What you need to know

Deferred Sales Trust

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What you need to know:
Deferred Sales Trust

Many small business owners are hesitant to sell a business interest or assets held in a company due to a significant capital gains liability. Deferred Sales Trusts (DSTs) are becoming a popular tax strategy to manage the tax liability associated with the sale of assets. With careful planning and expertise, Deferred Sales Trusts are a highly effective tool to mitigate or defer capital gains tax.

How to Qualify

- Must be considered a bona fide, third-party trust with a legitimate, third-party trustee.
- The trustee must be truly independent of the trust.
- Asset ownership must be transferred to the trust prior to the sale.
- The trust must take legal title to sale proceeds.

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What are deferred sales trusts?

Similar to an installment sale, Deferred Sales Trusts are drafted pursuant to Section 453 of the Internal Revenue Code. A Deferred Sales Trust is a legal contract between an individual and a third-party who owes the trust. An individual sells the property or business interest to the Deferred Sales Trust (usually for a fee) in exchange for the Deferred Sales Trust's contractual obligation to pay the individual a certain amount over a predetermined period of time. A Deferred Sales Trust is often referred to as a "self-directed note" because it allows the individual to control the terms.

How do they work?

Upon the sale of the assets, the capital gain is realized, but not recognized so no taxes are paid. There is no tax obligation to the trust on the sale, since the trust purchases the assets from the owner for the same price for which it is sold to the third party. The capital gain tax liability is partially or fully tax deferred over the terms created within the Deferred Sales Trust, which is negotiated in advance with the trustee.

FYI

With things always changing, be sure to talk with RPB to learn what the most current rules, regulations and changes that may apply to you when working with deferred sales trusts.

The property owner and the trustee have the flexibility to structure the payments. The individual property owner does not owe capital gains taxes until payments are received from the trust, which allows the individual to pay the capital gains tax in installments according to the terms identified in the agreement.

A property owner who wishes to avoid paying capital gains tax in the current year could defer the current installment payment. In addition, if the owner is seeking income, but wants to avoid capital gains tax, he or she could set up the installment contract to make interest-only payments which could defer capital gains taxes indefinitely.

For questions on this or any other topic reach out to the tax team at Reilly, Penner & Benton.