**What are Deferred Sales Trusts and How Do They Work**

A DST is a particularly elegant form of an installment sale under IRC Section 453.

But first we need to talk about conventional installment sales and the pro’s and con’s associated with them.

An installment sale is often commonly referred to as seller financing, whereby the seller takes back a note from the buyer for some or all of the purchase price, in lieu of immediate payment. Under this scenario the buyer and seller negotiate the terms of repayment of the note and a rate of return to the seller. The note is typically secured by the asset being sold. The seller defers recognition of their gain and only pays taxes on the amount of interest and/or principal actually paid to them each year.

**Pro’s**

* They are legal and well established under Section 453, which has been around for more than 85 years.
* They permit a seller of appreciated assets to defer recognition of their capital gains.
* They can provide an additional incentive to a buyer to acquire a hard to sell property.
* They provide the seller to realize a rate of return well in excess of bank rates of return.

**Con’s**

* Negotiated terms between buyer and seller requires compromise and seller often ends up with less than optimum terms.
* Condition of Collateral Risk. Sole collateral for repayment is the asset the Seller used to own and he has no control over how well the buyer will maintain the asset.
* Prepayment Risk. Buyer can prepay the note at any time either by selling or refinancing the asset forcing seller to fully recognize their gains all at once.
* Renegotiation Risk. Buyer may wish to renegotiate the note both in respect to payments and interest rate to benefit the buyer. They may threaten to refinance if you don’t cooperate forcing recognition of your capital gains.
* Foreclosure Risk. The buyer may fail to perform in making your scheduled payments forcing you to foreclose, adding loss of income, legal expenses, new realtor, escrow and title fees and possible extra investment in improvements to make the asset saleable again.
* Diversification Risk. Since your collateral is entirely dependent on the asset you used to own, a downturn in the market or financial difficulty for the buyer could force him to walk away. After expenses associated with foreclosure, you may have to resell your asset for less than you previously sold it for.

**How does the Deferred Sales Trust (DST) Work?**

The DST maintains all of the positive attributes of the conventional Section 453 installment sale, and completely eliminates the downside risks. The most common variation of the DST Structure involves two separate transactions, with the first being a Section 453 sale from the Seller/taxpayer to a third-party trust, in exchange for an installment note. The second step is for the trust to sell the asset to a buyer (procured by the Seller/Taxpayer). The Trust will purchase the asset initially for the same price the ultimate buyer will pay. For example, if the taxpayer elects to structure the first transaction as a 100% seller financed transaction (no lump sum distribution at the close), then there would be no immediate taxation to the taxpayer. Furthermore, if the note is structured to be interest only with a balloon payment after some period of years, then most, or all, of the capital gains can be deferred, and the use of the pretax proceeds invested by the Trust benefits the taxpayer over an extended period of time. Essentially the income that could be generated by investments within the trust, which secure the principal and generate the return to the taxpayer, would be based on the pre-tax proceeds instead of the after-tax proceeds, which could be significantly less. Said another way, the taxpayer can generate personal income on funds for an extended period that would otherwise have been paid in capital gains and depreciation recapture taxes.

**How are the funds invested?**

The Trustee will use an experienced, vetted and approved investment advisor to make investment recommendations to the taxpayer and Trustee that are consistent with the taxpayers risk tolerance profile and the Trustee’s obligations related to repayment of interest and principal over a timetable approved by the taxpayer (e.g. the “Note”). Typically the pre-tax proceeds will be invested in a diversified income and/or growth portfolio of securitized assets. Such assets can include, but are not limited to, annuities, REIT’s, bonds, ETF’s, stocks and mutual funds. In many circumstances, certain non-securitized assets can be acquired as well, such as physical real estate or a private business. This allows the taxpayer to not only defer the capital gains taxes but to exit from a concentration in the asset class of their sold property. The taxpayer has the ultimate say over how the funds are invested, so the ultimate investment portfolio can be as conservative or aggressive as the taxpayer desires.

**What transactions are good candidates and which ones are not?**

Any exit from an appreciated asset which would normally result in a taxpayer recognizing and paying taxes on capital gains, aka profits, can be sold using the DST Strategy. Businesses including C and S corporations, LLC, Partnerships, Sole Proprietorships, equity or asset structured sales can all achieve tax deferral through the DST.

Individual shareholders or partners who wish to go their own way can utilize the DST even if other shareholders or partners wish to go a different direction.

In addition, Real Estate including investment residential, investment commercial or industrial, raw land, Primary and Secondary Residences can also be sold through the DST.

The DST can also serve as an alternative to a 1031 like-kind exchange or a rescue for a failing or failed 1031 exchange.

Also viable for sale through the DST are high value collectibles including Art, Gems, Antiques, etc..

Minimum Viable Transactions for use with the DST. Typically, the minimum transaction that will be accepted for a DST is one where the seller/taxpayer is looking to sell an asset where the potential taxable gain on the sale of their asset is at least $200,000

Cautionary Transactions. A unique situation can exist in a given transaction where full tax deferral may not be possible or may require an additional strategy in order to fully defer taxes. This scenario is what is known as “Loan Over Basis”. This typically occurs with owners of investment real estate who engage in ‘cash out’ refinancing of their properties in order to pull equity, often to diversify their investments. When the amount of loans secured by the property exceed the adjusted basis of the property, this is called loan over basis. If the owner elects to sell the property, then the difference between the combined loan amounts and the adjusted basis becomes a taxable event, even with the DST. There are a few ways to handle or cure this particular problem. One is to do a 1031 exchange, if legally and practically viable; another is to use outside assets to pay down the mortgage(s) to a level approaching or equal to the adjusted basis; and finally do what is known as a bifurcated exchange where the seller does a partial 1031 exchange, often using a high LTV Delaware Statutory Trust to satisfy the ‘up in mortgage’ requirement of a 1031 exchange and use the DST to hold the remaining proceeds of sale for diversification and income needs.

**What are the advantages of a DST in comparison to other strategies**

**How to get your sellers onboard with the DST strategy**