Identifying a Viable DST Prospect

In general, if a seller of an appreciated asset is facing a Taxable Gain of $250,000 or more, they are a prime prospect for using the Deferred Sale Trust (DST).

Possible Transactions include:

- Sale of real estate held for investment
  - Raw land
  - Rental Condo or Single-Family Residence
  - Apartment Units
  - Commercial Property
  - Industrial Property
  - 2nd home
- Sale of a Business
  - Sole Proprietorship
  - C-Corporation
  - Sub-S Corporation
  - Limited Liability Company
  - General or Limited Partnership
  - TIC – Tenant in Common
  - Shareholder, Member or Partner's interest in a multi-owner business
- High value collectable
  - Art
  - Classic Cars
  - Sports Memorabilia
  - Gems
- Highly Concentrated Investment Asset
  - Crypto Currency
  - Concentrated Employee Stock in Public or Private Company

If your prospective transaction meets the above criteria, it is worth a review by your DST Trustee.

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SECURING THE PATH FORWARD

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Sample Scenarios:

Investment Real Estate Owners:

- Wants to get out of the real estate management business and wants to replace the rental income they are receiving.
- Owner is facing significant investment in deferred maintenance or repairs and does not have the capital to take care of it.
- Has nearly or fully depreciated their current property, wants to exchange but wants better depreciation write-offs on the upside property than would be available under a 1031 exchange
- Is involved in a partnership or LLC and wants to carve out their interest when the property is sold, achieve tax deferral, not be forced into a 1031 exchange, and reinvest in the same or alternative investments without being tied to their former partners.
- Wants to re-invest in real estate, but does not want to buy back in at the top of the market. Wants flexibility to take whatever time is needed for the market to correct or the right opportunity to present itself.
- *Special Note* Regarding Negotiating for a 1031 Exchange Upside Replacement Property
    - Give yourself and your Buyer more leverage in negotiating the purchase of their upside property.
        - It is not uncommon to see Exchangers pay top dollar or more for their upside replacement property. They have a finite window to identify their replacement property or they risk a large and looming tax consequence
        - It is not uncommon to re-open negotiations with the seller of your identified upside property after your inspections are completed. One or more material items almost always turn out to be not what you might have expected. The sellers in these circumstances typically know you are trying to complete a 1031 exchange or risk major tax consequences. As a result, they are often unwilling to compromise to correct or credit for the deficiencies you uncover after closer inspection.
        - Sometimes you are simply not able to identify and tie up suitable, if not ideal property for your upside due to the time constraints. Sometimes when this happens, your buyer simply has to "hold their nose and close", even if the replacement property is not ideal.

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- Here is where the DST can help put the control back into your and your client's hands.
    - The work we do is completely conditional in nature so if it helps you complete an exchange into the 'right' property, you won't owe us a dime. Think of it like an insurance policy with no premium unless you need to use it.
    - Don't find the 'right' property to invest into in time? No problem, park your money in the DST until you do find the right property.
    - Don't WANT to find a property so soon based on a perception that the market is going to be cooling off? Same as above.
    - The seller of the upside property you are looking to buy won't work with you to correct or pay for deficiencies in the property? Let the seller know that you have ensured you won't be subject to capital gains whether or not you buy his property, but you could hold him up from selling it to someone else until the end of your exchange period. Perhaps they will be a little more accommodating.

Owner Occupied Property:

Because of the existence of a special tax exclusion for the sale of primary residences, there may or may not be a tax implication for the seller, however long-term owners may be facing tax recognition in spite of the exclusion. For these clients we still need to ascertain if their taxable gain exceeds $200,000 to $250,000 or more since that will be the threshold where the DST can serve them best.

A more detailed description and case study for primary residence sales follows:

The IRS provides an exclusion under Internal Revenue Code Section (IRC) 121 for Homeowners who have lived in their home for ANY 2 years out of the preceding 5 years before the home is sold. In such cases, the IRS will exempt $250,000 in profit for a single owner/occupant or $500,000 for a married owner/occupant. The effect of this exclusion is that it adds the exclusion amount to the original purchase price of your property to determine if any tax is due upon the sale of your home.

Let's say you purchased your home for $500,000 as a married couple.

Now you want to sell. If your home is now worth $1,000,000. Because of IRC 121 you get to add the $500,000 exclusion to your original cost of $500,00, giving you a taxable basis of $1,000,000. In this example, you would pay NO taxes upon the sale of your home.

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Alternatively, let's say that you home was now worth $2,000,000. Yes, you get credit for the exclusion, but you have an additional profit of $1,000,000 that will be taxed at approximately 37.1%, costing you approximately $370,000 in taxes.

Imagine if you were able to defer paying this tax upon sale and in return invest the tax payment to generate personal income indefinitely? If you could earn 6% on that money (for example), that would mean you could generate an additional income in excess of $22,000/yr that would not be available if you were forced to pay the taxes upfront.

Our strategy may allow you to pull out some of your proceeds tax free to invest in your next home while deferring the taxes you would have paid AND generating an income stream to add to your other income.

Business Owners:

Most business owners who are able to sell their businesses have significant capital gains exposure. In most cases, they are hoping the proceeds of the sale of the business will largely fund their retirement. The DST is perfect for these owners because they can generate income based on the sales price as opposed to the net proceeds of sale minus the lump sum taxes they would otherwise pay.

Technical Details.

If your prospect is the owner of investment real estate.

Capital (taxable) gain is generally defined as the difference between what they originally paid for the property *(+ verifiable costs of property improvements)* vs. what they could sell it for after deducting the expenses of sale (e.g. real estate commissions, escrow, title, termite, etc.).

Another factor to consider is the fact that investment property owners have taken depreciation deductions for every year they have owned the property. When the property owner sells their property, the IRS will 'recapture' those write-offs by taxing the seller on the prior deductions they took as depreciation expense. To this extent, we typically add the TOTAL of all depreciation write-offs to the Capital Gain calculation to give a fair value of the total amount that would be taxed in an outright sale.

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Note regarding mortgages on the property. The amount of any mortgages on a property DOES NOT factor into the Capital Gain the seller would realize. The amount of any existing mortgage is only important to the extent that it exceeds the 'adjusted basis' on the property. (e.g. purchase price plus the costs of improvements, minus accumulated depreciation). This concept is known as "loan over basis". It usually only occurs when the client has previously done a cash-out refinance where they have pulled out some of their equity in cash to the point where the loan now exceeds their 'adjusted basis'.

Generally, we can consider a transaction where the client is facing a total taxable gain of $250,000 or more, and where the mortgages on the property is less than the sum of the original purchase price + cost of improvements – depreciation taken. The good news is that if the client has at least $250,000 in taxable gain, BUT the mortgage balance exceeds the basis, we can still structure the DST with a companion strategy to fully defer the capital gain. In other words, talk to your DST Trustee to analyze these transactions.

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