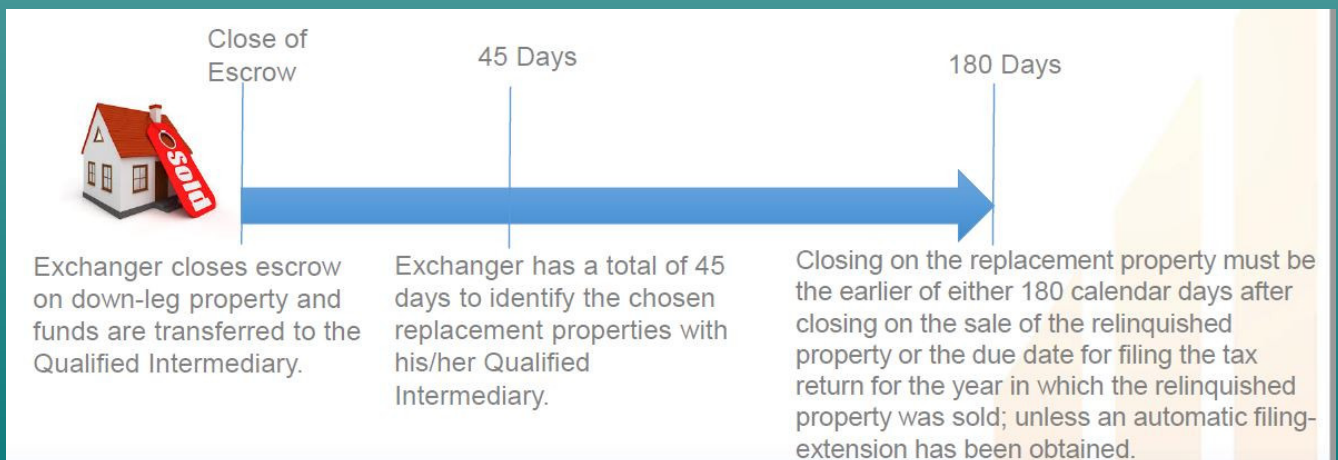
** Today's inordinately low rates of return for money market accounts, bank CDs and other liquid investments tilt the consideration in favor of exchanging.



What is a 1031 Exchange?

Basic Requirements for a 1031 Exchange

- Use a Qualified Intermediary (QI) – Upon close of escrow of the relinquished (sold) property the funds must be sent directly to a Qualified Intermediary who properly administers and documents the exchange for the taxpayer.
- Reinvest 100% of the net sales proceeds into the replacement properties.
- Purchase an equal or greater value in replacement properties as they had of relinquished property. For example, if they sold for \$1,000,000 they must purchase for \$1,000,000. Investors that paid off mortgages on the sale of their relinquished property must note that they must either take on an equal or greater amount of debt on the replacement properties and/or add outside cash to the exchange so as to purchase equal or greater value.
- Identify replacement properties within 45 days of closing escrow on the relinquished property.
- Closing on the replacement property must be the earlier of either 180 calendar days after closing on the sale of the relinquished property or the due date for filing the tax return for the year in which the relinquished property was sold; unless an automatic filing-extension has been obtained.





Deferred Sales Trust Process vs Rules

The Process

A Deferred Sales Trust is one you create while engaging a true third-party company to act as trustee. You would sell your investment real estate to this trust in exchange for a promissory note or deferred installment contract which you design and document in advance. Although you'll be the beneficiary of the trust, the third-party company will act as trustee. The trust you create will then sell the investment real estate and retain the proceeds which will be distributed to you, the beneficiary, according to the agreed upon promissory note or installment contract. Any undistributed proceeds from the sale can be held in cash or reinvested by the trust. The capital gains tax on the sale of the investment real estate is deferred; instead, you incur capital gains tax liability as you receive principal payments from the trust.

The Rules

As with any kind of tax-deferral investment, the Internal Revenue Service (IRS) has necessary qualifications for the Deferred Sales Trust. **Independence.** "Independence" means the trust is independent of you, your business interests, or your personal interests. If your uncle or sister-in-law is the trustee, the IRS could take a dim view of your activities. **No Money.** The IRS is very clear that, for a Deferred Sales Trust to qualify as such, an investor is not allowed to take "constructive receipt" of money when disposing of an asset. Leave all of that to your independent trustee. **No Ownership.** Before the asset sale takes place, you must transfer it to the trust, relinquishing your ownership of it. If the trust doesn't legitimately own the real estate, you might not be able to enjoy the tax-deferred benefits.



Advantages vs Disadvantages

Advantages

Option for a failed exchange. If you miss a 1031 Exchange deadline, the exchange isn't considered complete, your Qualified intermediary (QI) might relinquish the funds back to you. You could then be responsible for capital gains taxes and depreciation recapture taxes. With a Deferred Sales Trust, however, the QI releases any funds to the trust, rather than you, sparing you immediate taxes on a lump-sum payment.

More investment options. Unless you're living off the proceeds from the trust, the cash flow from the trust could be reinvested into other financial instruments that could, in turn, further defer your taxes.

Disadvantages

Complexity. Few tax-deferral programs are simple to set up. However, the Deferred Sales Trust can be somewhat more difficult to launch and manage than, say a Delaware Statutory Trust. The set-up fees could be higher, as well. **Not all depreciation recapture taxes are deferred.** You'll need solid advice from your tax professional here. Any depreciation taken on the relinquished property using accelerated depreciation methods which resulted in depreciation deductions greater than the straight-line method could still incur depreciation recapture taxes when using the Deferred Sales Trust.

Tax Deferred, Not Tax Eliminated. A 1031 Exchange, whether you use a Delaware Statutory Trust or some other qualifying replacement investment, does not eliminate capital gains taxes, they're deferred. Same thing with a Deferred Sale Trust – at least, until you start receiving the cash flow, which triggers capital gains tax exposure.



Compare the Differences

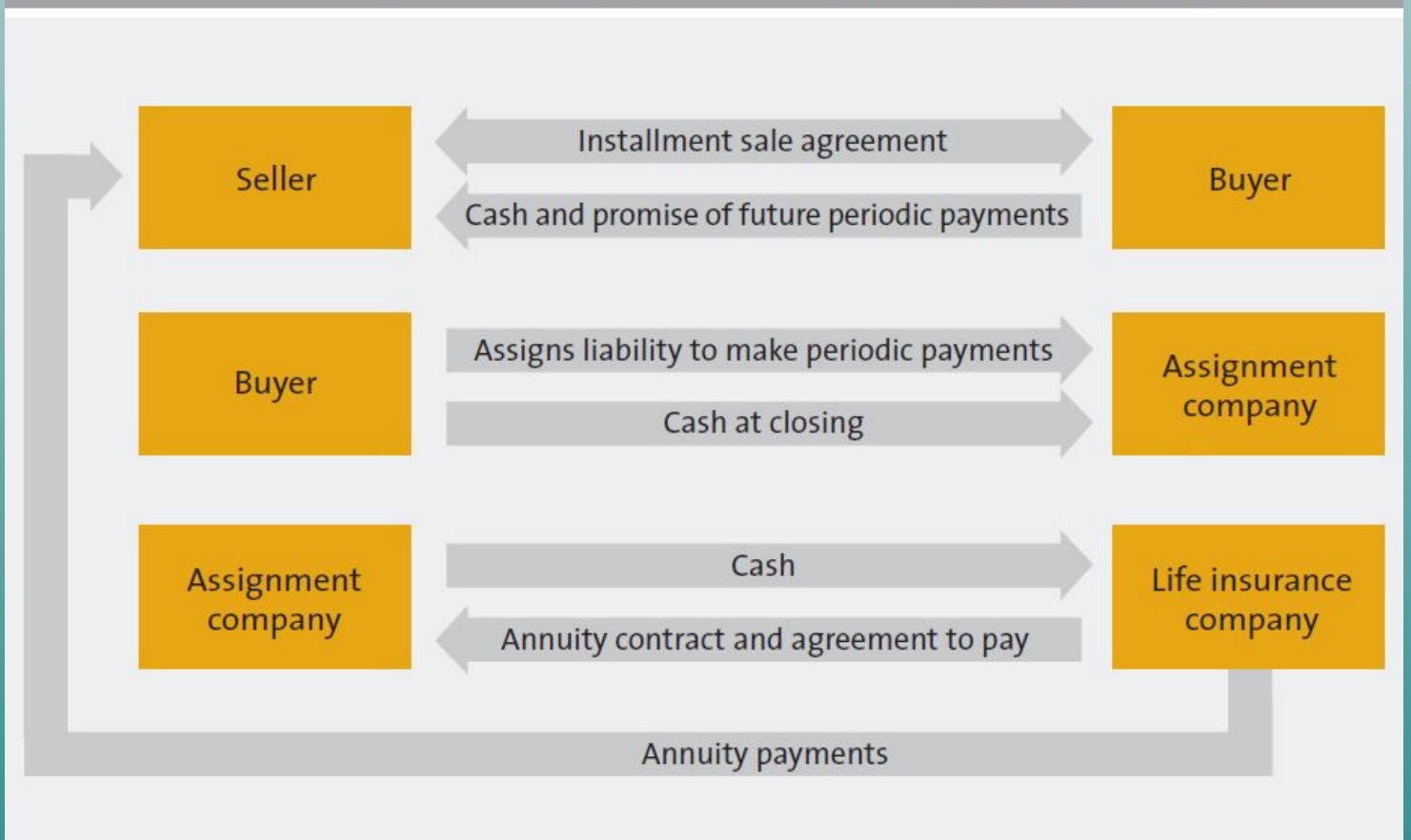
	Deferred Sales Trust	Delaware Statutory Trust
Governed By	IRC 453	IRC 1031
Transaction Type	Taxable sale of real estate incorporating deferred-payments	Exchange of direct ownership of real estate assets into fractional real estate ownership
Process	Investor sells real estate asset to third-party trust in exchange for promissory note or deferred payments arrangement. Third party trust then sells real estate asset to another investor and uses proceeds to make payments on the promissory note.	Investor sells real estate asset and proceeds are deposited with a Qualified intermediary who then invests in Delaware Statutory Trust on behalf of the investor.
Usage	Trust provides cash flow to investor, based on pre-arranged promissory note. Capital gains taxes are incurred as principal payments are received on the promissory note, not when real estate asset is sold.	Capital gains taxes are deferred until the Delaware Statutory Trust is liquidated with the sale of the asset, typically after a 5 to 10 year hold. Investors have the option to do another 1031 exchange at that time.
Advantage	Investors are able to access their real estate equity over time while spreading the payment of capital gains taxes over several years. Investors can end up paying significantly less in capital gains taxes.	Investors receive tax sheltered returns from passive investment in potentially high quality real estate. Ability to defer capital gains taxes repeatedly and ultimate pass on to heirs with no capital gains tax.
Disadvantage	Contains many rules and regulations. Can be costly to set up and maintain.	No control over the real estate asset. Investments are illiquid.



Flow Chart of a Structure Sale

Structures Sales are handy when a 1031 exchange doesn't work out timely also.

Structured Sale payout with Allstate International Assignment Company



Contact Us

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Reach us for any question or inquiry.
Our support team will respond to you in the shortest time possible.