Upcoming Events

MBBI Wisconsin Event
Craft Brewery M&A Trends
Sept. 19, 2017 | 4:30 to 7:00 PM
2108 N Farwell Avenue
Milwaukee, WI 53202

MBBI Chicago Event
Real Estate Strategies
October 17, 2017 | 5:00 to 7:00 PM
The Drake Hotel
23010 York Road
Oak Brook IL 60523

Register Now

MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

MBBI Newsletter September 2017

Best Use for Deferred Sales Trusts


Contributing Editors: Andrew Kelleher is a co-founding member of Kelleher & Buckley, LLC, and member of the Board of Directors for MBBI's Illinois Chapter. **Vasili Russis** is the head of the Tax and Wealth Structuring Department at Kelleher & Buckley, LLC with over 20 years of experience. Andrew and Vasili focus their practice in business sales, structuring, mergers, acquisitions, asset protection, and tax planning. Andrew Kelleher and Vasili Russis can be reached: akelleher@kelleherbuckley.com and vrussis@kelleherbuckley.com. Phone: (847) 682-5367

Deferred Sales Trusts ("DSTs") are advertised as vehicles to achieve tax savings or, more accurately, tax deferral. A closer look at the DSTs' mechanics, as well as the realities of transactions, illustrate when, or if, they may be useful.

What is a DST?

A DST is a planning mechanism designed to defer gains on a sale transaction. The deferral is intended to utilize the provisions of Internal Revenue Code Section 453 which provides for deferral of gains.

In a transaction involving a DST, a party holding assets ("Party 1") sells those assets to a DST. In exchange, the DST provides Party 1 with an installment note back to Party 1. The DST then sells the asset to a separate buyer ("Party 2"). The sale price on each transaction is the same, so that the DST has no gain. Usually the sale by Party 1 occurs just before the sale to Party 2.

The installment note is set up in such a manner to accommodate Party 1's tax situation and provide an income deferral for tax purposes. The cash from the sale is kept by the DST and used to pay the installment note. Any interest or other income earned on funds held by the DST from the Party 2 sale are taxed to the DST.

Issue in Using a DST.

The time value of money and tax deferral can be a major benefit from this planning. There are potential pitfalls in the planning that need to be kept in mind when looking into using a DST.

First, the planning will not give relief for any depreciation recapture for personal property. No matter when cash is received, depreciation recapture is taken into account during the year of sale. Therefore, Party 1, whether it receives one dime from the installment note, will have to pay tax on ordinary income for the amount of depreciation recapture. Wise planning would likely include that a partial payment be made in year 1 under the installment note to cover tax from depreciation recapture.

Of more concern would be whether the sale to Party 2 will actually happen. As mentioned, the sales involving Party 1 and Party 2 happen close in time, but if that is not the case there is risk

CONTINUED Page 2

2017 SPONSORS ILLINOIS

Platinum

Gold

Silver

Midwest Dealmakers

mbbi MIDWEST BUSINESS BROKERS AND INTERMEDIARIES

Best Use for Deferred Sales Trusts

that the sale to Party 2 will not occur and the funds for payment of the note will not be in place. In a similar vein, if there is a delay in payments to the DST from Party 2, for whatever reason, then such delay could affect the cash flow paid out under the installment note.

In sales of businesses, representations and warranties are made by both parties, but the most reliance is usually placed on a seller's representations and warranties. Those representations and warranties can be the subject of post-closing disputes. One question that arises is, because Party 1 has no interests in the assets sold by the DST to Party 2, what representations can be made by Party 1 to Party 2 regarding the business sold? Further, if the sale transaction involving Party 2 involves earn-outs, contingencies and/or amounts escrowed, how will the installment note treat such issues, especially if payment of any of those items is not made?

Similar to the contingency issues raised previously, in the event litigation is commenced by Party 2, how will that affect Party 1, who has no privity of contract with Party 2. Additionally, there has been concern that the use of a DST will change the negotiating dynamics, i.e., Party 2 may be able to go after the DST under contract law, even with indemnifications of the DST by Party 1.

In certain situations, the DST planning may be a better alternative than a 1031/like-kind exchange when selling real estate. The installment payment can, of course, be structured to have installment payments made as Party 1 wishes to receive cash flow. The benefits of using a DST in the situation are somewhat akin to a 1031/like-kind exchange, as a 1031/like-kind exchange defers gain until a later sale of property, while DST provides deferral until installment note payments are made. A DST could be a good alternative to a 1031/like-kind exchange in a situation where a seller of real estate has no interest in or sees a future problem with acquiring replacement property. Also, unlike a sale of a business, a real estate sale does not have post-closing hold backs that are found in business sales; therefore, in a real estate sale, a DST may provide a viable option for tax deferral.

Added Points to Note.

The DST provider used is also of utmost importance. Certain promoters of this planning claim there is a private letter ruling issued by the IRS evidencing its consent to this planning – however, this private letter ruling has not been disclosed (if it at all exists). In any event, the planning involving a DST should work under Internal Revenue Code Section 453, as mentioned previously. Anyone seeking to use a DST needs to also take into account added attorney's fees that may be involved in the work involved with a DST, as well as the fees charged by the DST provider.

If the situation is right, a DST may provide an economic benefit that may not otherwise be available. The terms of the installment note need to be reviewed, ensuring that the use of the DST makes sense, as well as the realities of how a DST will affect a transaction. When there are no holdbacks on a purchase and limited representations and warranties, a DST may make sense and provide an economic benefit.

Andrew J. Kelleher and **Vasili D. Russis** focus their practice on business sales, structuring, mergers, acquisitions, asset protection, and tax planning. The law firm of Kelleher & Buckley, LLC provides legal counsel to business owners and individuals in a wide range legal matters including corporate law, litigation, tax law, employment law, estate planning, estate and trust administration and real estate. Andrew Kelleher and Vasili Russis can be reached at akelleher@kelleherbuckley.com and vrussis@kelleherbuckley.com